New issue costs and methods in the UK equity market

This article[1] sets out the results of an exercise to establish the costs of various types of new issue method for companies coming to the equity market for the first time and for existing quoted companies making further issues of equity (secondary issues). It examines the costs in terms of the expenses and, for initial offerings, derives estimates of the degree of 'underpricing'. It also looks at how the market is likely to change in response to changes in The Stock Exchange.

- *For initial offerings, placings involve significantly lower expenses than offers for sale and are the most popular method for small issues. Tenders are more accurately priced than fixed-price offers for sale, but a significant amount of 'underpricing' is still usual.*
- *The expenses involved in making initial offerings on the USM are lower than for the listed market.*
- *The lowest-cost method of making a rights issue is by deep discount, because such issues are not underwritten, but they are relatively rare.*
- *There are substantial economies of scale in all the new issue methods because of the number of costs which are unrelated to the size of the issue.*

Between January 1983 and March 1986, £7 billion was raised through initial offerings to the market, made when companies entered the Exchange for the first time; £6.5 billion was raised in the listed market and £0.6 billion in the USM. The choice of issue method depends upon Stock Exchange rules, the cost involved and the likely effect on the performance of the issue in the aftermarket. Under Stock Exchange rules, placings used to be limited to issues totalling £3 million or less. For small offerings the placing is the most favoured issue method, in part because the costs are significantly less than those for an offer for sale, and the vast majority of issues under the £3 million limit were by this method. On 27 October, the date of the Big Bang, The Stock Exchange changed its rules to enable placings to be used for larger issues—up to £15 million in the listed market and up to £5 million in the USM. For issues above the old £3 million limit, the offer for sale at fixed price predominated, but offers for sale by tender were also popular in the listed market. The tender method produces more accurate pricing of issues than fixed-price offers for sale but, in order to ensure a buoyant aftermarket, a significant element of underpricing is still usual.

Secondary issues by companies already quoted on The Stock Exchange have usually been rights issues and in the period January 1983 to March 1986, £11.6 billion was raised by this method. The cheapest method of making a rights issue is by deep discount, because there is no need for an underwriting group, but issues by this method are relatively rare. The predominance of rights issues reflected the strict pre-emption requirements in the United Kingdom. The Stock Exchange required companies to seek a favourable vote of the shareholders on the terms of each non-rights issue. As part of the rule changes on 27 October, the Exchange liberalised this requirement to give companies more flexibility to make non-rights issues, while at the same time retaining necessary safeguards for shareholders. This change could lead to the introduction of a wider range of techniques for secondary issues. The change in The Stock Exchange's rules to allow 100% outside ownership of member firms, which took effect in March this year, will also aid this process. This is because it has permitted the development of large securities conglomerates, which can use their greater capital resources to offer new types of service in the issue market—for example, bought deals, where the issuing house buys all the shares from the issuer and then feeds them out into the market.

Initial flotations of equity

A company seeking admission to the London Stock Exchange, either the listed market or the USM, has several choices of method. If a company simply wishes to obtain a Stock Exchange quotation for its existing shares, rather than linking its admission to the market with the issue of new shares to the market as a whole, it may be able to enter the market by *introduction.* But under Stock Exchange rules, a company entering the market by this route must have at least 100 shareholders and a significant proportion of the firm's shares must already be held by the public[2] —25% for a full listing and 10% for a quotation on the USM.

(1) This article was written by Mrs P D Jackson of the Bank's Financial Supervision—General Division.
(2) Shareholders other than directors and connected persons and large shareholders—ie those holding 5% or more of the company's equity.

If a company wishes to use the listing to raise extra capital from the market, it can make a placing (subject to the size limits set by The Stock Exchange) or an offer for sale—the latter can be at fixed price, or by tender. In a *placing* the company sells the new shares to the issuing house, which will have pre-placed the majority of the shares with its clients; one quarter of the issue must be made available to the general public by the sponsor or given to another distributor for its clients. (Until recently the rule was that a quarter of the issue had to be offered to the jobbers who had to pass on nine-tenths to meet any demand.)

In an *offer for sale* the issuing house or broker enters into an agreement with the company to purchase or find purchasers for the shares at a fixed price. The shares are offered to the general public at this price and the issuing house arranges for the issue to be sub-underwritten, at the same price, by a group of investing institutions. In an *offer for sale by subscription* the company (rather than the issuing house or broker) offers the shares direct to the public. But this is largely a technicality because such issues are generally underwritten by an issuing house or broker, giving the issue almost the same form as a usual offer for sale. The offer for sale by subscription is a rare form of issue method, largely confined to investment companies.

The final variant is an *offer for sale by tender.* This differs from the offer for sale at fixed price in that the public is invited to tender for the shares at any price over a stated minimum. In a true tender the minimum price accepted would be the price which just ensured that all shares were sold. Each investor who had tendered for shares at above this price would be allocated shares at the price each had tendered. However, this method is not used for equity issues in the London market; instead, issues are made using a common price tender. A single striking price is set to ensure that the issue is sold and investors who had tendered for shares at a price at or above it receive shares at the striking price. In order to ensure that the aftermarket is buoyant and that there is an adequate distribution of shares in the hands of the public, the striking price is usually set at a point where demand for the issue by investors exceeds the available supply and investors' bids for shares are then scaled down. In an offer for sale by tender the issuing house or broker agrees to purchase or to find purchasers for all the shares at the minimum price, and it is sub-underwritten by the investing institutions at that minimum price.

The choice of new issue method

The choice of issue method reflects differences in the costs inherent in the different methods and also concern about the performance of the issue in the aftermarket. A placing is the most favoured method for small issues, in part because the costs are likely to be lower than those of an offer for sale as a placing does not involve sub-underwriting by the investing institutions and the advertising obligations are less. In addition, there is a general view that widespread advertising, which is part of the offer for sale process, is not appropriate for small issues because it could generate more demand than could be satisfied, unless issues were given a high price which might not be sustained in the aftermarket.

