STOCK STRATEGIES

Is a Rights Offering the Right Stuff?

In the wake of the coronavirus pandemic, companies may turn to equity capital to avoid becoming too leveraged. A rights offering is one of the fairest ways to proceed.

BY JOHN DEYSHER

As a mutual fund, we are routinely notified of various corporate actions regarding our security holdings such as stock splits, special dividends and acquisition proposals. Earlier this year, our custodian bank notified us of a corporate action we hadn't seen for a while, a rights offering. Specifically, we received one right for every share of Williams Industrial Services Group (WLMS) we owned. Each right allowed us to purchase approximately 0.283 shares of Williams Industrial common stock at $1.30 per share, a 15% discount to the 25-trading day volume average price for the period immediately preceding the rights offering. The rights offering expired March 2, 2020, and no fractional shares were to be issued.

Williams Industrial had 19,027,200 shares outstanding at the time of the offering, so assuming the rights offering was going to be fully subscribed, they would have issued approximately 5,384,600 new shares at $1.30 per share and raised about $7 million in new equity capital. The share base would have increased 28.3% to 24,441,810 shares. The additional capital is to be used to fund the company's strategic growth initiatives and for general corporate purposes. The offering prospectus, including terms and risk factors, was on file with the U.S. Securities and Exchange Commission (SEC).

We fully subscribed to the offering. The offering itself was fully subscribed, so a backstop wasn't needed. All 5,384,600 shares were issued in March at $1.30 per share, raising $7 million in gross proceeds. It appears that most shareholders maintained their proportional ownership interest.

__John Deysher__ is president and portfolio manager of the Pinnacle Value Fund, a diversified, SEC-registered mutual fund specializing in the securities of small and micro-cap firms. He is a CFA charterholder and has managed equity portfolios for over 30 years. Find out more at www.aaii.com/authors/john-deysher.

What Does All This Mean? And What Is a Rights Offering?

A rights offering (rights issue) is a distribution of subscription rights to buy additional shares of a company made to the company's existing shareholders. With the issued rights, existing shareholders have the right, but not the obligation, to buy a specified number of shares at a given price within the subscription period. Much less popular than secondary or initial public offerings (IPOs) to the general public, the rights offering gives the existing shareholders priority in buying newly issued shares. Rights offerings often raise capital at attractive valuations and our experience with past rights offerings has been very favorable. A decade ago, when many banks and financial institutions were forced by regulators to raise capital at compelling valuations, we were able to take advantage of this once-in-a-generation opportunity.

With the issued rights, existing shareholders have the right, but not the obligation, to buy a specified number of shares at a given price within the subscription period.

Investors can find out if their companies are doing a rights offering by monitoring their ticker newsfeeds through their preferred websites (e.g., Yahoo, Google, brokerage firm, etc.). Since a rights offering is a raising of capital, usually there is a press release announcing it. Such an announcement may be combined with an earnings or other announcement. The press release will normally indicate the target amount to be raised, the number of rights to be issued, the exercise price, the ex-rights (expiration) date and when the prospectus will be filed with the SEC. The prospectus is not typically mailed, so investors must monitor the SEC's EDGAR database (www.sec.gov/edgar.shtml).

Nuances of Rights Offerings

There are several characteristics of rights offerings investors should familiarize themselves with before deciding whether to participate.

1. Potential Dilution

Although it's your choice whether to exercise your rights, if you do not, your percentage ownership interest will be diluted. The equity pizza pie will be larger, but your proportional slice will be smaller. You will own a smaller ownership interest of future earnings, cash flows and net assets.

Why wouldn't you exercise your rights?

» You already own a substantial amount and don't wish to own more even at a favorable price.

» Your assessment of future prospects is uncertain and while you don't mind owning what you have, you don't want to own more.

» You may be more bearish and wish to sell, not buy.

2. Transferable Versus Non-Transferable

Oftentimes, the rights you receive are transferable prior to expiration. This means you may sell your rights on the secondary market, assuming such a market develops. If the exercise price is below the market price, the rights will generally have value and may be sold to other investors who wish to exercise them.

However, that value will decline as the expiration date approaches since rights that aren't exercised expire worthless. In our example, the Williams Industrial rights are non-transferable—meaning only we may exercise them and if we don't exercise they will expire worthless.

n the secondary market, assuming such a market develops. If the exercise price is below the market price, the rights will generally have value and may be sold to other investors who wish to exercise them.

[Editor's note: Check with your broker for instructions regarding participation and the ability to sell your rights. Information might be provided under the terms "corporate actions" or "tender" on a broker's website. You may also find it helpful to contact the broker's client services department when seeking specific information regarding the process of and fees related to the handling of rights.]

3. Oversubscription Privilege

Although our Williams Industrial rights were non-transferable, we did have oversubscription privileges. When oversubscription privileges exist, any rights not exercised by one shareholder may be exercised by another seeking to buy more shares.

These latter shareholders are seeking to "oversubscribe" and will be awarded any unsubscribed rights based on their proportional ownership of common stock pre-rights offering. Any unsubscribed rights will be allocated proportionately in a manner fair to all shareholders. Since rights offerings are often favorably priced, it's been our experience that most existing shareholders will fully subscribe and that shares available for oversubscription are often minimal.

