Slaughter and May Podcast

Equity Capital Markets in the COVID-190 crisis

Gillian Fairfield	Hello everyone, my name's Gillian Fairfield and I'm joined today by my colleagues, Richard Smith and James Cook to discuss what we've been seeing in the equity capital market space. Now, clearly COVID and lockdown have meant that for many businesses the usual cash flow that they rely on has been slashed. This has driven a lot of activity on the equity capital raising front. Richard, can you tell us a bit more about what we've been seeing.
Richard Smith	Yes, so, we've seen a number of companies including many of our clients carrying out equity raises, and even more considering them, at the moment. The primary drivers are, of course, generally to solve short term liquidity problems caused by the pandemic or to strengthen balance sheets and reduce net debt. You know, to help companies weather the crisis and most often, in reality, it's a mixture of both. So far we have seen a number of quite large placings from issuers raising between 10 per cent and 20 per cent of their issued share capital and we have acted on many of those as I say. Those have tended to be companies that are large enough that they can raise a meaningful amount, by issuing between 10 and 20 per cent of their share capital, but not so large that their book builds, in order to generate their investor demands cannot be done quickly and that's a key feature of a placing, of course. Alongside that, we have seen a number of less sizeable raises by smaller companies in the market, and we expect that there may well be some larger raises as the lockdown continues using a variety of different structures. Those, in often more documented processes, inherently have a longer lead time given the need for an FCA approved prospectus. If you want to issue 20 per cent or more of your issued share capital, and potentially the need also for shareholder approvals in general meetings depending on the structure.
Gillian Fairfield	Yes, and I think that ties into what we saw after the last crisis, the financial crisis of 2008, that there is a bit of a longer leading time before some of the more sizeable rescue rights issues. But Richard, on practical note, what sort of market reception are these getting, I mean how are investors reacting when companies go out to market?
Richard Smith	Well, on the ones we've done, you know, there appears to be sufficient demand out there for the right opportunities. Now, of course, we don't know what situations there have been in the market where companies may have wall crossed investors they need to discover that they in fact did not think it was the right time. But of the ones that we have been involved with, you know, there has been investor demand. There was a lot of talk initially about first mover advantage – getting out there quickly in order to you know, take the demand before it dissipates. But it's probably fair to say that we're actually seeing some investors biding their time and being selective about where to deploy their capital. Particularly those investors that have a range of investments across a particular sector. And that might suit some issuers and of

	course there are companies considering whether it's better to wait in the hope more market certainty and share price recovery. A lot of the successful placings have been largely filled by supportive shareholders, although there are certainly plenty of hedge fund and new investors waiting in the wings and expressing significant interest. That can, of course, create a bit of tension in the allocation process and it's fair to say that company management are now consistently taking a very active role in allocations and existing shareholders are themselves giving clear guidance on their expectations. Management are also subscribing in placings themselves as a tangible way of showing confidence to investors, you know, companies often think that is a very important feature of being able to demonstrate that confidence to the market. Investors have, as you would expect, been focussed on the extreme downside and worst case modelling. They don't want companies to sugar-coat things and it's very hard to sugar-coat things in this environment in any case. They want to be sure that their money will resolve any liquidity problems and they're not throwing good money after bad. And also that there's not going to be another raising just around the corner. Obviously some of the key variables for modelling purposes are how long the pandemic will last for, which of course, nobody can predict, and how long it will take for the companies' revenues to return, which will of course, vary from company to company. So perhaps, unsurprisingly, we've not seen any standard assumptions emerging in the modelling work we've seen.
Gillian Fairfield	So Richard you mentioned investors obviously want to know what the company considers the extreme downside position to be. I mean are investors setting out what they want to see from companies as regards how they are helping themselves? I mean presumably it will be the case that an equity raise will be one of an entire range of measures that the companies are adopting. Is that right?
Richard Smith	Yes, and of course, investors want to know what the holistic financial position is for the issuer and when justifying the need to do an equity raise, companies will need to say (a) how they're being affected by the current situation; and (b) everything that they are doing to sort that out. So that will include a range of those self-help measures. Both to preserve cash, alongside the equity raising and generally to shore up their financial position. So that might be sorting out their debt arrangements, whether that's taking on new debt, or extending or amending their existing debt facilities, obtaining lender covenant waivers if they are facing potential covenant breaches over the coming period. Reducing their cost bases, whether that's through redundancy or other measures. Furloughing is a regularly reported on step that many issuers have been taking under the *Job Retention Scheme* that the Government put in place. Cutting discretionary spend as a general matter and even negotiating with pension trustees over their deficit repayment plan. So there is a whole range of those types of measures that companies are taking, and as part of explaining their position to investors, will need to describe.