The choice between a fixed-price offer for sale and an offer for sale by tender is largely dependent upon the nature of the company and market conditions. A tender method is used when there is some uncertainty about the price at which the shares should be sold. This might be either because the company has some unusual features, making a direct comparison with other quoted companies difficult, or because market conditions are such that prices are changing rapidly, for example in a very buoyant market. In theory the tender method could be used to ensure that the issue is finally priced very close to the market. But this is clearly not the case if the striking price is set at a point where bids for shares exceed the available supply and therefore have to be scaled down.

In an offer for sale at fixed price the issuing houses price conservatively as a protection against the risk inherent in bringing an untried company to the market for the first time. Even in an offer for sale by tender it is not necessarily clear how much demand there is for the shares at different prices, because some investors ask for more shares at a particular price than they actually want, in the expectation that bids will be scaled down, given that this is the usual practice. The reluctance to price aggressively reflects the fact that in the United Kingdom the success of an issue tends to be judged by market participants according to the buoyancy of the aftermarket, and the associated premium in the issue price, even though this represents an opportunity cost to the existing shareholders of the company issuing the shares. In general a fixed-price offer for sale is regarded as extremely successful if it is up to four times oversubscribed and the price goes to a premium of about 10% in the aftermarket.

In the period January 1983 to March 1986, 367 companies entered The Stock Exchange by a method which involved the raising of new ordinary share capital from the market—the majority (256) of these companies entered the USM and 111 gained a full listing. These figures do not include introductions or transfers from the USM involving the raising of new funds through placings or rights issues. Nor do they include issues for assets, such as vendor placings (discussed later). Tables A and B set out the amount raised by each issue method broken down into size of issue—up to £3 million, £3–5 million, £5–10 million, and over £10 million. In total, £6,451 million was raised from the listed market (including the £3,916 million British Telecom issue) and £559 million was raised from the USM. In the up to £3 million bracket by far the greater part of issues, by amount raised, were placings (70% in the listed market and 94% in the USM). The majority (85% in the listed market and 71% in USM) of issues (by amount) exceeding the £3 million limit for placings were fixed-price offers for sale, but offers for sale by tender were also reasonably widely used for medium-sized issues—tenders accounted for 25% of issues amounting to between £3 million and

Table A
New issue methods: amount raised by companies seeking a full listing for equity

	1983			1984			1985			Q1 1986			Total		
Size of issue	Amount raised £ millions	Per cent of total	Number of issues	Amount raised £ millions	Per cent of total	Number of issues	Amount raised £ millions	Per cent of total	Number of issues	Amount raised £ millions	Per cent of total	Number of issues	Amount raised £ millions	Per cent of total	Number of issues
Up to £3 million															
Placings	—	—	—	19.0	100	7	11.3	79.6	4	6.0	100	3	36.3	70.1	14
Offers for sale (a)	7.3	57.9	3	—	—	—	2.9	20.4	1	—	—	—	10.2	19.7	4
Tenders (b)	5.3	42.1	2	—	—	—	—	—	—	—	—	—	5.3	10.2	2
Subscriptions	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Total	12.6	100	5	19.0	100	7	14.2	100	5	6.0	100	3	51.8	100	20
£3–5 million															
Placings	—	—	—	—	—	—	—	—	—	3.6(c)	41.9	1	3.6	4.2	1
Offers for sale	3.8	19.9	1	14.7	63.4	4	22.1	63.5	5	5.0	58.1	1	45.6	53.2	11
Tenders	15.3	80.1	4	3.5	15.1	1	12.7	36.5	3	—	—	—	31.5	36.8	8
Subscriptions	—	—	—	5.0	21.5	1	—	—	—	—	—	—	5.0	5.8	1
Total	19.1	100	5	23.2	100	6	34.8	100	8	8.6	100	2	85.7	100	21
£5–10 million															
Placings	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Offers for sale	9.7	22.9	1	44.7	87.3	6	105.4	84.2	15	11.0	100	2	170.8	74.3	24
Tenders	32.7	77.1	4	6.5	12.7	1	9.7	7.8	1	—	—	—	48.9	21.3	6
Subscriptions	—	—	—	—	—	—	10.0	8.0	1	—	—	—	10.0	4.4	1
Total	42.4	100	5	51.2	100	7	125.1	100	17	11.0	100	2	229.7	100	31
Over £10 million															
Placings	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Offers for sale	79.4	46.0	4	4,358.1	87.3	9	539.6	83.4	11	253	93.9	1	5,230.1	86.0	25
Tenders	93.2	54.0	5	625.7	12.5	3	80.4	12.4	2	16.5	6.1	1	815.8	13.4	11
Subscriptions	—	—	—	10.8	0.2	1	27.0	4.2	2	—	—	—	37.8	0.6	3
Total	172.6	100	9	4,994.6	100	13	647.0	100	15	269.5	100	2	6,083.7	100	39
Total issues															
Placings	—	—	—	19.0	0.4	7	11.3	1.4	4	9.6	3.3	4	39.9	0.6	15
Offers for sale	100.2	40.6	9	4,417.5	86.8	19	670.0	81.6	32	269.0	91.1	4	5,456.7	84.6	64
Tenders	146.5	59.4	15	635.7	12.5	5	102.8	12.5	6	16.5	5.6	1	901.5	14.0	27
Subscriptions	—	—	—	15.8	0.3	2	37.0	4.5	3	—	—	—	52.8	0.8	5
Total	**246.7**	**100**	**24**	**5,088.0**	**100**	**33**	**821.1**	**100**	**45**	**295.1**	**100**	**9**	**6,450.9**	**100**	**111**

(a) Fixed price offers for sale.

(b) Offers for sale by tender.

(c) An exception to the £3 million limit for placings which was made for technical reasons for an Irish issue.