4. Backstop

If a rights offering is fully subscribed, including oversubscription privileges, the issuing firm will raise the specified level of capital as planned. To assure this occurs, often a major shareholder will act as a "backstop" and buy any shares not fully subscribed. In our example, the Williams Industrial rights offering was fully backstopped with a commitment by Wynnefield Capital Inc.—the largest shareholder—to purchase all unsubscribed shares of common stock in the rights offering. The backstop assured that all 5,384,600 new Williams Industrial shares would be sold and the target capital would be raised. It was also a major vote of confidence on future prospects. (As previously noted, the offering itself was fully subscribed so a backstop wasn't needed.)

If a backstop investor does not exist, the issuer may hire an underwriter to market the issue to existing shareholders. Typically, the underwriter will earn a fee for shares subscribed and agree to subscribe for any shares offered but not taken up by shareholders. Absent a backstop

Key Features of Rights Issuances

Dilution

Rights issues increase the number of shares outstanding. Shareholders who do not participate will see their ownership interest decrease.

Potentially Transferable

You may be able to sell your rights if a market develops to do so. Like options, rights that are not exercised will expire worthless.

Oversubscription Privileges

An oversubscription clause allows shareholders to receive additional shares in the rights offering proportional to their pre-offering ownership. This occurs if one or more shareholders decline to exercise their rights and others are seeking to "oversubscribe."

Backstop

A major shareholder will often agree to buy any shares that are not fully subscribed. An underwriter may be hired by the issuing firm to perform this function in the absence of a backstop investor. This ensures that all shares offered are sold.

No Immediate Tax Effect

Participation in a rights offering is not a taxable event. The cost basis for the shares acquired will be the exercise price, and this price may be different than the price you paid for shares acquired prior to the rights offering.

investor or underwriter, a rights offering may be done on a best-efforts basis—although this requires careful analysis of shareholder appetite since a less than full subscription may result in a negative impact on share price.

The backstop agreement is always detailed in the prospectus.

5. Income Tax Consequences

For U.S. federal income tax purposes, there is generally no income or loss from receiving or exercising rights. The basis of any shares acquired for calculating capital gains and losses is the exercise price. The shares received in an offering are freely tradeable.

For the issuer, because there is no major ownership change of control, funding from existing shareholders enables the issuer to retain all or a significant amount of any net operating loss (NOL) carryforwards to offset future taxable income.

Should You Participate?

Rights offerings are much more popular in Asia and Europe than in the U.S., where they are often viewed as an indicator that a company has exhausted all other financing sources. This is not always true and as value investors our ears perk up when we hear about a rights offering. Because of the perceived stigma, rights offerings often allow equity ownership at attractive valuations.

Because of the perceived stigma, rights offerings often allow equity ownership at attractive valuations.

As attractive as a rights offering sounds, an investor must always evaluate the fundamentals before deciding to participate. The attractive valuations that rights offerings may present often occur when a firm is experiencing difficulties. In better times a firm might do a secondary offering, raising less expensive capital and broadening the shareholder base. (A secondary offering is offered to a broader group of investors and often involves the offering of existing shares instead of the creation of new shares.)

In our example, Williams Industrial used the rights offering to raise equity capital in conjunction with a refinancing of its existing credit facilities. They have undergone a multi-year restructuring and while much progress has been made, there is still work to do. One should not view the rights offering as an automatic road to riches. As always, investigate before you invest.

Here's an example of a recent rights offering. In July 2019, Hertz Global Holdings Inc. (HTZ) issued 57,915,100 new shares at $12.95 per share, a 14% discount to the prevailing market price. The offering was oversubscribed, with affiliates of Carl Icahn purchasing 30% of the offer. Hertz shares were trading at approximately $20 per share in mid-February before falling to $3 in mid-April.

Conclusion

In summary, if capital must be raised, a rights offering is one of the fairest ways to proceed by offering an attractive price to existing shareholders. They often know their own holdings best and the rights provide the opportunity to increase their position if they wish. It is greatly preferred to private placements of convertible preferred stock or debt to institutions that often extract egregious terms that leave existing shareholders in doghouse.

At some point in the near future, rights offerings may become more popular. In the coronavirus pandemic's wake, companies are drawing down credit lines and may soon turn to equity capital to avoid becoming too leveraged. At this point, equity capital may be very cheap and managers may choose to reward current shareholders with these bargain shares via a rights offering rather than selling shares to new investors. Of course, equity capital is usually cheap for a reason, so investors need to evaluate the company's fundamentals, management and outlook before moving forward. ■

JOIN THE CONVERSATION ONLINE
Visit AAII.com/journal to comment on this article.

MORE AT AAII.COM/JOURNAL
Turbulent Times Make Cash King Again by Derek J. Hageman, May 2020
Ignore What CEOs Are Saying … Watch What They're Doing by James Paulsen, October 2019
Proxy Voting for Individual Investors by Robert Stein, July 2015