

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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SHARE PLANS: OPPORTUNITY OR NEW RISK?

Capital raisings through share purchase plans are becoming a market fad with a rising chance that they are more for the convenience of small companies and less for the convenience of small shareholders.

thebigpicture has found 34 share purchase plans, summarized in the table on page 4, currently open or completed since the beginning of December 2003.

The average market capitalisation of the companies involved is \$266 million. However, half of the 34 companies had a market capitalisation of \$20 million or less. The bias in usage is very much to the smaller end of town.

The 34 companies averaged 5,360 shareholders. Half had 1,900 shareholders or less according to their last public reports which would have accompanied annual reports late in 2003, in most cases.

This selection of companies could raise a potential \$937 million (given the \$5,000 limit per shareholder) without the issue of any documentation other than the terms of the offer and an application form.

One potential limit on how much could be raised is ASX listing rule 7.1. In general terms, this puts a cap of 15% on the number of shares being issued over 12 months

Share Purchase Plans: The Regulatory Background

Under some conditions, the Australian Securities and Investments Commission (ASIC) allows listed companies to raise capital from small investors without issuing any significant documentation, such as a prospectus, or supplementary information about business performance.

ASIC policy statement number 125 issued in March 1997 sets out the rationale for these raisings and class order 02/831 formalizes the conditions.

The relief is available for ASX listed companies so they can offer "small numbers of additional shares" to existing shareholders. ASIC currently puts an annual \$5,000 limit on the amount a single shareholder can invest under these so-called share purchase plans. This was increased from \$3,000 last year.

The original aim of the relief was to allow shareholders to top up their shareholdings when they held less than a marketable parcel. It was not intended to facilitate fundraising, according to ASIC.

Shareholders were able, through this means, to acquire smaller parcels of shares than it would normally be economic to purchase on the market.

With on-line execution of orders now commonplace and stamp duty having been removed, share purchase execution costs have been greatly reduced. The costs associated with a \$5,000 transaction could easily be close to 0.5% for the smallest of investors. On this count, the share purchase plans are less needed despite their burgeoning usage.

Subsequently, the rationale was broadened to offer relief from the prospectus requirement where the amount to be raised from each investor was to be "quite small" and the cost of legal compliance high compared to the amount being raised and the regulatory benefit flowing from compliance.

The ASIC policy document recognises that there is a trade-off between investment risk and the benefits from allowing the plans to proceed.

Underpinning the arrangements, for the regulator, are the ASX continuous disclosure rules. As long as they are being met and shareholders have access to annual reports "a shareholder should be able to make an adequately informed decision on whether to invest a relatively small additional amount, on the basis of that information, and without the benefit of a prospectus", according to ASIC.

(Continued on page 2)

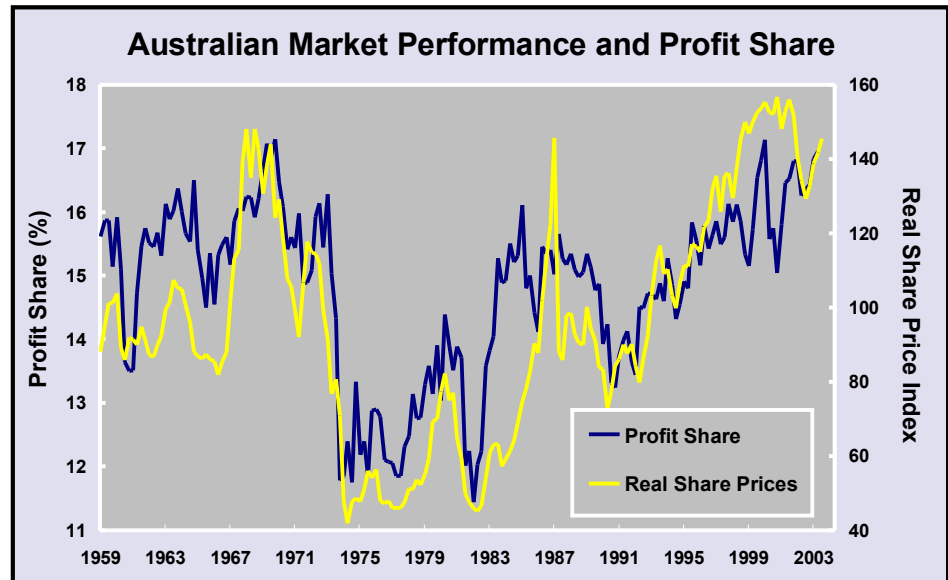
THE WEEKLY CHART SPOT

The ABS reported a 3.1% rise in corporate gross operating surplus (profit before interest and after tax) in the December quarter for a 12.1% rise over the year.

With income growth generally strong the profit share (relative to non-farm product) rose slightly from 16.8% to 16.9% keeping it at the upper end of its historical outcomes.

The chart illustrates that there is little history of sustained share price moves occurring without significant movement in the profit share.