Gillian Fairfield	And how about dividends, I know that is always a tense one, isn't it. But what are we seeing on the dividends front?
Richard Smith	Well many, many issuers, indeed, a large proportion of the FTSE 350, have already cancelled or suspended or deferred, depending on how you want to put it, their dividends, that they were otherwise due to announce. So there has been a large hit to the investor community in terms of income receipts from the FTSE over the last few weeks and I am sure we will see that continue until the market stabilises.
Gillian Fairfield	And so for issuers that are contemplating placings, James, what do you think are the key things that they would need to know?
James Cook	Yes, so the placings we've seen to date have almost exclusively been implemented through accelerated book build processes. Typically they've been launched after market close one night, and then they're filled overnight, and the announcement of the results have been put out the next morning. Although we have seen a few going intraday on the book build, although that slightly is more difficult, because obviously the market price is moving as you are doing the book build. But whichever method people use they've almost always been preceded by at least a day or two of discussions with major shareholders on a wall cross basis, both to test the demand and appetite, and also to effectively pre-fill the book before you go out and do your book build to a large extent. Now, many of the raises are using, what we call, a cash box structure and what that does is effectively enable a company to issue shares on a non-pre-emptive basis in excess of the 5 or 10 per cent that companies usually have standing AGM authorisations for from their shareholders. And it's quite interesting these cash box structures are being used because they've typically been avoided in recent years. Investor bodies have made pretty clear that they should not be used to circumvent these limits that are put in place by shareholders at the AGM. But in the current climate there has been a change of scene in that, at least on a temporary basis, and the pre-emption group, which uses the key guidance in this area, has relaxed their positon on this and actually recommended that on a case by case and temporary basis, investors should consider supporting these non-pre-emptive cash box placings of up to 20% of issued share capital. And actually the FSA, the Investment Association, the AFME and various others have all indicated their support for this approach and we've seen plenty of issuers doing it. It's probably just worth noting on that though I think Gillian, actually that there's a few conditions that the Pre-emption Group have recommended issuers should satisfy when doing this. A few of them are sort of common sense and would probably be done anyway. So they state the issuers, for instance, should consult with major shareholders, which of course, you'd want to do anyway. Explain the specific company circumstances fully in their announcements and more so involve management in the allocation process, which actually Richard mentioned earlier, is something on a practical level, people are keen to do anyway. The fourth one though is a bit trickier, they suggest that you proceed on a soft pre-emptive basis to the extent possible in your placing.
Gillian Fairfield	Right okay, I mean that does sound more difficult, I agree that the other ones that you mention, those are pretty much what would expect most issuers to be focussed on anyway. But, Richard this soft pre-emption requirement what exactly does that

	boil down to, you know, particularly if you are talking about an issuer that has quite a lot of retail shareholders?
Richard Smith	Yes, I think it is particularly difficult for retail shareholders but we can come on to that. And of course the Pre-emption Group has not actually set out any particular definition for what soft pre-emption means. While it is not too difficult to broadly allocate shares pro-rata amongst existing shareholders who participate in the placing, those are of course typically institutional shareholders. So I think what soft pre-emption really means in that context is that you should try to involve as many of the institutions that are currently in your register in a placing as possible. And obviously try to allocate in a broadly pro-rata way. I think that's what the Pre-Emption Group is trying to get at. And really I think they were saying there, that we don't want you to favour just the very large, if you like price setting, institutions in your register, you also need to give due attention to some of the smaller institutions. So I think the Pre-emption Group is focussing very much on the institutional side in reality. But that, you know the outcome of a lot of these placing processes is that retail shareholders are not able to be involved and that has created a reasonable degree of controversy in some parts. There was an article in *The Times*, for example, a couple of weekends ago that a number of the "Great and the Good" in the investment management sector had penned an open letter calling for companies to make more efforts to accommodate retail shareholders in those offerings which is not something that has ever really been done before. But it is possible to do it, and we've been working with one client called Primary Bid and they have a tech platform that enables retail investors to access accelerated book build placings, real time, so that retail investors can benefit from the placing price and then of course, as often happens, an increase in the share price following a placing, once a company's financial position has improved. And their platform takes no longer to operate than involving an institution in a normal book build process and it's very easy to plug into a structure, so we may see more companies looking at those sorts of options to involve retail shareholders over time.
Gillian Fairfield	So it's kind of a Pre-emption light, I guess we would say?
Richard Smith	Exactly right.
James Cook	I guess we've focussed on placings so far, largely because that's been the key tool we've seen deployed today. Richard mentioned earlier that obviously, potentially there may be larger equity raises in the pipeline which have inherently a longer timeline just because they need prospectuses and potentially shareholder approval. Gillian, have you seen much in the pipeline in this area yet?
Gillian Fairfield	Yes, I think that as we saw on the last financial crisis these larger issuers do take, they do have a longer lead in time. And James as you've mentioned, I think most of the equity raises we've seen to date have been the sub-20 per cent one so as to make the most of the Pre-emption Group's stance on the guidelines we discussed earlier.

