Rights Issues and Share Purchase Plans

Rights Issues

A rights issue is a pro-rata offer to buy additional shares in a company. The company is issuing each of its shareholders a document that is the legal right to buy additional shares in a set ratio to the number of shares already held. The issue may be renounceable or non-renounceable.

If the issue is renounceable, the shareholder has the right to buy the additional number of shares for the price in the offer, or to sell that right on the stock market. Providing the rights price is below the current market price ex-rights, the rights will have some value. That value will be the number of cents the exercise price of the rights is below the current market price, less the brokerage in selling the rights.

If the issue is non-renounceable then the rights may not be sold on the market or otherwise. The investor must take up the rights or allow them to lapse.

A rights issue is very fair because every shareholder has the opportunity to take up new shares in proportion to their existing holding. This means that their relative interest in the company is not diluted. If the shareholder decides instead to sell the rights, then there is some compensation for allowing the dilution to occur.

Dilution refers to the idea that if the shareholder owned x% of the company before the rights issue and took then up, their percentage holding is not diluted, because they will still own x% of the company after the rights issue. However, if they do not take up the rights, they will get some compensation from selling the rights, but after the issue their ownership of the company will have been diluted to less that x% of the issued shares.

So, the decision in a rights issue should be straight-forward in principle, but difficult in the specific circumstances. If the shareholder thinks their investment is a good one and the additional shares offer a better prospect than any alternative current opportunity to invest the money to pay for the shares, then they should take up the rights issue. Easy? Well, not in practice. The prospects for the company making the rights issue has to be assessed. The same has to be done for the seemingly attractive alternatives. Then they must be weighed up. The unconscious overlay is the psychological sunk cost bias because the investor owns shares in the company and therefore is emotionally involved whether the investor realises it or not.

There is another option to consider: sell the rights and bank the money. That will compensate in some way for the dilution of interest in the company. That may sound like a poor decision if the company is any good. However, with experience, we all should come to a realisation that having sold the rights, the whole picture changes. It is now a simpler decision to weigh up the alternative opportunities including buying more shares in the company making the right issue. Our minds work in strange ways at times. Sometimes a seemingly backward step can be a good one in that it opens up opportunities that are all equally weighed up.

What do I do? I consider each case on its merits. If I regard further investment in the company as the best use of my cash reserve, it is good question why I have not bought more shares in the company already. So, I tend to make that the hard option, versus selling the rights, and make the rights offer earn its preference in hard analysis.

Welcome to the cutting edge of making investment decisions. They are never easy. The thinking involved is hard work. If that seems too difficult, it does not matter much whether you take up the rights or sell them. It does not matter which, because an optimal solution to the problem is not being sought.

Share Purchase Plans (SPPs)

Share purchase plans are like rights issues, but different in one way. For small shareholders, they can increase their share in the ownership of the company at what might be an attractive price, but not so for large shareholders. This is because there is a limit of $15,000 that may be invested under the share purchase plans. If the number of shares the small shareholder takes up increases their ownership proportion in the company, they are diluting the large shareholders. For large shareholders, the share purchase plan is always dilutive because the limit on the number of shares that can be bought on the plan will always be less than their present share of the ownership of the company.

I am usually a large shareholder for this purpose, so I rarely bother with share purchase plans, which I see as being more trouble than they are worth and because of the risk of scale-back (see below). However, I have taken some up occasionally if they are very attractively priced and then sometimes simply quickly sold them to realise the attractive price difference between the market price and the share purchase plan price. These are not common situations and take up an opportunity presented by events between the setting of the price for the plan purchase and its closing date. Last minute action of this nature is facilitated by applying electronically using BPAY®.

A major problem is that share purchase plans can also be subject to scale-backs, especially when they are priced attractively. This is when the number of shares applied for is greater than the total number the company has decided to issue. The scale-back is usually proportional, but it is wise to read the small print (most people don't). The downside here is that the money for the plan has to be paid up front and there is a delay before the balance is repaid if there is a scale-back. No interest is paid on those funds that are refunded.

Other than those complications, the decision process is the same as for rights issues.

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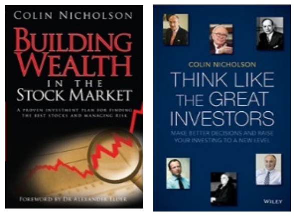

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