SLAUGHTER AND MAY/ THE DEAL TEAM

TAPPING YOUR SHAREHOLDERS: RIGHTS ISSUES BEST PRACTICE

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Introduction

The Covid-19 pandemic has caused companies around the world to closely scrutinise their financial and operating models, as well as their financing needs going forward. UK companies have already raised £2.8 billion of equity since the beginning of March, with European companies raising £2.1 billion during the same period.

There have been a mixture of drivers: to solve short-term liquidity problems caused by the immediate impact on revenues of the Covid-19 pandemic, to shore up balance sheets and reduce net debt to weather the ongoing uncertainty, and to enable the continued execution of management's strategic plans once the firefighting of the current crisis has abated – or more often, a mixture of all three.

All of these recent transactions in the UK have been placings of shares undertaken as "accelerated bookbuilds", either overnight or intra-day and usually preceded by a day or two of discussions with major shareholders on a wall-crossed basis. A number of these have involved companies raising between 10% and 20% of their issued share capital. Slaughter and May have advised on a number of such placings.

In this article we look beyond the accelerated placings of recent weeks, to explore the key internal execution steps that companies should consider when they decide to prepare for a larger pre-emptive offering, like a rights issue, which requires an approved prospectus. In contrast to the recent placings, rights issues and other pre-emptive offerings tend to be more involved processes with longer lead times and are generally reserved for larger equity raises. A number of companies in the UK and in Europe are currently considering transactions such as these, and we expect several to announce over the coming weeks: watch this space!

Shareholder approvals and shareholder consultation

A key first step in planning any equity raise is to check the standing authorities from your most recent annual general meeting. For UK companies with market-standard authorities, this will mean the ability to issue shares to existing shareholders and on a non-pre-emptive basis up to the statutory prescribed thresholds without the need to seek fresh shareholder approval. However, companies do not always have these standard annual general meeting authorities, meaning shareholder approval can sometimes be required when it otherwise would not be needed - it is always worth checking this at the outset of any equity raise.

In addition to reviewing the company's current shareholder approvals, guidance from institutional bodies and market expectations will play a role in structuring an equity raise. For instance, in the UK, the pre-emption guidelines have been temporarily relaxed to allow for up to 20% of a company's issued share capital to be issued on a non-pre-emptive basis (if the company's shareholder authorities also permit). In some situations, issuers may therefore be able to take advantage of this instead of having to rely on a rights issue requiring a prospectus. Be mindful, however, of the expectation that existing shareholders will still be consulted and preferentially allocated in a non-pre-emptive raise; something which institutional shareholders such as Schroders have emphasised in recent weeks, with others, such as Fidelity International, highlighting the need to include retail shareholders.

In the event that a general meeting is required, it is worth giving early thought on how best to ensure shareholder engagement. A number of companies already hold their annual general meetings as "hybrid" meetings involving both physical and electronic elements. This solution could be considered for a general meeting, as it reduces the organisational complexity for the company and offers shareholders flexibility, and has been welcomed by shareholders - as long as they can still actively participate in a meaningful way.

Any requirement for a fresh shareholder vote has a direct effect on deal execution, with a longer transaction timetable, different risk (and pricing) considerations for underwriting and less deal certainty.

The working capital statement

Companies publishing a prospectus in the EU are required to make a statement that they have sufficient working capital for at least the next 12 months (known as a "clean" working capital statement). This is typically supported by an extensive stress-tested financial modelling exercise involving the company, its underwriting banks and, in the UK, the company's sponsor and reporting accountants. However, this modelling exercise is undertaken by the advisory team in the background and not disclosed to the market, and the company is not allowed to state its assumptions as part of its working capital statement in the prospectus.

Market practice to date has strongly preferred a clean working capital statement.

What has changed in the current crisis? The UK FCA's recent Statement of Policy on recapitalisation issues during the coronavirus crisis and the associated technical supplement now allow a clean working capital statement (which would otherwise be "clean" but for the effects on the company of the Covid-19 pandemic), to be publicly accompanied in the prospectus by the key Covid-19 modelling assumptions underpinning the reasonable worst-case scenario. They must be clear, concise, and comprehensible. Non-Covid-19 assumptions may not be included.

The FCA gives examples of these key Covid-19-specific modelling assumptions - for example, relating to the length of time the company expects its business to be disrupted or the expected speed of recovery. On the other hand, the FCA would not expect to see any uncertainties/qualifications regarding, for instance, underwriting arrangements, bank facilities or anything that appears to cut across the working capital confirmation.

