HUGH SANDEMAN

The author is a senior advisor to Langham Capital. He can be reached at hugh.sandeman@langhamcap.com

Need for speed

Time lags in offering rights issues could lead to short selling

Board resolutions authorising fresh capital increases are coming thick and fast as the market recovers. In familiar jargon, new capital is authorised as GDRS, ADRS, FCCBS or QIPS, or some combination of these. In practice, of course, if the deal happens, it will be a rapid sale by bankers over the phone to institutional investors, with one or more of these confusing labels attached; a relic of the still transitional nature of SEBI's capital market rules.

This transition will be almost complete when SEBI eventually makes the small concession that listed companies can simply sell new equity at or near the prevailing market price, not the average over the prior two weeks. The much bigger concession was made three years ago, when qualified institutional placements were introduced, hedged about with a completely impractical rule that tied pricing of new issues to the higher of a six-month or two-week trailing average. This sensible and overdue reform, though initially flawed, removed the burden on listed Indian companies of offering follow-on equity issues to retail and high networth individuals, along with the mountainous disclosure required for IPOs. At the same time, it began to put an end to the effective outsourcing of Indian follow-on offerings to foreign stock exchanges.

When institutional-only equity offerings became standard practice in international equity markets from the early 1990s, two things became clear, also relevant in India's equity market. First, it did not matter to retail investors that they were not sold shares directly in follow-on offerings, provided the deal was struck at or near market price. Access to IPOs (available in the US and Japan, but often not in Europe) was important. So was protection against loss, by existing shareholders, in rights issues offered at large discounts. But buying small lots in the secondary market was easier than buying in a follow-on offering.

Second, the format of the institutional offering had to evolve quickly to keep ahead of secondary market practices, notably short selling. For a time, large follow-on offerings were marketed worldwide in road shows that lumbered from Tokyo and Hong Kong westwards, only to find on arrival, a week or two later, that institutional investors planning to buy the new shares had already profited at the issuer's expense by selling the existing shares short, driving down the offer price in their favour. Hence, the shift to selling over the phone in a single morning with the offer document following a few days later.

These same market forces have now caught up with rights issues. The painful experience of selling rights offerings for sinking British banks has already led to faster rights issues in the UK, a close parallel to SEBI's drastic shortening of the rights offering timetable and its recent reduction in rights issue disclosure. A more basic reform is now being considered by UK's Financial Services Authority (FSA), to offset the corrosive impact of short selling on conventional trading of subscription rights.

The problem comes back to timing. Rights issues in the UK can either be made at or near the current price (maximum discount of 10 per cent, where it is assumed that existing holders need no compensation and there is no trading of subscription rights), or at a discount. In a discounted offering, existing retail holders need time to sell their subscription rights and recover some of their losses if they do not want to buy. The trouble is that in difficult times, short sellers can use this offer period to drive the issuer's share price down to the discounted offer price, making the subscription rights worthless.

The FSA is thinking of importing a neat solution from Australia that accounts for the dominant role of institutions in rights issues, while protecting retail investors. Known as a RAPIDS offering, this splits a rights issue timetable between institutions and retail, and dispenses with the need for trading subscription rights. Institutions get only four days to decide whether to subscribe – too quick for short sellers to get their claws in. Their response sets the price for the offering. Retail investors then have an extra two weeks to decide if they want to buy. Any surplus of the proceeds over the discounted offer price goes pro rata to all existing shareholders.

If it proves workable in the larger UK market, the need for institutional investors to move with speed can be squared with the greater deliberation required to give the retail investor a fair deal. This sort of approach is nice to have in a heavily institutionalised market like the UK, but will continue to be essential in India, where the retail investor still has a major role to play. ◆