Table B
New issue methods: amount raised by companies seeking a USM quotation for equity

	1983			1984			1985			Q1 1986			Total		
Size of issue	Amount raised £ millions	Per cent of total	Number of issues	Amount raised £ millions	Per cent of total	Number of issues	Amount raised £ millions	Per cent of total	Number of issues	Amount raised £ millions	Per cent of total	Number of issues	Amount raised £ millions	Per cent of total	Number of issues
Up to £3 million															
Placings	66.8	93.3	57	112.6	90.9	75	142.5	95.8	77	12.7	100	6	334.6	93.7	215
Offers for sale	3.6	5.0	2	6.1	4.9	3	1.0	0.7	1	—	—	—	10.7	3.0	6
Tenders	—	—	—	5.2	4.2	2	5.3	3.5	2	—	—	—	10.5	3.0	4
Subscriptions	1.2	1.7	1	—	—	—	—	—	—	—	—	—	1.2	0.3	1
Total	71.6	100	60	123.9	100	80	148.8	100	80	12.7	100	6	357.0	100	226
£3–5 million															
Placings	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Offers for sale	8.2	29.9	2	11.5	100	3	13.6	100	3	—	—	—	33.3	63.4	8
Tenders	19.2	70.1	5	—	—	—	—	—	—	—	—	—	19.2	36.6	5
Subscriptions	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Total	27.4	100	7	11.5	100	3	13.6	100	3	—	—	—	52.5	100	13
£5–10 million															
Placings	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Offers for sale	24.2	80.4	3	15.3	100	2	38.4	100	6	6.9	100	1	84.8	93.5	12
Tenders	5.9	19.6	1	—	—	—	—	—	—	—	—	—	5.9	6.5	1
Subscriptions	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Total	30.1	100	4	15.3	100	2	38.4	100	6	6.9	100	1	90.7	100	13
Over £10 million															
Placings	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Offers for sale	—	—	—	25.7	100	2	—	—	—	—	—	—	25.7	43.4	2
Tenders	13.5	40.3	1	—	—	—	—	—	—	—	—	—	13.5	22.8	1
Subscriptions	20.0	59.7	1	—	—	—	—	—	—	—	—	—	20.0	33.8	1
Total	33.5	100	2	25.7	100	2	—	—	—	—	—	—	59.2	100	4
Total issues															
Placings	66.8	41.1	57	112.6	63.8	75	142.5	71	77	12.7	64.8	6	334.6	59.8	215
Offers for sale	36	22.2	7	58.6	33.2	10	53.0	26.4	10	6.9	35.2	1	154.5	27.6	28
Tenders	38.6	23.7	7	5.2	3	2	5.3	2.6	2	—	—	—	49.1	8.8	11
Subscriptions	21.2	13.0	2	—	—	—	—	—	—	—	—	—	21.2	3.8	2
Total	**162.6**	**100**	**73**	**176.4**	**100**	**87**	**200.8**	**100**	**89**	**19.6**	**100**	**7**	**559.4**	**100**	**256**

£10 million in the listed market and 37% of issues amounting to between £3 million and £5 million in the USM. Offers for sale by subscription accounted for a very small proportion of issues on either the listed market (0.8%) or the USM (4%).

New issue costs
A company making an initial offering has to pay a wide range of expenses. Some of the costs are not affected by the size of the issue, making small issues relatively expensive. Whatever the size or type of the issue the

company is required (under the Companies Act and The Stock Exchange's rules) to publish a prospectus setting out detailed information on its financial state—for listed companies these requirements are set out in the listing particulars. The preparation of the prospectus involves considerable work and cost in terms of accountancy and legal fees. These fees depend upon the complexity of the issue, but are not directly related to its size.

Another cost which is largely fixed is the advertising charges. The Stock Exchange rules set out the minimum advertising requirements. For USM issues The Stock Exchange stipulates that a formal notice must be published in one national newspaper. But, although this is regarded as adequate for a placing, the issuing houses and brokers generally feel that for an offer for sale a prospectus should be published in a national newspaper to attract public attention. For the listed market The Stock Exchange generally requires that the prospectus be published in two national daily newspapers. However, they make an exception for issues which are within the limit allowed for placings—requiring only the publication of a prospectus in one national newspaper and a formal notice in another newspaper. In addition, the company frequently advertises its latest results to encourage demand for the issue. The company also has to pay for its inclusion in the Extel service publicising financial information.

The costs related to the printing of the prospectus, application forms, allotment letters etc are to a degree related to the size of the issue but they are also affected by the issue method. In a placing, there is no need for the distribution of application forms and prospectuses to the public. Receiving banks' charges are related to the number of applications submitted and the number of allotments made, and are therefore as much affected by the degree of oversubscription as by the size of the issue. In a placing, the registrars' fees are nominal or nil, because the number of initial investors is much smaller than in an offer for sale and the registration department of the issuing house often undertakes the initial registration of allotment letters.

The Stock Exchange's charges for companies seeking a full listing are based on the market value of the company (ie including any existing shares) rather than just the size of the new issue. These charges vary from £520 for a company with an issued share capital of £500,000 to £14,000 for a company with an issued share capital of £100 million. The Stock Exchange also has graduated annual charges based on the nominal value of the issued share capital from £520 for companies with capital of not more than £1 million to £3,680 for nominal capital exceeding £100 million. There are no initial charges for USM quotations (although there are charges for further issues) and the annual charge is fixed at £1,500.

One major cost which is based on the size of the issue is capital duty, which is paid by the company. It amounts to 1% of the amount raised by the issue of new shares. That part of an initial offering which involves the sale of existing shares is exempt from capital duty.

The remuneration of the financial institutions involved in the issue is based on the size of the issue. The issuing house or sponsor of an issue charges commission amounting to around 2% of the amount raised from the public and may charge an additional fee as well. The broker to the issue is paid a fee of around $\frac{1}{4}$% for arranging the sub-underwriting or placing. Under Stock Exchange rules it is necessary to have a broker to the issue (which would be a Stock Exchange member firm), to approach the Exchange, if the sponsor is not a member firm. The investing institutions which sub-underwrite offers for sale receive $1\frac{1}{4}$%. Both of these fees are paid by the sponsor out of its 2% fee. The broker to the issue may charge the company an additional fee to cover advice provided, under a separate arrangement. In some issues, to encourage active marketing, recognized intermediaries are paid commission of around $\frac{1}{8}$% by the company in respect of applications bearing their stamp.

