Paying the Price for Shareholder Rescues

Many Australian investors feel that the capital raising frenzy of the past 12 months was a gift from God. ‘Free money’ I heard it described as and, in some cases, it was. Small shareholders offered $15,000 share purchase plans at substantially discounted prices were sometimes able to make more than their initial investment simply by participating.

But shareholders as a whole cannot ‘win’ out of a capital raising unless the capital is put to good use and earns above average returns. Most of the capital raised over the past year has been expensive equity used to repay what was once very cheap debt.

The net result for investors is a loss, not a win, and this will become obvious to all shareholders over the next year. The cost will manifest itself as substantially lower earnings per share.

Consider, as a fictional example, Formerly Leveraged Pty Ltd. Formerly Leveraged earned $100m of earnings before interest and tax last year. It had $500m of debt and was paying an average interest rate of 5% p.a., translating to $25m p.a. of interest expense. After meeting the interest bill, earnings before tax was $75m and, given it had 100m shares outstanding, that translated to 75 cents per share.

Midway through last year, at the height of the credit crisis, Formerly Leveraged’s bankers decided they wanted their money back. With no other alternatives, the company turned to shareholders and undertook a discounted capital raising. At the time, the shares were trading at $6 each – a pre tax multiple of 8 times. To ensure all shareholders participated, the directors priced the offer at $5 per share and offered another 100m shares. The $500m proceeds repaid all of Formerly Leveraged’s debt.

You would think that the company should simply trade at a weighted average of the pre-raising price and the $5 issue price, or $5.50 per share (the theoretical ex-rights price, in the lingo). But let’s look at what’s happened to the earnings per share. Assuming the company still makes $100m of earnings before interest and tax, pre tax earnings would be $100m (there is no interest now that there is no debt), but there are twice as many shares on issue. Pre tax earnings per share would be 50 cents ($100m profit divided by 200m shares), down 33% on last year’s 75 cents per share.

Ignoring growth, franking and other complicating factors, when a stock is priced at 8 times pre-tax earnings, investors are demanding a return of 12.5% (1 divided by 8). If you raise equity at a cost of 12.5% per annum and use it to repay debt that was costing 5%p.a., there is going to be a lot less cash left over on a per share basis, as Formerly Leveraged’s shareholders found out.

They won’t be on their own. You probably won’t read about it in the press releases – most PR savvy companies will probably follow Wesfarmers lead and spend all their time talking about top-line earnings and neglect to mention earnings per share – but for those prepared to do a little digging, the cost of last year’s rush for capital is about to become painfully apparent.