History also suggests that any large move from this point (in either the profit share or the market) is more likely down than up.



Source: Australian Bureau of Statistics, ASX and thebigpicture Economics

SHARE PLANS: OPPORTUNITY OR NEW RISK? CONT'D

(Continued from page 1)

without shareholder approval.

In several recent instances, companies offering shares have anticipated that the number of new shares might exceed the number of shares allowed by the listing rule and have sought a waiver from the ASX. Where the requirement has been waived, companies have been allowed up to 30%, double the number normally permitted. Among the companies in the table which reported receiving a waiver were Tox Free Solutions, Hillgrove Gold and Alcaston Mining.

If there had to be more substantial documentation, many of the offers listed in the table would probably not have been made. The more obvious exceptions might be where companies have made placements of shares with institutions or professional investors and wish to ensure that their smaller shareholders get a chance to buy shares at a similar price.

Since significant placements are normally made at a discount to the market, small shareholders frequently feel aggrieved at missing out. Using a share purchase plan is a way of easing that tension.

National Australia Bank and Foster's are examples of larger companies which have used the share purchase plan as an investor relations tool in this way. Among the companies reviewed here, CSL, Macmahon Holdings, Highlands Pacific and Ale-

sco used the share purchase plan to follow up a placement. In each of these cases, the market capitalisation of the companies involved was at the upper end of the range of companies in the table.

Participating in a share purchase scheme after a placement modifies the risk for a small investor. He or she can take some comfort from knowing that a range of professional investors and analysts have reviewed the condition of the company, including reasons for a capital raising, and concluded that it warrants support. These larger companies, too, would normally receive greater general press scrutiny than the more numerous smaller users of the share purchase plan arrangements.

Most often, however, the plans have been initiated in an apparently opportunistic fashion to raise additional funds for unspecified general business purposes. In these situations, there are four concerns.

- Has all the relevant information required by a reasonable investor to make a decision been made available?
- Are investors making considered investment decisions or are they simply being tempted by the discounts on offer and the chance of a quick return?
- Do such fund raising activities conform with the spirit of the dispensa-

(Continued on page 3)

SHARE PLANS: OPPORTUNITY OR NEW RISK? CONT'D

(Continued from page 2)

tion by being 'small'?

- Does use of the relief raise the chance of a growing systemic risk for small investors?

Firstly, is the information adequate? One should be able to assume under the continuous disclosure obligations imposed by the ASX listing rules that all the relevant information for an investment is readily available. However, information does not flow evenly or continuously. For example, the day before the release of a company's annual results, there is less information than the day after. The results release and its validation by auditors and directors and subsequent review by professional analysts is normally considered a vital piece of information for investors.

In several instances among the companies reviewed here, share purchase plans were timed to conclude immediately prior to the release of half-year profit announcements.

Sound practice should require that companies are precluded from having offers open after the conclusion of an accounting period and before the release of the results for that period.

Where a share issue is unrelated to any specific transaction, it should be initiated after the release of an annual or half year profit result to ensure that investors are able to have access to timely prospectus-style information to assist their decision making.

What is the motivation for investment? In theory, a company should not be urging an investment on its shareholders. And, in recognition of this, all the companies include a caution in their shareholder letters about seeking appropriate investment advice before acting. However, they invariably urge participation by:

- suggesting that taking up shares in the plan is a sign of support for the company;
- indicating that it would be a convenient way of topping up an existing holding which might not be economic;
- emphasizing that there are no costs attached (unlike an on-market purchase which would attract brokerage); and,
- offering the shares at a, sometimes

substantial, discount to the existing share price.

Having a discount to the current market price is the norm for share purchase plan offerings. However, the magnitude of the discount can vary considerably. Among the surveyed companies, the lowest discount was 2.7%. The highest was 45%. Discounts of 10% and 20% were common.

Unsurprisingly, the company offering a discount of 45% had a take-up of 2½ times its targeted amount while subscriptions for most of the others fell well below their stated targets.

Framed in the right way, plans can easily be used to attract speculators and entice people to participate in ways more reminiscent of Kmart than Warren Buffett.

Are these fund raisings small? CSL raised \$111 million, a large absolute amount but equivalent to only 6.4% of its existing funds employed. In contrast, many of the raisings are of a few hundred thousand dollars. In a market where billions are being raised, the latter are barely a blip on the decimal point. However, they are not necessarily small relative to the impact on the individual company raising the capital.

In one instance among the companies reviewed, the amount raised exceeded the funds (net debt plus book equity) already employed in the business. In another, the raising approached 50%. In each of these cases (and arguably any case where the amount raised exceeds 20% of the funds already employed), there would be a material impact on the financial capacity of the firm. Using the description "small" might be a linguistic stretch.

In these cases, too, it is hard to believe that an investor has full access to the necessary information if he or she is not alerted explicitly to the potential of the issue affecting the balance sheet so substantially.