However, some companies may wish to provide disclosure over and above the permitted Covid-19 assumptions, in order to guide investors appropriately on the expected financial results in a new normal (and inherently uncertain) operating environment. This may only be possible by making a "qualified" working capital statement.

The working capital workstream is always important, however in the current environment it will be the key driver of the company's overall disclosure. It will inform the company's equity story and the size of the equity raise, and its eventual financial health. Companies are advised to focus on their financial model, and subject it to considerable scrutiny, very early in the process.

The nature of Covid-19 risk factors (and their relationship to the working capital statement) has also been a key focus of FCA attention – and is likely to be a point of development as issuers start discussing their draft prospectuses with the FCA in earnest.

The prospectus – short or long form?

Since July 2019, when the new EU Prospectus Regulation came into force, existing listed companies that wish to raise further capital have had the option of preparing a simplified prospectus with reduced disclosure requirements that are proportionate to and focused on what is relevant for secondary issues.

The FCA recognises the need to facilitate fundraising on capital markets and the importance of reducing the cost of capital, and its recent Statement of Policy on recapitalisation issues during the coronavirus crisis reminded issuers and their advisors that "they may wish to consider using the new simplified prospectus… This form of the prospectus is tailored for secondary issuances."

The key execution advantage of using a simplified prospectus is the reduced historic financial information, particularly as there is no requirement for an operating and financial review. This can shorten time-to-market, especially given that prior financial history may be less relevant in the new environment.

Depending on the company's shareholder base and jurisdictions in which a rump placement is expected to be offered, it may not, however, be advisable to use a simplified prospectus. Even in such instances, in our experience in the UK, we are seeing a number of issuers choosing to supplement this form of simplified prospectus with targeted voluntary disclosures to address specific overseas investor requirements and expectations, rather than simply using the full form prospectus.

Preparing for a rights issue, whether it involves a full form or simplified prospectus, can be time-consuming. For companies that are not regular issuers, preparing a prospectus may require starting from scratch as the prospectus disclosure could put the company's historic disclosure in a different context and require additional detail to make it fit for purpose.

Due diligence, verification, and comfort exercise

A rights issue, especially one with a US element, will involve an in-depth business and financial due diligence process by the banks and the lawyers. In addition, a verification exercise will be required to ensure that the prospectus and other shareholder and investor materials contain everything that is needed in an accurate manner.

Both these processes, and the other comfort work to ensure that the sponsor and underwriting banks are satisfied, take time and require input from the executive management team – as pointed out above, the working capital position will be complex and is only one of the comfort workstreams. The due diligence process will need to be underpinned by a dataroom. In the next article of The Deal Team's Race to Recapitalise series, Stephen Murphy will walk through issuer best practices for due diligence and dataroom management.

Timing and practicalities

What does winning the race mean for a rights issue? It all depends on the company's readiness and the in-house (wo)manpower to run the transaction. Key internal points we would consider clarifying quickly include:

- Internal resources required – and potential impact on other parts of the business (who may be working remotely or juggling other commitments) – and whether additional external support (e.g. publicity, project management etc) might be helpful

- Availability of financials, which is often the most important factor in determining timing. How quickly can the (audited/reviewed) financials be ready, which in the current crisis has the extra challenge of the going concern statement?
- Agreeing a clear and focused rationale for the capital raise and use of proceeds upfront (in consultation with internal stakeholders and external financial and legal advisers) will save time in the long run – and ensure all parties are singing from the same song sheet in terms of the prospectus disclosures, investor presentation and other marketing materials
- Speed to turn the existing company disclosure into an approved prospectus and investor presentation
- Rapid turnaround of the banks and lawyers' due diligence requests, particularly UK sponsor requests
- Regulatory review process and current workload
- The impact of remote working: with in-person transaction management and drafting sessions no longer possible, think carefully about how to choreograph a smooth and efficient process for drafting, collaboration, review and sign-off

There is broad support in the market for recapitalisations where the company can articulate a clear, convincing rationale for the equity raise, presented as part of a thoughtful assessment of the company's immediate financial position and ongoing financial needs. Giving careful thought to the points in this article will help an issuer be ready to swiftly approach the market when the time is right.

Watch The Deal Team's video accompanying this article here

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