Stock Rights Offerings: Raising Additional Equity Capital At Lower Cost

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**The
Hallwood
Group
Incorporated***

(**Note:* Hallwood Group is the only merchant bank listed on the New York Stock Exchange as well as The Stock Exchange, London. Firm underwriting of equity-raising Stock Rights Offerings is a principal specialty service of the bank.)

Raising capital with additional equity rather than debt is increasingly desirable for leading corporations today. Relatively high levels of debt already exist on corporate balance sheets. Debt/equity ratios are already under strain; and costs remain high for any assumption of new debt. Meanwhile there are many outstanding current corporate investment opportunities available. Proceeds of equity financing may be profitably reinvested at today's high rates of return or used for general corporate expansion.

The Hallwood Group's stock rights method for raising new equity capital for its corporate clients is a most useful alternative today to the more common recent market practice of direct new issue offerings. Neither technique is universally superior. In fact, in the London market—where the principle of shareholder preemptive rights is dominant—the Hallwood-style stock rights method of equity capital raising is the overwhelming choice of corporations. In recent years there have been some seven rights offerings per month in the London market.

Since the early 1970s, Hallwood has underwritten stock rights offerings for many U.S. and NYSE-listed companies as well as London-listed corporations. In the light of this successful rights underwriting experience—as well as the experience of other leading merchant bankers utilizing the technique—the Hallwood merchant banking team is well equipped today to serve U.S. corporations by providing new equity capital through underwritten stock rights offerings. The service has proved especially useful to corporate clients where the corporation seeks to increase its equity by some 20 to 25 per cent. In that general circumstance, Hallwood-designed rights programs offer four distinct advantages:

1. The program fairly rewards and further encourages investors seeking longer-term capital gains—whether individuals or institutions—by granting present shareholders pre-emptive rights in the offering to purchase new shares at a slight discount to market. Alternatively, present shareholders may sell their discount rights for their equivalent market value. In conventional new issue offerings, on the other hand, present shareholders normally receive no priority.

2. In Hallwood-planned and client approved equity-raising programs, client directors and corporate officers are fully assured of total fulfillment since Hallwood Group (backed by its own substantial assets and its highly-developed international sub-underwriting network) firm underwrites each rights offering on the effective proxy date and remains at total risk for one full month. This contrasts with the "best efforts" commitment that frequently applies in conventional new issue offerings.

3. Hallwood's service fees for its stock rights equity programs are substantially lower—they equal 2 per cent of funds raised—compared with customary charges for conventional new issue offerings where 6 percent fees are not uncommon.

4. Hallwood programs provide the advantage

of virtually instant market assimilation of new shares created in its rights offerings. In contrast, with conventional new issues there are often protracted and investor-discouraging periods of minimal stock price movement following an offering. The after-market advantage of Hallwood programs relates, in fact, to the intrinsic structure of rights offering plans themselves, and the high degree of stock value and price predictability which the plans permit.

Characteristics of Hallwood Programs Hallwood programs are based on fundamental criteria tested in extensive experience with rights offerings on the New York Stock Exchange; The Stock Exchange, London; and on other world exchanges. A first criterion is that a shareholder in a healthy, growth company with relatively actively-traded shares (perhaps 5 per cent or more of shares outstanding changing hands monthly in NYSE trading) is predictably highly responsive to an offer of rights to buy new shares if the offer is for purchase of one new share at a slight discount to present market price for every four shares presently owned. Thus, an increase of shareholders funds of some 20 per cent is a well-demonstrated parameter for success in rights offerings. Secondly, in a Hallwood rights offering, shareholders who do not wish to take up their rights are not required to invest further cash in the newly-offered shares at all. They have the option to sell their rights in a rights market which is promptly created when the offer becomes effective. Indeed, rights markets have proved to be very active on the New York Stock Exchange. Activity is underscored by Exchange rules which permit, in effect, higher margin (up to 75 per cent) for rights purchases. Finally, in a Hallwood-style rights offering, the basic issue price (the discounted new share price for each four shares held, defined as the ex-rights price) is set by actual supply and demand in the market for the corporation's shares at the time the rights offer goes effective.

