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RIGHTS ISSUES: IS THE TIME RIGHT?

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Rights Issues: Is the Time Right?



Andrew Case

By Andrew Case from Dechert – Andrew Case is a US securities lawyer and counsel in the London office. He advises on the execution of SEC-registered, 144A and Regulation S equity, equity-linked and debt transactions.

The ongoing turmoil in the capital markets means that an increasing number of companies have been forced to seek alternative means of raising capital. While rights issues represent an important and relatively common capital raising strategy among European main board companies, due in part to the existence of statutory preemptive rights on the issuance of new shares in favour of shareholders; rights issues for AIM-quoted companies have generally been viewed as a less favourable alternative to a capital raising from new investors through an underwritten or reasonable endeavours share placings. Share sales to new investors at substantial discounts to market value, however, can attract controversy, which may persuade AIM-quoted companies to reconsider the use of rights issues to raise needed capital without upsetting existing shareholders. Perhaps the time has come to consider the rights issue as a respectable capital raising technique for AIM-quoted companies?

Structure of Rights Issues

Rights issues typically provide a company's existing shareholders the opportunity to purchase a pro rata portion of the additional shares being issued at a specific price per share, often at a significant discount to the current market price. Because a rights issue is extended to all existing shareholders on this basis, there

is no dilutive effect to shareholders who exercise the rights issued to them. Under the Companies Act 2006, a rights issue must be open for acceptance by shareholders for not less than 21 days from when the circular is deemed to be received by them but can be closed 23 days following the posting of the rights issue circular (assuming a general meeting of shareholders is not needed).

The rights issued pursuant to rights issues are transferable and traded on the same securities exchange on which the company's ordinary shares are listed. Shareholders not exercising their rights are therefore able to mitigate the dilutive effect of the rights issue by selling such rights on the open market. Rights issues are ordinarily structured to include a "backstop," or a standby commitment by a third party (usually an investment bank or a related party of the company), to purchase any shares that are not subscribed for by existing shareholders (or their transferees) upon exercise of the rights. In the absence of a backstop, shareholders who exercise their rights may be entitled to subscribe, subject to certain limitations and to allotment, for additional shares that remain unsubscribed.

Advantages and Disadvantages of Rights Issues

Rights issues offer several potential advantages to companies over secondary offerings of ordinary shares. Some companies appreciate the equitable method of offering all existing shareholders the opportunity to purchase shares. Rights issues that are backstopped provide a company with certainty of execution.

Most rights issues feature an investment bank to coordinate the rights issue and assist the company in garnering interest in the rights. Sales commissions associated with this role are typically lower than underwriting commissions for share placings. In addition, because rights issues are targeted at existing shareholders rather than new investors, roadshow expenses are generally lower than those associated with a secondary offering of ordinary shares. Larger placings will often require shareholder approval (as a consequence of the company having insufficient authority to increase its authorised share capital and/or allot shares), the receipt of which is not a certainty and may involve significant delay to a company's financing plans. A rights issue, however, would generally not require such approval unless the company does not have sufficient authorised and unissued share capital or the transaction otherwise needs to be approved (for example, the rights issue is being used to finance a Class 1 transaction, a reverse takeover or a transaction with a related party). Historically, overseas security laws were used as a



justification for not posting the rights issue circular to shareholders resident in certain jurisdictions such as the United States and Japan. Recent practice is however changing and the FSA may ask for a letter explaining why certain jurisdictions should be excluded.

The most significant downside to a rights issue is the requirement that the offering be conducted with a Prospectus Directive-compliant prospectus approved by the FSA where the company has more than 100 shareholders resident in any EU jurisdiction (unless the company is seeking to raise less than EUR 2.5 million in any 12-month period). This can add to the cost and the time needed to prepare the necessary documentation as the rights issue circular will need to comply with the same level of disclosure as in an AIM Admission.

Recent Rights Issues

A number of European financial institutions have recently completed rights issues in part to recapitalise their balance sheets and to allay market concerns regarding their exposure to mortgage-backed securities. There are not many examples of rights issues on AIM, however Zambezi Resources Limited did announce a 1 for 5.7 rights issue on 5 August 2008 to finance its exploration work and other working capital requirements. The time may be right for the rights issue to be viewed as a viable capital raising technique for AIM-quoted companies in these difficult times.

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