Placings do not bear the same cost because they are not sub-underwritten by the investing institutions—saving the payment of the $1\frac{1}{4}$% fee. However, the brokers to the issue may receive a slightly higher fee for undertaking the placing of the shares.

On a straightforward offer for sale in the listed market amounting to £7 million the expenses might amount to around 8%, with the breakdown shown in Table C.

Table C
The expenses on a typical offer for sale of £7 million

	£	Per cent of amount raised
Capital duty (if all the shares issued in the offer for sale are new)	70,000	1.0
Stock Exchange listing fee (initial plus annual) for a company with total share capital of £14 million with a nominal value of £3 million	7,340	0.1
Advertising costs	98,000	1.4
Printing costs	30,000	0.4
Extel fees	1,500	0.0
Receiving banks' charges	10,000	0.1
Accountants fees	93,500	1.3
Legal fees	98,000	1.4
Issuing house fee (including sub-underwriting commission of $1\frac{1}{4}$% and the broker's fee of $\frac{1}{4}$%)	140,000	2.0
Additional advisers' fees	14,000	0.2
Total	**562,340**	**8.0**

These figures do not include the 15% VAT, charged on the fees, because the VAT can be recovered under the normal input tax rules by most trading companies and is therefore not usually a cost.

Thus professional (legal and accountancy) fees might account for around a third of the total expenses (although this would depend upon the complexity of the company and the issue). Fees to the issuing house and the broker might account for around a quarter of the total expenses, with over half of this payment going to the group of investing institutions sub-underwriting the issue. The other large components are the advertising costs and the capital duty. The expenses involved in making an issue are not, however, the only costs involved in an initial offering. Another important cost is any underpricing—ie the extent to which the price at which the shares are issued is less than that which the market subsequently establishes. This is a clear opportunity cost to the existing owners of the company.

An exercise was carried out to investigate issue costs, including both the direct expenses and underpricing. Data were collected where possible on the total expenses paid by the company (which are usually shown in the prospectus) for initial offerings made in the listed market between January 1983 and March 1986 and any initial offerings on the USM made between January 1984 and December 1985—a shorter period was used for the USM because of the substantially larger number of issues on that market. The sample covered equity issues for cash (placings, offers for sale, subscriptions or tenders) by companies registered in the United Kingdom or the Republic of Ireland. Any issues involving special factors, for example acquisitions, were excluded from the sample, as were any initial offerings of investment trusts. This gave a total sample of 98 issues on the listed market and 162 on the USM.

Data were also collected to help to establish the degree of underpricing. The samples used for underpricing and expenses were slightly different because there was one issue for which no information on expenses was available and one for which the share price following the issue was not available, making the calculation of the underpricing impossible. To allow time for the market for each issue to settle down, the share price after the first three months was used as the basis for the underpricing calculations. 'Underpricing' was calculated by using the growth in the share index (the FT-Actuaries all-share index for the listed market and the Datastream index for the USM), over the three months following the date the stock was listed on the Exchange, to estimate what the issue price could have been. The price taken for offers for sale by tender, when calculating the underpricing, was the striking price.

$I(t)$ = the index on the listing date
$I(t+3)$ = the index three months later
$P(t)$ = the issue price
$P(t+3)$ = the share price three months after the listing date
$P(e)$ = the estimated 'true market' price at the time of issue

$$P(e) = \frac{I(t)}{I(t+3)} \times P(t+3)$$

$$\text{Underpricing (per cent)} = 1 - \frac{P(t)}{P(e)} \times 100$$

This can give only a rough indication of the degree of underpricing because news about the sector or the particular company could lead to differences in the relative performance of the company and the market index. In addition, the underpricing does not necessarily represent pricing errors. It may be necessary, given the structure of the UK market, to sell a new issue, which is a relatively large block of stock, at a lower price than could be obtained for smaller blocks of stock in the secondary market. Also, market participants may be justified in pricing fixed-price issues conservatively, when they are bringing untried companies to the market for the first time, to protect both themselves and the company against the risk of failure. In effect, rather than charging higher underwriting fees to bring a relatively unknown company to the market, they may rely on conservative pricing to reduce the risks. But this does not affect the fact that it is a cost to the company.

Table D
Listed market: new issue costs, 1983–86 Q1

Costs as percentages of amounts raised; *numbers of issues in italics*

	Expenses			Underpricing + Overpricing –			Total cost		
	Number in sample	Average	Median	Number in sample	Average	Median	Number in sample	Average	Median
Up to £3 million									
Placings	*13*	11.2	10.3	*13*	5.8	5.7	*13*	17.0	13.9
Offers for sale(a)	*3*	17.8	20.8	*3*	- 3.6	- 1.5	*3*	14.2	13.5
Tenders(b)	*1*	8.8	8.8	*1*	- 6.7	- 6.7	*1*	2.1	2.1
Subscriptions	—	—	—	—	—	—	—	—	—
£3–5 million									
Placings	*1*(c)	6.1	6.1	*1*	4.0	4.0	*1*	10.1	10.1
Offers for sale	*10*	11.6	11.9	*10*	15.4	16.3	*10*	27.0	28.2
Tenders	*7*	10.0	10.0	*7*	8.4	5.8	*7*	18.4	14.7
Subscriptions	*1*	5	5	*1*	-26.2	-26.2	*1*	-21.2	-21.2
£5–10 million									
Placings	—	—	—	—	—	—	—	—	—
Offers for sale	*23*	8.6	9.0	*23*	2.3	4.1	*23*	10.9	13.2
Tenders	*6*	7.4	6.7	*6*	10.1	10.2	*6*	17.5	19.5
Subscriptions	—	—	—	—	—	—	—	—	—
Over £10 million									
Placings	—	—	—	—	—	—	—	—	—
Offers for sale	*21*	4.7	4.8	*22*	5.3	4.6	*21*	9.2	7.9
Tenders	*11*	3.7	3.3	*11*	7.3	3.8	*11*	11.0	7.0
Subscriptions	*1*	3.9	3.9	*1*	- 5.3	- 5.3	*1*	- 1.4	- 1.4

(a) Fixed price offers for sale.
(b) Offers for sale by tender.
(c) An exception from the £3 million limit for placings was made for an Irish issue.

