Capital Raising Steps

Capital raising for privately owned companies necessarily carries a tension between the amount of cash needed and the cost of obtaining it. The greater the equity in the company that is conceded, the greater the cost.

In the present market, the need for cash might be high and the challenge will be to ensure that the sacrifice in obtaining it is not too great. Suggestions to meet that challenge follow.

Sale and Leaseback Arrangements

A neat solution is a sale of an asset accompanied by entry into a lease of it from the new owner. In this way the value of the asset is unleashed, generating an immediate cash injection equal to the value of the asset, without interruption in the use of the asset.

Sale and leaseback arrangements are generally limited to commercial premises and high value plant and equipment. The sale proceeds will invariably be tax free, save to the extent of any depreciation recovered, and will facilitate repayment of debt and restoration of working capital, at the cost of an ongoing rental outlay for use of the asset. They have in some cases been implemented for illicit tax purposes (where, for example, the purchaser of the asset has tax losses and the arrangement is driven by the wish to utilise them by offsetting them against the rental income, thereby permitting an arbitrage of the tax benefits reducing the rental amount that would otherwise be payable). However, provided they are entered into for genuine purposes and the lease arrangement reflects commercially struck terms, the tax consequences become incidental and not problematic.

Ordinarily, in the case of real estate, the lease is on a "triple net" basis, by which the costs of ownership of the property are separated from the costs of operating the property. The seller, as lessee under the lease is liable only for operational costs including rent and Opex.

The price for the asset is supported by the ongoing rental stream. This lends a sale and leaseback arrangement towards one that will reflect market values regardless of business conditions and neatly aligns investor expectations with those of the seller.

Convertible Notes

Convertible notes are:

a. Debt in character insofar as they confer an interest entitlement and a right to be repaid (these rights are usually secured by a general security agreement);

b. Equity in character insofar as they confer a right to convert the notes to shares in the issuing company.

They have the advantage over shares in that they overcome the need for the investor and the issuer to agree on a valuation. In contrast, where cash is raised upon an issue of shares, the issuer is at peril of substantial dilution because the difficulty in agreeing upon a valuation usually results in an agreed ownership percentage for the investor that favours the investor.

Instead, in the case of an issue of convertible notes, this valuation problem can be deferred until the time the notes are due to convert. Often that will be triggered by an additional capital raising round, in which case there will be other data available by which the shares are valued and the conversion ratio for the notes may readily be established. Consequently, raising funds by way of convertible notes tends to be relatively easy and problem free, with protections for the investor (in the form of security) and for the issuer (in the form of delayed and market referenced valuation data to establish the conversion ratio).

Tax consequences of convertible notes are also relatively straight forward. They are subject to our financial arrangement rules and these respect the hybrid characteristics of the notes.

Redeemable Preference Shares (RPSs)

RPSs are similar to convertible notes in that they allow valuation to be deferred until later, again often when there is a wider capital raising round. The RPSs can be issued on terms that the amount payable on redemption is not determined until the redemption date and by reference to a chosen set of indicators.

There is enormous flexibility around the terms on which RPSs can be issued. Often they carry no voting rights (other than self protective voting rights which ensure their terms and priority are not disturbed). Where that is the case, from the issuer's perspective they essentially entail receipt of the subscription moneys and a debt payable on redemption, with no loss of capital in the interim. From the investors perspective they represent an investment that is made attractive by the dividend rate attached to the RPSs (pre 1992 the dividend was tax free between corporates) and/or an advantageous valuation established to determine the redemption amount. The investor also benefits from priority in repayment ahead of holders of ordinary shares.

Issuing RPSs is governed by the Companies Act and is straight forward. Some readers will recall specific redemption procedures prior to the 1993 Companies Act (creation of a share premium reserve on issue of the shares and the requirement for a redemption reserve of twice the par value of the shares in order to permit redemption). These are no longer applicable, instead redemption is now dictated solely by solvency of the company.

Shareholder Agreements versus Subscription Agreements

When admitting a new shareholder upon an issue of shares, I am sometimes asked whether the terms of issue can be built into a shareholder agreement or whether a separate subscription agreement is required.

Often the two are combined. While it is not wrong to do that, I believe it is better to keep them separate. The shareholders agreement should be viewed as operational, providing for how decisions about the company are to be made and placing any desired restrictions on them.

The subscription agreement on the other hand is purely a functional agreement establishing the obligation to issue and to subscribe for the shares, and their terms. Other than where specific warranties about the state of the company or subscription of the shares is to be underwritten by a third party, an agreement is not generally required and the objective can be achieved by a document recording the issue of the shares and their terms.

My advice therefore is to keep a shareholders agreement separate from any subscription agreement.

Don't hesitate to get in touch about any of these matters as I would be only too glad to help.