Thus, since the amount of discount-to-market in the one new share offered the holder of four shares will be directly assumed in the trading price of each *right* to the discount, the actual amount of the discount is technically irrelevant from the point of view of the corporation raising the new equity funds. The shareholder is not prejudiced whether he elects to buy the new shares offered him or to sell his rights to do so in the rights market. In a sense, the market utilizes the actively-traded rights as a balance wheel mechanism during the rights offering period. The common stock price and the price of the right will be kept in instant equivalent value balance by market forces.

Meantime, the corporation will have likely already put its new equity funds to work for present (and future) shareholder benefit. A hypothetical, yet typical example of a Hallwood-style rights offering may help illustrate the entire procedure.

A Typical Example Let us suppose that Company "A"—with its shares listed on the New York Stock Exchange—decides that shareholders can benefit substantially if the company can raise some $22 million in new equity capital. Presently, Company "A" stock-

holders' equity is $83,325,000; 3,333,000 shares are outstanding; book value is $25 per share; and the shares are now trading on the NYSE at $30 per share.

Hallwood is asked to prepare a plan to raise $22 million, and the Hallwood plan is approved by Company "A". The main structure of the approved offering is as follows: Company "A" shareholders are granted 1 right for each share presently held; and, for every 4 such rights, one new common share of Company "A" may be purchased at $27, or a 10 per cent discount from market.

At a quick glance, one might expect that the market for Company "A" shares might plunge downward to $27 per share. However, a value computation quickly shows that no such drop would occur. In fact, Company "A" stock can expectably be modified downward by market forces only very slightly, to approximately $29.40 per share:

Each shareholder receives 1 right for each share presently held, and the privilege of utilizing 4 rights to purchase 1 new common share of Company "A" for $27:

—Value of shareholder's original shares at market	= $120
—Cost of 1 new share	= 27
—Value of total holding	= $147
—Market value per share, post offering ($147 divided by 5)	= $29.40

Importantly, because the value at market of the 5 shares held after the offering ($147) is the same as the market value of the original 4-share holding ($120) plus the price paid for the new share ($27), shareholders who subscribe for rights to shares record no gain or loss in the transaction. Similarly, a Company "A" shareholder who elects to sell his rights rather than subscribe to the offering records no gain or loss in the transaction.

In the Company "A" case, the initial value of each right will be 60 cents, with the value of 4 rights $2.40:

—Value of original 4 shares at market	= $120.00
—Value of same 4 shares post offering (4 times $29.40)	= $117.60
—Value of 4 rights necessary to purchase 1 new common share	2.40
	$120.00

On a value analysis basis the call value of each right and its market value will be paired during the entire rights offering period, and market forces will price the rights and Company "A" common shares in tandem accordingly. In any case, no gain or loss is realized, and no Company "A" shareholder is disadvantaged whether he elects to exercise or to sell his rights.*

The rights market which immediately develops in Company "A" rights is very important since, in effect, it protects the value of Company "A" shares. It may possibly even enhance the price of Company "A" shares indirectly, since a new audience of investor support—one interested in lower-priced investment vehicles—may be attracted to Company "A" via the rights market. Moreover, the rights purchaser can participate with the special advantage of using, in effect, 75 per cent

*A shareholder may also purchase rights during the offering so that he will hold a sufficient number of rights to purchase an even number of new shares.

margin compared with the 50 percent margin rule now in effect for purchasing common stocks.

Recall, too, that Company "A" has demonstrated itself to be a healthy, growth company which is well regarded by the investment community and with its shares actively traded. A clear reflection of investor esteem for Company "A" and its management, of course, is the fact that the common shares have been trading substantially above book value ($25 per share). In addition, since the new share subscription price ($27) is also above the pre-offering book value, and despite the fact that 25% more shares will be outstanding, the post-offering book value per share will actually be slightly above the pre-offering $25 per share.

