Analysis (/category/analysis)

Five lessons from recent sharemarket capital raisings

Margin Call: Stephen Bennie has some lessons and reminders for investors.

.().

By **Stephen Bennie**
Tue, 02 Jun 2020

Auckland Airport's capital raising was dubbed Project Falcon

As capital raisings continue to rumble on, we consider what, if any, lessons have been learned.

Lesson one

Beware US Private Placement (USPP) notes. Bank lenders do not like any hint of getting pushed behind in the queue to get their money back. Take Auckland Airport for example: over lockdown it was likely to breach the USPP note covenants that would then give the note holders first call on the assets of the airport. This is not a good development for the banks that hold the senior debt, let alone the equity holders.

As a result, Auckland Airport raised a quickfire $1 billion in April by issuing new shares in a deal that investment bankers code-named Project Falcon. That deal took the airport’s cash balance to $1.34b, which is amazingly close to the combined amount of its current bank debt of $650 million and USPP debt of $702m, to $1.35b. Reviewing the list of New Zealand companies with USPP notes, Sky City, with its $349m outstanding notes, must be looking like next cab off the rank.

Lesson two
Sometimes even free shares are not free. Last year, New Zealand Rugby got 5% of Sky TV for ‘free’ as part of renewing the Sanzaar rugby rights. At that time, Sky TV was trading around 60c, making the stake a $13m renewal sweetener. Perhaps they even had notions that Sky TV shares could trade back to previous highs, which would make the stake worth upwards of $100m!

Unfortunately for New Zealand Rugby, it had to agree to hold the shares for at least two years. That means it has been faced with the decision to take up its rights during Sky TV’s recent capital raise or be materially diluted, and the scale of dilution is enormous. Post the rights issue and a curiously small institutional placement, there will be 300% more Sky TV shares than there were previously on issue. The alternative to being diluted is to cut a cheque for $7.4m to fully take up the entitlement. So much for ‘free’ shares! One piece of good news, though, at least this deal was not called Project Falcon.

Lesson three
Allocations in capital raisings are becoming more transparent. In sharemarkets, one of the most mysterious places is the broker’s ‘bookbuild’ room. This is the place where investment bankers, alongside the companies issuing the new shares, decide who gets what.

You might imagine that this is an orderly procedure, but the stakes can be very high and the feedback is that it is more like a scene of chaos where wild promises of lavish future commissions and clients' loyalties swirl and pitch through the wee small hours. Investors will beg, plead, and demand, sometimes all three in one phone call, to be 'looked after' and receive a good allocation from the 'bookbuild' room.

Even after the fact, it can be very unclear what percentage allocation is a good or bad one. Now, however, the world appears to have changed. Stock exchanges are now demanding that allocations will, in the first instance, be determined by how many shares investors own of the company when the capital raising is announced. A pro-rata approach is transparent and sensible and how it should always have been, it is just not as interesting a process.

Lesson four
Companies do not say sorry. To be fair, this was known well before this tidal wave of capital raisings. Raising capital to fix a broken balance sheet is no badge of honour that boards and executives should wear with any sense of pride. It is, in essence, a very clear and public admission of failure.

Some might argue that Covid-19 represents an existential threat that could not be seen. But years of paying dividends from debt by too many of New Zealand companies made them highly vulnerable to an event such as this. Hopefully in future, we will see more boards setting sustainable and appropriate dividend pay-out ratios, ones that do not rely on ever increasing bank debt.

Lesson five
Retailers should not carry high levels of debt. The retailing business model generally runs with a substantial level of lease obligations relating to rent on its chain of stores. This represents a high level of leverage for a retailer which conservative operators counterbalance by having cash in the bank.

Comparing the differing fortunes of Kathmandu and Hallenstein Glasson through the recent lockdown illustrates this very clearly. Kathmandu went into March with net debt of $273m while Hallenstein Glasson had net cash of $12m. To put this difference in stark context, the two businesses are of a similar scale in terms of operating profit: at their recent interim results Kathmandu reported an operating profit of $29m (pre IFRS) while Hallenstein Glasson reported $22m.

This demonstrates that Kathmandu was not just carrying debt, it was carrying a very high level of debt. No surprise then that within six days of New Zealand having moved to level 4, Kathmandu was forced to raise $207m, which more than doubled the shares on issue. This in striking contrast to Hallenstein Glasson, which has currently only had to defer its interim dividend.

Stephen Bennie is a co-founder of Castle Point, a NZ boutique fund manager

This content was not paid for by NBR

By **Stephen Bennie**

Tags:
Castle Point Fund Management (/tags/castle-point-fund-management)
Stephen Bennie (/tags/stephen-bennie)

Comments 1 comment

◯ **Castle Point** ◯ **Anonymous**

Type something...

750 / 750 characters

Posting this comment indicate you've read and will abide by NBR's terms and conditions on commenting (/terms-and-conditions).

Add comment

deekers44 Tue, 02 Jun 2020 - 10:49am

Nice quick insight.

Reply