Table E
Unlisted securities market: new issue costs, 1984–85

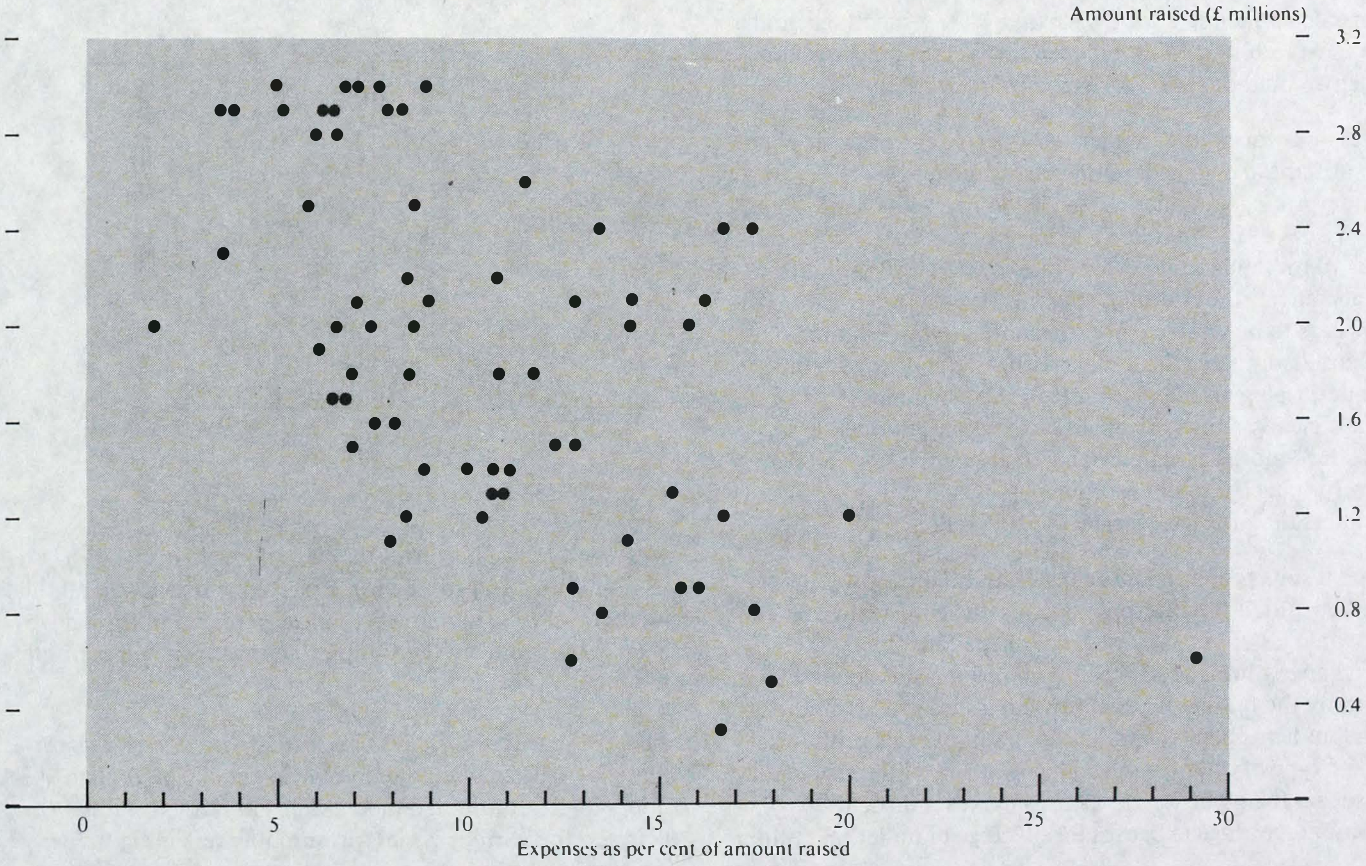
Costs as percentages of amounts raised; *numbers of issues in italics*

	Expenses			Underpricing + Overpricing –			Total cost		
	Number in sample	Average	Median	Number in sample	Average	Median	Number in sample	Average	Median
Up to £3 million									
Placings	*139*	11.1	10.0	*139*	9.5	9.8	*138*	20.5	18.9
Offers for sale(a)	*3*	16.6	15.6	*3*	– 0.2	– 9.6	*3*	16.4	6.0
Tenders(b)	*4*	8.6	8.0	*4*	8.9	4.1	*4*	17.5	13.5
Subscriptions	*1*	20.0	20.0	*1*	10.6	10.6	*1*	30.6	30.6
£3–5 million									
Placings	—	—	—	—	—	—	—	—	—
Offers for sale	*6*	7.9	8.9	*6*	9.1	10.6	*6*	17.0	20.0
Tenders	—	—	—	—	—	—	—	—	—
Subscriptions	—	—	—	—	—	—	—	—	—
£5–10 million									
Placings	—	—	—	—	—	—	—	—	—
Offers for sale	*7*	7.6	7.1	*7*	-11.4	-12.2	*7*	-3.8	-3.2
Tenders	—	—	—	—	—	—	—	—	—
Subscriptions	—	—	—	—	—	—	—	—	—
Over £10 million									
Placings	—	—	—	—	—	—	—	—	—
Offers for sale	*2*	2.3	2.3	*2*	– 8.4	– 8.4	*2*	-6.1	-6.1
Tenders	—	—	—	—	—	—	—	—	—
Subscriptions	—	—	—	—	—	—	—	—	—

(a) Fixed price offers for sale.
(b) Offers for sale by tender.