Since Company "A" shares are trading at approximately $29.40 as the rights offering begins, the shareholder who elects to sell his rights (at 60 cents each) would be selling above book value. Moreover, Company "A" shareholders—whether they subscribe to new shares or sell their rights—jointly benefit substantially from the overall results of the rights offering.

Overall Results of the Offering In the example, Company "A" will raise $22,497,750 (and net $22,047,795 after deducting the 2 per cent underwriting fee) from the sale of 833,250 new shares at $27 per share. The new shares (833,250) of course represent one new share for each four originally outstanding (3,333,000), so that shares now outstanding total 4,166,250. Stockholders equity has of course increased from $83,325,000 to $105,372,795, or approximately $25.29 per share.

The important overall benefit to all Company "A" shareholders of course relates to the uses and benefits from the new equity capital raised by the company. Company "A" officers and directors may indeed have many outstanding options for beneficial use of the new funds, including these:

- —the company may elect to use the funds (or part) to make a key acquisition on favorable terms;
- —it may elect to re-invest the funds (or part) for the short or long term at today's high interest rates;
- —Company "A" may elect to use the funds (or part) to build facilities to expand production, to seize opportunities to expand market shares; or to launch a new product or series of products with major high profit growth potential.

The options are of course numerous. Singly, or in combination, they can yield most beneficial results for Company "A" shareholders. A primary reflection of those benefits is likely to be steadily increasing earnings per share at rates higher than earnings of its competitors, and the compensatory relatively higher price/earnings valuation of Company "A" shares compared to its competitors.

In fact, in Hallwood-planned stock rights offerings generally, earnings per share will increase following completion of the offering providing the company's marginal return on capital is higher than its average return. In a

given instance, retiring a significant short term debt with part of the proceeds of a rights offering may achieve a higher marginal return on capital because of interest cost savings. Similarly, placing the funds to achieve today's market rate of interest (presently approximately 12 per cent) can help achieve higher marginal return on capital and higher earnings per share if that market rate of return is higher than a company's average current return on capital.

Of course if a company has a present return on capital above even today's high market rates of interest, it might be best advised to invest its new funds from its rights offering in its own business to help expand operations, increase production, gain higher market shares for its products over its competitors, and still further improve its total return on capital for on-going greater benefits to shareholders.

Moreover, in the Company "A" case as in all Hallwood rights offering programs, the near and longer-term benefits to shareholders are predictably plannable by management with full assurance of the total new equity funds to be raised. This of course is because it is Hallwood Group's policy to firm underwrite its stock rights offerings rather than offer its services to clients only on a "best efforts" basis. Additionally, in the case of Company "A" as in all its offerings for equity raising by stock rights, Hallwood Group's fee for the entire service is 2 per cent of funds raised. That is substantially less than fees commonly assessed by other underwriters.

As a further potential advantage to its stock rights clients—depending on the degree of response of the client's shareholders to the offering—rights offerings firm underwritten by Hallwood Group may bring a desirable, widely-dispersed new group of investors to the company's shares. These are the quality international funds in the United Kingdom, Switzerland, Holland and Japan which comprise Hallwood's international network of sub-underwriters. Any unsubscribed shares which Hallwood might receive in one of its underwritten rights offerings would be allotted and distributed, in accord with appropriate sub-underwriting agreements, to the quality funds in the international network. These funds would hold any such Company "A" shares—or those of any other quality growth client of Hallwood Group—with a view to long term capital gains appreciation. Indeed, long term investment is the fundamental perspective of all the major international funds in the Hallwood Group network.

The long term view is central as well to Hallwood Group's total client service philosophy. This is the case regardless of which specific merchant banking service Hallwood is performing for a client. While actual financings may be planned and accomplished for clients in a short span, the perspective and intention of a Hallwood Group service is always to assist the long term, continuing success of the client's enterprise.