If the funds raised are critical to ongoing business operations, the use of the share purchase plan has probably gone beyond the original motivation for prospectus relief. The assumption that a share purchase plan is incidental or of no material importance is no longer valid.

At a minimum, an investor should be able to understand how important the fund rais-

"Framed in the right way, plans can easily be used to attract speculators and entice people to participate in ways more reminiscent of Kmart than Warren Buffett."

(Continued on page 4)

SHARE PLANS: OPPORTUNITY OR NEW RISK? CONT'D

(Continued from page 3)

ing is to the ongoing operations as a way of determining risk.

A serious investor would also need to know the company's likely course of action in the event that the fund raising fails to meet its objective.

Against this background, perhaps an extreme but clearly feasible illustration might put the systemic risk more clearly. Let's say a company with 10,000 shareholders initiates a share purchase plan. It is scheduled to close a week before the annual results are going to be released.

The company is known to have been performing poorly with losses in both the prior two years. Its last published balance sheet showed that its cash reserves would not be able to sustain another loss of the same size.

Company executives have said they expect at least another year of similarly poor returns. However, they have tempered their assessment with optimistic references to a brighter future.

This company makes a deeply discounted offer to its existing shareholders (say 30%) at a time when the market generally is rising so optimism is high and good deals are hard to find. It raises the maximum of \$50 million.

Its results are subsequently released. They show no improvement in business performance. The annoyance of large shareholders grows. They had already been losing patience and are upset at the dilution of their voting power by the share purchase plan. They begin selling their shares.

The price drops 75% within two days. Small investors, not having sold anything since their new shares are yet to be issued, are

facing losses of \$32 million, nearly two thirds the amount they subscribed.

We have learnt in recent years that our public capital markets can be undermined dramatically by events which are unlikely but which arise when people push what is legally permissible to the limits.

This is an example of what could happen as the convenience of small shareholders is subordinated to the capital raising objectives of companies which might not otherwise have such easy access to the capital market.

Recent Share Purchase Plans

	Market cap. (\$m)	Closing date	No. of shareholders	Potential raising (\$m)	Actual raising (\$m)	Discount (%)
Synergy Equities	4.7	5-Dec	4131	20.7	0.9	45.0
Chemeq	439.1	8-Dec	5573	27.9	8.4	7.5
Datafast Telecom's	23.8	18-Dec	6021	30.1	1.1	15.0
SSH Medical	5.0	19-Dec	2729	13.6	0.6	29.0
Westonia Metals	20.2	31-Dec	432	2.2	0.3	PP
Macmahon Holdings	256.6	23-Jan	5438	27.2	14.1	PP
Australian Pure Fruits	20.7	27-Jan	1209	6.0	0.7	20.0
ReLode	7.1	30-Jan	1042	5.2	0.5	10.0
Highlands Pacific	201.4	30-Jan	14645	73.2	23.0	PP
CSL	3962.7	30-Jan	52089	260.4	111.0	5.0
Drillsearch Energy	12.4	2-Feb	1482	7.4	0.9	20.0
Conquest Mining	14.1	6-Feb	1577	7.9	0.6	12.8
Golden Cross Resources	14.7	16-Feb	1216	6.1	1.9	8.0
Anglo Australian Resources	9.0	16-Feb	1345	6.7	1.2	15.0
Hillgrove Gold	23.5	16-Feb	1875	9.3	0.5	15.0
Citigold	61.5	23-Feb	5096	25.5	1.0	0.0
MPI Mines	206.1	24-Feb	2250	11.3	6.2	15.0
Alesco Corporation	375.5	27-Feb	4844	24.2	12.0	PP
Revenir	1.9	1-Mar	1185	5.9	0.6	20.0
Sino Gold	280.4	5-Mar	355	1.8	0.5	20.0
Service Point	3.0	5-Mar	2094	10.5	0.1	10.0
Tox Free Solutions	3.4	12-Mar	1088	5.4	0.1	18.6
Pacific Hydro	415.2	12-Mar	12404	62.0	14.5	5.0
National Telecoms	5.0	16-Mar	1436	7.2	NYA	20.0
Alcaston Mining	4.5	19-Mar	913	4.6	NYA	3.6
Bounty Oil and Gas	16.2	19-Mar	1272	6.4	NYA	20.0
Gradipore	61.5	22-Mar	5173	25.9	NYA	5.0
ING Industrial Fund	1251.8	22-Mar	19893	99.5	NYA	2.7
Centennial Coal	609.0	23-Mar	6451	32.3	NYA	2.6
Pacrim Energy	6.9	26-Mar	2402	12.0	NYA	20.0
New World Alloys	9.7	1-Apr	1083	5.4	NYA	20.0
ION	404.5	5-Apr	13902	69.5	NYA	3.0
Choiseul Investments	319.2	14-Apr	1897	9.5	NYA	2.5
Apollo Gold	12.9	16-Apr	2305	11.5	NYA	10.0

PP: Price at which earlier placement was completed.
NYA: Not yet available/no announcement made.

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