The results of the exercise are shown in Tables D and E. The figures clearly confirm that there are substantial economies of scale in new issues. In the listed market, the average expenses on offers for sale of up to £3 million are 17.8% of the amount raised but they fall to 11.6% for issues in the £3–5 million bracket, 8.6% for issues of £5–10 million and 4.7% for issues of over £10 million. The same pattern is clear in the figures for offers for sale on the USM. Chart 1, which plots the expenses on USM placings made in 1985 against the size of the issues, clearly shows the same effect. On small issues (under £1½ million) the expenses can amount to as much as 15% to 20% of the amount raised, whereas for placings towards the upper end of the £3 million limit the expenses can be around 5% to 10% of the amount raised. But the chart also shows the substantial variation in expenses for similar sized issues.

Chart 1
Expenses on USM placings in 1985



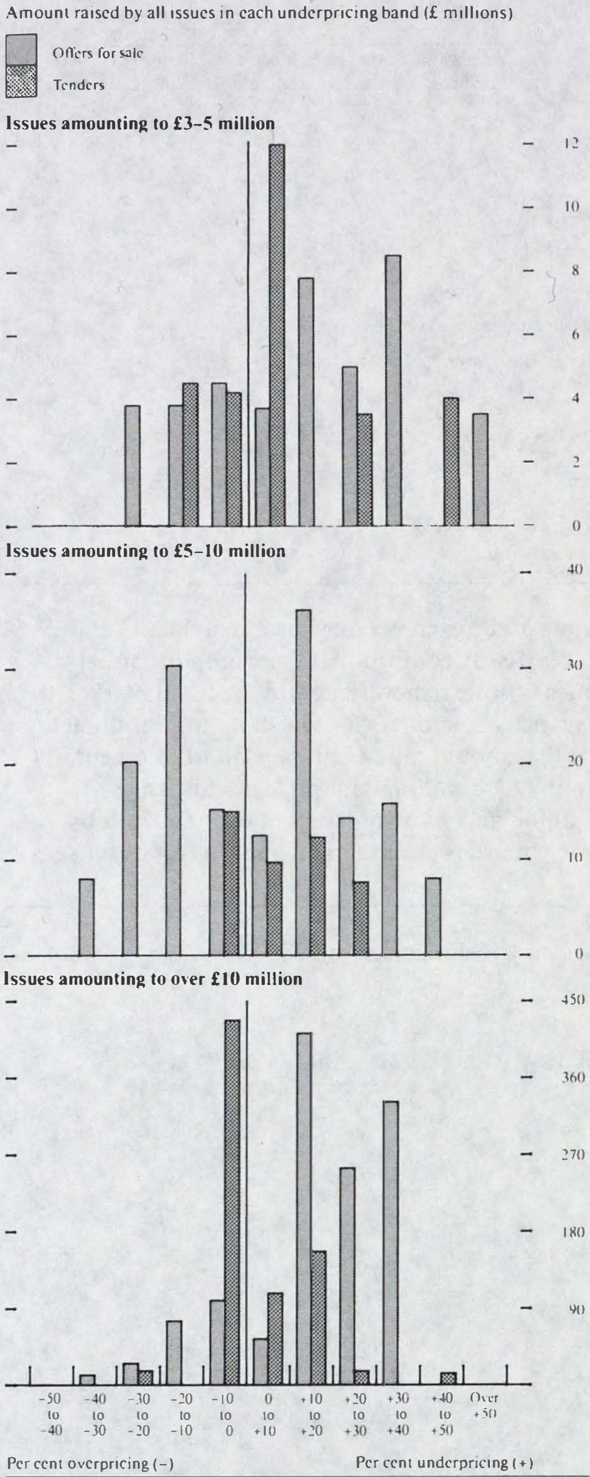
The figures in Tables D and E also confirm that the expenses involved in making issues on the USM are lower than for the listed market. In each size band the average expenses for offers for sale on the USM are at least 1% to 2% lower than those on the listed market. This partly reflects the lower advertising costs (because The Stock Exchange's requirements are less onerous for USM issues). In addition, the prospectus requirements are less stringent. In the listed market no more than six months can have elapsed since the date of the last audited accounts whereas in the USM the period is nine months. The Stock Exchange's fees are lower for USM issues but these are a small component of costs. The underpricing on offers for sale on the USM also seems to have been rather less than on offers for sale in the listed market, indeed on average they seem to have been overpriced. This is a surprising result given that the USM is a market for rather less well-known and smaller companies where accurate pricing might be expected to be rather more difficult, encouraging the sponsors to price issues conservatively to avoid the risk of failure. Some market participants would argue that this result is explained by the relative lack of liquidity of USM issues which leads the price to drift in the aftermarket, but one would expect that this would be taken into account in the initial pricing of the issue.

The expenses on tenders in the listed market appear from the figures to be somewhat less than those on offers for sale but the difference is not particularly marked and is in any case difficult to explain. The two issue techniques are in fact virtually identical, except for the pricing method. The average expenses for fixed-price offers for sale of £3–5 million are 11.6% and those on tenders are 10.0%. In the £5–10 million range, the average expenses for offers for sale and tenders were 8.6% and 7.4% respectively and in the over £10 million bracket the average expenses for the two methods were 4.7% and 3.7% respectively.

It is noteworthy that tenders (at the striking price) involve a substantial degree of underpricing. The average underpricing of tenders in the listed market is 8.4% for issues of £3–5 million, 10.1% for issues of £5–10 million and 7.3% for issues of over £10 million. This reflects the fact that, even in a tender, the price appears to be set to ensure substantial over-demand. Chart 2 compares the underpricing on tenders with the underpricing on offers for sale in the listed market. The chart clearly shows, as might be expected, that tenders produce more accurate pricing of issues. The spread from overpricing (−) to underpricing (+) is rather less for tenders than for fixed-price offers for sale.

The results presented in Tables D and E are, however, rather difficult to interpret as far as the comparative advantages of placings are concerned. The Stock Exchange's limit of £3 million on placings tended to stratify the market, with almost all issues of £3 million and under as placings and all issues of over £3 million as some type of offer for sale. The influence of the size of an issue on the percentage expenses makes it difficult to compare average expenses for placings of under £3 million

Chart 2
Underpricing on tenders and offers for sale, on the listed market



with the average expenses for offers for sale of £3–5 million. To provide some basis of comparison all the issues on the listed market totalling £2.5–3.5 million have been extracted from the sample. These are shown in Table F by type of issue.