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A Word About The Hallwood Group, Inc.

The Hallwood Group is a publicly-owned company listed on the New York Stock Exchange and The Stock Exchange, London, with net assets of approximately $100 million. Shares are widely held, with more than 12,000 holders in the U.S. and the United Kingdom.

The largest Hallwood shareholder is a private company controlled by Hallwood Group senior management. Substantial share stakes are also held by Britannia Arrow Holdings PLC, M & G Investment Management, Scottish Northern Investment Trust Limited and Gartmore Investment Limited.

Britannia Arrow Holdings PLC is a public company listed on The Stock Exchange, London. It has extensive fund management interests in the United States and it is one of the most important fund management companies in the United Kingdom.

M & G Investment Management Limited is a subsidiary of M & G Group PLC which is listed on The Stock Exchange, London. The Group is controlled by Kleinwort Benson PLC, one of the United Kingdom's largest and most influential merchant banks. On a discretionary basis, M & G manages and advises mutual funds, pension funds, closed-end investment trusts and insurance company funds totalling approximately $3 billion.

Scottish Northern Investment Trust PLC is a publicly-owned Scottish investment trust with assets of approximately $250 million.

Gartmore Investment Limited is a fund management company managing closed-end investment trusts, pension funds, open-ended unit trusts, insurance company funds and corporate portfolios. Assets under management total approximately $1.8 billion. Gartmore is owned jointly by British and Commonwealth Shipping Limited and EXCO Limited. The latter company is well known for its service of providing financial information through its Telerate business in the United States.

In addition to its other activities, Hallwood Group specializes in the merchant banking service of assisting unrelated publicly-owned companies in raising new equity share capital through the medium of cash-underwritten rights offerings. Merchant banking is conducted by Interallianz Hallwood, a company jointly owned by Hallwood Group and Interallianz Bank Zurich AG, a fully authorized, privately-held Swiss Bank with main offices in Zurich and Tokyo. Shareholders of Interallianz Bank include many of the leading corporations and financial institutions of Switzerland and Japan:

Bank Leu AG
Hentsch & Cie
Hilti Aktiengesellschaft
Industrie- und Handelsbank Zürich AG
«Winterthur» Schweizerische Versicherungs-Gesellschaft

Dai Nippon Printing Co., Ltd.
Fuji Oil Company, Ltd.
Kajima Corporation
Nippon Credit Bank, Ltd.
Nippon Steel Corporation
Suntory Limited
Tokyu Corporation
Toshiba Corporation
Toyota Motor Corporation

Interallianz Hallwood and the private predecessor company of Hallwood Group, Inc. (Hallwood Holdings) have since 1971 specialized in providing new equity capital to client companies listed on the principal stock exchanges of the United States, the United Kingdom and Europe. Over the years, while Hallwood generally acts as lead underwriter in offerings, a growing network of major international investment organizations has been assembled in the United Kingdom, Switzerland, Japan and elsewhere which is available to participate in Hallwood client projects in a sub-underwriting capacity. The conservative, long-term investment viewpoint of Hallwood's international sub-underwriting investors represents one of the fundamental special appeals of Hallwood-led underwritings to the extent, in any particular offering, that shares are not taken up by a corporate client's existing shareholders.

During 1984 Hallwood underwrote offerings in excess of $86 million. During the last five years equity capital has been raised for clients with a wide range of objectives.

Date of Underwriting or Placement	Client	Amount of Underwriting
September, 1979	Bank and Commercial Holdings Ltd.	$ 1,185,000
December, 1980	First Pennsylvania Mortgage Trust (NYSE-listed)	21,514,000
November, 1981	The UMET Trust (NYSE-listed)	20,030,000
April, 1984	Institutional Investors Trust (NYSE-listed)	17,662,000
April, 1984	Schlesinger International Fund (Luxembourg) SA	34,000,000
December, 1984	Saxon Oil Company Inc. (NASDAQ: "SAXO")	52,000,000