"RIGHTS" ISSUES

One of the best psychological innovations in the investment world is that of rights issues. If a Company wishes to raise more capital it had become quite common for the opportunity to be given to existing shareholders in that Company to provide the new capital in proportion to the existing shareholdings. I say "had" because since the introduction of Corporation Tax it has become relatively more expensive to raise additional capital by Ordinary shares compared with debentures or loan stock. However, rights issues are beginning to creep back again on the investment scene, and there are approximately 30 rights issues open at the moment, according to the Financial Times. Thus, for instance, should a Company wish to increase its Ordinary share capital by 25% then each shareholder is invited to increase his own shareholding by one share for every four previously held.

It is common practice to make the new issue of shares on what appears to be attractive bonus terms to the existing shareholders. For instance, the price of the Company's £1 shares before the issue is made might be 30/- and shareholders are invited to subscribe for the new shares at, say, 20/-. If the annual dividend being currently paid by the Company is 6% and the Company in the circular setting out the offer indicate that this 6% dividend will be maintained on the increased capital, then it might appear that the shareholder is being invited to invest further money at 6%.

It must be borne in mind, however, that the shareholder has an opportunity should he so wish of selling his "rights" and in the case described above they would probably be worth 10/- per share, so that in considering this new offer of investment one has not only to take into account the pound of new money required but also the 10/- produced by by the sale of "rights" which is automatically being forfeited is the rights are taken up. Thus the cost of the new investment is really 30/- and in effect one is not making the new investment on a 6% yield basis but only at 4%. This is where the psychological success of this method arises because existing shareholders are persuaded to make a further investment in the Company under the impression that they are doing so on a higher yield basis than they in fact are. There may be other better investments available at that time yielding, say, 5% but which the shareholder has not bothered to discover merely because his attention has been thus focused on the opportunity of further investment in his present Company.

I am frequently consulted by shareholders on this particular problem and I usually ask one or two simple questions. The first is have you any money available at the moment for new investment, or, alternatively, do you wish at the moment to make a further investment. Invariably I find that the answer is "no", in which case the benefit of the bonus element in the offer can be taken advantage of by the sale of the rights and the receipt of the tax free proceeds. Some people, indeed, go to the trouble of selling enough of the rights to produce the cash to pay for taking up the remainder, so that the cash position is as before.

But if the answer to the question whether there is money available for new investment is "yes", then the next important question is whether one would make a further investment in the Company making the offer. I think in most cases the answer to this question would not necessarily be "yes". In other words, the probability is that there are better investments elsewhere. I have often heard the comment that unless one takes up one's rights in these circumstances one is losing one's share in the Company. This is a situation which does not worry me at all. I am really not interested whether my shareholding in a Company is .001 or .0009. What I am concerned about is that the money which I have invested in that particular Company produces a reasonable investment return.