This comparison of issues of a similar size does indicate that placings by and large involve lower expenses than offers for sale, although there is substantial variation between the various issues, presumably reflecting the

Table F
Comparison of the costs on offers for sale and placings

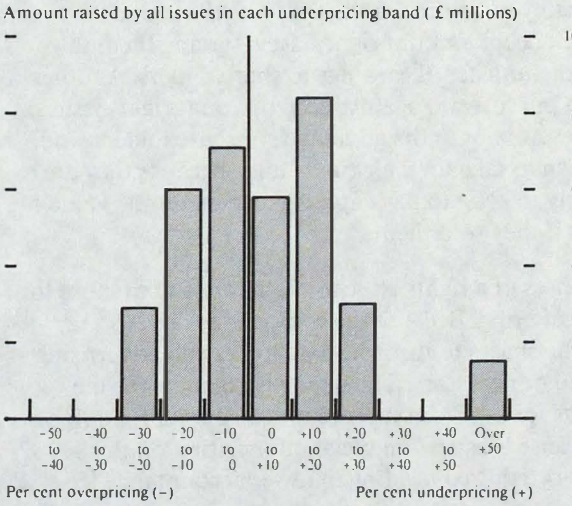
	Proceeds (£ millions)	Costs (per cent of amount raised) Expenses	Underpricing + Overpricing −	Total Costs
Offers for sale				
	2.5	8.6	4.9	13.5
	2.5	20.8	−14.1	6.7
	3.5	12.9	76.9	89.8
	3.4	10.1	17.6	27.7
	2.9	24.1	− 1.5	22.6
Average	**3.0**	**15.3**	**16.8**	**32.1**
Placings				
	2.9	5.0	8.9	13.9
	3.0	7.3	16.5	23.8
	3.0	10.3	27.4	37.7
	3.0	21.7	−14.4	7.3
	2.9	9.7	5.7	15.4
	2.5	8.9	10.7	19.6
	2.9	14.7	− 2.8	11.9
	3.0	3.8	− 0.2	3.6
	2.9	9.7	12.2	21.9
	2.9	13.3	−20.1	− 6.8
Average	**2.9**	**10.4**	**4.4**	**14.8**

different complexity. This cost advantage for placings is what one would expect because they are not sub-underwritten and there is less need for the company to promote itself widely.

The figures for underpricing do not, however, indicate a marked difference between the two methods. The average for the offers for sale is distorted by the very substantial underpricing of one issue. The underpricing for the other offers for sale is broadly in line with the underpricing of the placings. Chart 3 shows that the pricing of the majority of placings on the listed market by amount varied between overpricing of 10% and underpricing of 20%.

Chart 3
Underpricing on placings, £0–3 million, on the listed market

Amount raised by all issues in each underpricing band (£ millions)



Secondary issues

Existing UK quoted companies wishing to raise extra capital through a further issue of equity have traditionally made rights issues—ie the shares have been offered to the existing ordinary shareholders in proportion to their existing holdings. This reflects the pre-emption requirements which have been enshrined in The Stock Exchange rule book and, since 1980, in the Companies Acts as well (to implement the second EEC Directive on company law). Under the 1985 Companies Act a company proposing to allot equity securities for cash must offer them first pro rata to all existing shareholders. This requirement can be waived for a period of up to five years by a special resolution of the shareholders. The Stock Exchange's rules have been tighter than the Companies Act requirements because, regardless of any waiver of those requirements, quoted companies were required to obtain the approval of shareholders in a general meeting, for the actual terms of an issue. The Investment Protection Committees, which represent the large institutional investors, also laid down their own conditions—that waivers from the Companies Act requirements should generally only be for one year's duration and should not permit non-rights issues of more than 5% of the authorised share capital in any year. The pre-emption requirements are intended to protect shareholders from a dilution of their stake in a company and also from a dilution of their earnings through the sale of shares to the general public at a discount to the market price.

In the last few years there has been extensive discussion of the form which the pre-emption requirements should take. Some managements had begun to find The Stock Exchange's requirement for a vote on the terms of each non-rights cash offer rather inflexible at a time when structural changes in international financial markets were creating a wider range of capital-raising opportunities. This is because the necessity of holding an extraordinary general meeting (which under the Companies Act takes at least three weeks to arrange) led to a significant delay in carrying out an issue. In addition, some managements thought that the publicity surrounding the EGM vote tended to depress the company's share price at a crucial time. Because of this, companies—for example those wanting to make a foreign issue in order to widen their shareholder base or to promote their commercial image abroad—started to find ways round The Stock Exchange's rules. Under a long-standing Stock Exchange concession they could avoid the requirement for a vote on the terms of the issue by making a bond issue with a small convertible element (under 5% of the company's issued share capital) and encourage conversion into equity relatively quickly. However, such issues were not particularly to the advantage of either the management or the existing shareholders because the use of a convertible entails more risks for the company than a straight equity placement. The company is at the mercy of a wide range of market developments which may determine whether the bonds are converted into equity. Also the company has to conduct investor awareness exercises to ensure that when the bonds are converted, the equity ends up in firm hands. Companies involved in an acquisition had another way round The Stock Exchange's rules because they could use a vendor placing (see below) as an alternative to a rights issue.

To give managements greater flexibility while at the same time maintaining protection for the existing shareholders, The Stock Exchange started on 27 October to allow the waiver of pre-emption rights, in advance, for periods of up to one year, as long as they receive a favourable 75% vote from those voting at a shareholders' meeting (including proxies). This will enable the shareholders to impose conditions on any waiver. Issues must be within a firm's authorised but non-issued share capital, but the shareholders could impose further size limits on non-rights issues and also limits on the size of the discount vis-à-vis the market price of the existing shares at the time of the issue. To ensure that the shareholders have enough information on which to base any decision on the disapplication of pre-emption rights in future years, companies making a non-rights issue will have to disclose in the annual report the terms of the issue, including the price compared with the market price of existing shares.

