ASX Goes the Wrong Way on Capital Raisings

The Australian Stock Exchange has released a consultation paper looking to cut the time required for companies to raise capital. Whilst the goal of the proposed changes, to protect smaller shareholders from unfavourable placements to large shareholders, is laudable enough, I'd suggest that by streamlining the capital raising process the ASX is actually doing shareholders a huge disservice.

In truth it is too easy to raise capital in Australia.

The recent Billabong raising is a perfect example. After calling a trading halt and announcing yet another earnings downgrade, Billabong announced a $225 million non-renounceable, fully underwritten, six for seven share issue at a 44% discount to the last closing price. What's this money to be used for? Oh, the strategic review is progressing so we don't have a clear answer to that yet. The clear beneficiaries are management, the bank and the underwriters.

Had Billabong been forced to seek shareholder approval for this they would probably have been knocked back. But, unfortunately, shareholders have to choose between stumping up the cash or allowing the underwriters to take part of the company from you at an unfair price.

One justification often used is that an otherwise worthy company is suffering because of an excessive debt load. The argument being that the costs of financial distress can be minimised through a cash injection. Whilst this has merit in some circumstances, it often doesn't tell the whole truth. When a company has an excessive debt load, there is also a good chance that the fair value of the debt is now less than its stated value.

This might sound like an unusual statement, but consider the bank's circumstances:

- They've previously lent money to a business, the amount and terms of which were determined having assessed the business's prospects and risks;

- The business now appears to not be as prosperous as first thought, or the risks more serious, and the amount lent was probably excessive and/or the terms too favourable;

- The bank is now bearing a considerable amount of the business's downside risk, whereas equity owners get all the upside, if any;

- If the debt is fixed or long dated, the company may benefit for some time from terms more favourable than could now be obtained in the debt markets.

This is particularly the case where the valuation of the business is uncertain or there is a wide range of possible outcomes. The 'optionality' can be of significant value to shareholders. The flipside is, if you raise capital to pay down debt, you might be paying off debt at 100 cents to the dollar that has a fair value of 80 cents. You're effectively bailing out the banks from a risky position.

The benefits of reducing the costs of distress need to be weighed against the lost ‘optionality’ to decide whether it’s appropriate to raise capital. This is really a specific example of the general test of whether an adequate return will be generated on the additional investment. Unfortunately the people who make this decision - even if they understand what needs to be weighed up - have incentives skewed in favour of keeping the business running and reducing the risk of insolvency.

That’s not good for shareholders, and it’s not good for Australia as a whole. Too much capital is wasted on inefficient businesses because the shareholders don’t have the right to say no to capital raisings. I can think of countless examples, some of which unfortunately we’ve participated in, where a company that sought capital is now worth less than the amount raised.

The ASX and Takeovers Panel both look at capital raisings from the point of view of providing protection against larger shareholders exploiting smaller ones. That’s a noble pursuit, but they come unstuck when they try to weigh this up against the company’s need for ‘liquidity’. That’s not the balance that’s needed. Liquidity itself is not a positive thing if it’s going to result in capital being wasted. Some companies don’t so much need to raise capital as to cut costs, streamline and hope to make it through.

What should be done to improve the situation? I’d suggest that the number of new shares that can be issued without shareholder approval should be restricted to less than 20% of the existing register. If they wan’t to raise more than that, management should be able to put that to a vote at an expedited meeting within four weeks of being announced. That provides sufficient flexibility for management and adequate protection for shareholders, which is the real balance that needs to be struck.

Don’t hold your breath on that happening. I get the feeling we’re headed the wrong way down this road.