	So when it comes to larger equity raises I think the key hurdle there is going to be what a company needs to say in its prospectus and the trickiest issue is probably going to be the working capital statement that companies need to give. So of course this is where we look to the FCA for some guidance. Just to restate the basic position of course, a company going out with a prospectus, to give a clean working capital statement, an issuer would need to say that it's got sufficient working cap to meet its requirements for 12 months. Although in practice companies do tend to look ahead for an 18 month period. Now the FCA has always said in the past that in order to give a clean working cap statement, a company cannot then list a whole long list of assumptions and caveats. Now the real difficulty under this current crisis is how can a company be absolutely sure of how the COVID crisis is going to play out? And so the FCA in their recent statement of policy, they did relax the position on this and they've said that issuers can include what they are using as the key COVID-19 related assumptions to underpin a reasonable worse-case scenario. So, for example, you know, a company might want to say that they've based their working cap work on the fact that, say 75 per cent of the company's premises, will reopen at a particular point in time and that they're predicting, you know, a certain percentage of the normal revenue for the second half of 2020, compared to their 2019 level. And we have seen some companies use this slightly more nuance stance, for example, like the recent Aston Martin prospectus. They came out with a prospectus which essentially said that they couldn't give a clean working cap statement but they gave some specific disclosures around why this was and why management nevertheless felt confident that they would have sufficient working cap following the equity raised. I think it's fair to say that various people had been agitating for a greater breadth of relaxations from the FCA but of course the FCA is wanting to do a balancing act between facilitating fund raising in what are pretty extraordinary circumstances at the moment but at the same time protecting investors. I mean the other thing the FCA flagged for issuers which they might want to have regard to if they are doing a prospectus-based issue is the simplified prospectus regime, which would significantly cut back on the work that is required to actually prepare a prospectus. Though the one problem that I would flag on that front is that where offerings have a US shareholder element that's significant, it can create some issues there as US securities law typically drives a higher level of disclosure. So what we may end up getting to is simplified prospectus but then topped up with additional disclosures where that is needed by the company's own specific circumstances. So just to turn the question round back to both of you, I would ask, looking into your crystal ball, what do you see coming up next?
James Cook	It's a very good question. I think we're going to inevitably see more companies going out but also that we'll see more innovative structures for raises, seeing maybe convertible bond placings, I know we've seen a couple of those already. Open offers, like the Cathay one launch recently. May be some conditional placings with clawback and probably various hybrids of those and more traditional structures as well.

Richard Smith	Yes, I agree. Just in terms of timing I'm pretty sure we're going to see a trickle of the placings and some rights issues or open offers as we head into the summer, so in the next few weeks. I suspect once furloughing ends, people are back to work, Government schemes stop paying out money to issuers, we will then see another wave come the Autumn using people's interim financials. So in the September/October window where, you know, that might be where we will see some of the larger rights issues come into the market. And it's going to be very interesting to see how investors react to that. I think they will make it clear that issuers don't have carte blanche and that raises have to be carefully structured and justified and I think investors will want to know what the holistic financial position is of the issuer company before they are prepared to handover money in the context of the current environment. So, that's going to be, create some interesting tensions between some companies and issuers over the next few weeks. Not least of all because some of these issuances will have to be done at pretty high speed.
Gillian Fairfield	Yes, great, okay thanks both so it sounds like it's a question of watch this space. So thank you Richard and thank you James. And if anybody has any questions do get in touch with your usual Slaughter and May contacts.