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Thinkpiece

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The Rights & Wrongs of Rights Issues

Reviving an underused technique on the TSX

The Rights & Wrongs of Rights

Reviving an Underused Financing Method

- + Rights issues are the best way of raising funds in a way that does not disadvantage existing shareholders
- + The practice is the established norm in the London and Australian markets
- + With the paucity of funds from traditional flippers that Bay St cultivates for private placements, the rights issue may be about to return to its place in the sun
- + Canada's paperwork-light bias means that it is a natural market for fundings using only short-form prospecti
- × There is an exceptional degree of ignorance and suspicion amongst Canadian investors towards the practice
- × Desperado managements appear to be latching onto the deep-discount rights issue as a means of "blackmailing" existing holders into coughing up extra funds or see themselves diluted into oblivion

Tailwind for Iranian Mining

We have long been fans of rights issues. They are somewhat of a lost art form in Canadian capital markets and never had traction in the US, but are a (almost) mandatory first stop in the other capital markets I have worked in (i.e. Australia the UK and Argentina). Instead private placements ruled the roost with results that were less than pleasing to us. It wasn't that Canadian companies claimed the rights issue process unwieldy that annoyed us, but that they used this bogus rationalisation as an excuse to default to private placements which gave a means to prioritise insiders, friends and family and selected strategic investors who turn out to be no more strategic than the next carpetbagger.

Ideally though rights issues should be a means to raise funds from individuals already informed and committed to the corporate direction rather than having to tout the attractions to a whole new base and in the process diluting the existing shareholders. Indeed with Canada's paperwork-light system, it is ironically much cheaper to run a rights issue for a TSX-listed entity than for an ASX- or LSE-listed company. We have always suspected Australian regulators having a secret compact with prospectus printers Downunder for a "make work" program, as printing costs are one of the most onerous regulatory burdens ASX companies face and rights issues there are not paperwork-light.

Deep Discount

Pricing a rights issue can be a work of art and depends on whether the company is going to have tradeable rights or not. If the company wants the rights to trade then there either needs to be sufficient discount that the rights will have some value (and thus liquidity). If it doesn't have a traded right then the issue can be priced to an attractive level to maintain existing holder's interest.

Of course, rights that trade have a better chance of success because it means the marketplace can move the rights from parties not disposed or able to subscribe to those who will (or might).

Then there is the deep discount issue. The example of this, par excellence, was the issue that RTZ did in the wake of the financial crisis. This invariably involves an issue at a price that is seemingly so derisory that one cannot pass on the opportunity to take up the issue. RTZ's issue sticks in the mind because at AUD$15.2bn it was certainly gigantic, and it involved 21 new shares for every 40 held at $28.29 per share. At the time that represented £14 per share and the stock was trading at £31 on the announcement. It was pretty much a slam dunk.

Such an issue seemed almost like a gift, indeed bonus shares that you only have to pay a pittance to get (rather than bonus shares that are free). However this is where the brutal dilution comes in. If you are RTZ with a big ticket stock price then the deep discount issue is a (sort of) stock split that just brings the denominator down.

However if you aren't RTZ and instead you are Tinpot Mines NL trading at 6 cts then the deep discount issue at one sixth of the current stock price is no bonus, and no gift and exactly the opposite of attempting to give the stock a more tradeable price, It is basically a massive dilution which is made even more like Russian Roulette by the use of the number six in the process…

A Case in Point

The urge to write on this theme seized us because a real example of this crossed our transom in recent days. It was at a mining company not unknown to us. Besieged by multiple problems, legal, operational, management and strategic, not to mention high debt and on-going loss-making operations, this company which we will, in the interests of charity (not that they deserve charity) continue to call Tinpot Mines NL (even though they are not ASX-listed which is the only place where NL i.e. No Liability companies trade) decided to whisk a deep discount rights issue out of its turban.

The fact that the bulletin board denizens thought that they were being done a favour by management implied that most could not tell the difference between RTZ and Tinpot Mines. Then again if IQ testing was a requirement for investing in Tinpot Mines in the first place, most of these investors would have been saved from themselves a long time ago.

Did the managers of Tinpot make the right decision? Well, their benighted stock price went up so they were probably patting themselves on the back. Though we were wondering if it was short covering by bears who similarly did not know that a deep discount rights issue is like a gift from heaven to deliver stock on closing that is bought back at a mere fraction of the level at which the stock was originally shorted. This raises the existential question of whether it is possible for both shorts and longs in a particular stock to be as dumb as each other?

Going beyond the dead-cat bounce after the announcement then we may ask whether the rights issue is actually going to get existing holders of Tinpot to throw "good money after bad" by subscribing on a one for one basis at 1 ct for a stock that has been as high as 15 cts in the last twelve months. If they are card-carrying fans (and many in the bulletin board seem to be…. or at least taking a break from their schizophrenia meds) then maybe they will indeed shell out for the bargain of the century (while blithely ignoring the deeply troubled underpinnings that are not going to be solved to any great extent by the Widow's Mite raised by the current issue). We can safely say that the company would not have had a snowflake's chance in hell of doing a conventional placing, at say 4cts, when the stock was trading at 5-6 cts with the occasional recent dive to 4.5cts and the December quarter results still coming down the pike (on a rickshaw with a busted wheel by the looks of it).

RTZ had a 96% take-up on its 2009 rights issue, so the bar has been set high...

Conclusion

Rights issues are definitely a tool in the corporate armoury that Canadian companies should be dusting off. Frankly the old model of shareholder-unfriendly private placements is now being treated with the contempt it deserves and such financings are just not easy to pull off. Rights issues are the perfect tool for rewarding long term holders and fighting that feeling that shareholders are just there to be milked. Is it any surprise that Australian mining finance markets in the best of times and the worst of times seem to have less disgruntled shareholders than in Canada?

But beyond that there is the question of the deep discount rights issue. If one thinks about it, it is now the only way that many companies with low denomination share prices can get around the TSX prohibition against financings beyond a certain discount to VWAP. When your stock is at 5 cts and you want (need) to finance at 3cts then that is a 40% discount and no doubts about it. However when your stock is at 6 cts and you decide to finance at 1 ct you are essentially holding a gun at the head of shareholders and telling them to stump up or lose half the value of their stock.

If your story is worth the candle then one might just stomach management challenging one to play Russian Roulette but if the story is just an unfinanceable barrel of not very pleasant monkeys then one is indeed tempting long-term shareholders to just decide to take their tax losses and as Dylan Thomas put it "go gentle into that good night".

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