The Companies Act and Stock Exchange pre-emption requirements do not apply to issues of shares for assets, for example vendor placings—ie where one company purchases another company by issuing its shares to the other company's shareholders and the latter acquire cash by placing the shares in the market, even though this amounts to the same thing as a company making a cash issue to raise the funds to purchase another company. Vendor placings can have the same effect on the existing shareholders, in terms of dilution of their holdings and their earnings, as other non-rights issues. For this reason there is pressure on companies from institutional investors to include clawback provisions. A vendor placing with 100% clawback is very similar to an underwritten rights issue, because the existing shareholders of the offeror company are given the opportunity to purchase all the new shares at the issue price. In a vendor placing with 100% clawback, all the shares are placed with the institutions but they have to hand back any shares demanded by the existing shareholders—in effect they are acting as underwriters. However, in contrast to a rights issue, the existing shareholders must take up their option to purchase stock to benefit from any discount because they have no rights which can be sold. In practice, the clawback provisions are often nowhere near as large as 100% and even in these cases the actual clawback is often significantly lower still. This probably reflects the fact that the institutions with whom the stock had been placed are likely, themselves, to account for a significant proportion of the shareholdings.

The different treatment of vendor placings and cash offers under the old Stock Exchange rules, gave companies flexibility when making acquisitions. A three-week delay for an EGM would have proved restrictive.

Issue costs

Rights issues are similar to offers for sale, except that they are offered pro rata to the existing shareholders rather than to the public at large. Rights issues are generally made at a 15% to 20% discount to the market price, but because the shares are issued pro rata to the existing shareholders this does not represent a cost—any shareholders who do not want to take up their rights can sell them and therefore gain the benefit of the discount. Such issues tend to be underwritten by an issuing house, which agrees to take up any shares not subscribed, and the issue is usually sub-underwritten (at a fee of 1¼%) by a group of the major investing institutions. Any shares which are not subscribed, because some 'lazy' shareholders do not take up or sell their rights, are generally sold in the market and the premium is distributed to those 'lazy' shareholders. The sub-underwriters will only have to take up any stock under their commitment if the share price of the existing equity falls sufficiently between the date when the issue price is fixed and the last date of acceptance, a period of at least 21 days, to wipe out the discount leaving the rights issue looking unattractive. But with discounts of 15% to 20% the probability is small.

Some companies avoid the need for underwriting and sub-underwriting by making deep discount rights issues. The discounts on such issues are usually in the 40% to 60% range. The expenses on such an issue are likely to be close to 1¼% rather than the charges of 3¼% or more on underwritten issues. Even though the differences in the costs of the two types of issue method are so marked, deep discount issues account for a relatively small proportion of rights issues (9% in 1985) and have been used mainly by financial firms. This may be because managements prefer the certainty of an underwritten issue. In a deep discount rights issue, the company stands the risk because it will raise less cash if the issue is not taken up—although the likelihood of this is slight given the size of discount. It may also reflect the fact that the 1¼% sub-underwriting fee is paid to a group of institutions which are likely to hold a significant proportion of a company's shares, and is therefore regarded as encouraging a favourable response to the issue. Another possible explanation is that managements are concerned that the market might react unfavourably to any cut in their dividend per share following a deep discount rights issue, forcing them to increase the transfer of earnings to shareholders. Another argument put forward against deep discount rights issues is that they are not to the advantage of shareholders who do not wish to take up their rights fully, because they are more likely to have to pay capital gains tax on the value of the rights if they sold them.

The expenses of a rights issue are rather less than those for an initial offering. Because the company is directly offering the shares to its own shareholders no advertising is required or necessary. The listing particulars (or the prospectus for a USM issue) are much simpler for a rights issue, because less new financial information on the company is required, leading to lower accountancy fees.

But the company does have to pay substantial printing and distribution fees and the legal fees are probably only slightly less than those on an offer for sale. The Stock Exchange charges a fee based on the value of the issue—the fee schedule for the listed market is the same as for an initial offering. The fees charged by the issuing house and sub-underwriters are also almost the same for rights issues and offers for sale—the issuing house takes a fee of around 2% and pays the sub-underwriters 1¼% and the broker to the issue ¼%. The typical expenses on a £100 million rights issue are shown in Table G.

Table G
Typical expenses(a) on a £100 million rights issue

	£	Per cent of amount raised
Capital duty	1,000,000	1.00
Stock Exchange listing fee	14,000	0.01
Printing costs	23,000	0.02
Distribution costs	14,000	0.01
Receiving banks' charges	42,000	0.04
Accountants fees	50,000	0.05
Legal fees	17,500	0.02
Issuing houses' fees (including sub-underwriting and brokers fees)	2,000,000	2.00
Total	**3,160,500**	**3.16**

(a) These expenses do not include the 15% VAT charged on the fees but this VAT can be recovered by most trading companies and is therefore not usually a cost.

By far the most important costs on such a large issue are the issuing house fees and the capital duty. The same is not true of small rights issues because, as in the case of offers for sale, the accountants' fees and legal fees are not related to the size of issue and therefore assume greater importance. The printing costs are also more significant for small issues. A typical rights issue of around £3½ million might have expenses amounting to 8%, with legal fees, accountants fees, printing and distribution costs and registrars fees accounting for around 5%. Capital duty at 1% and fees to the issuing house, broker and underwriters of around 2% would make up the rest.

The total expenses involved in rights issues made by a sample of 87 UK companies in 1985 are shown in Table H. The figures clearly show the substantial difference in cost between deep discount issues and other rights issues. They also show the economies of scale in rights issues. For usual underwritten rights issues, the average expenses as a percentage of the amount raised total 8¼% for issues of £3 million or less but fall to 4% for issues of over £10 million.

Table H
The costs of rights issues made in 1985

Average costs as per cent of amounts raised; *numbers of issues in italics*

	Deep discount issues		Other rights issues	
£1–3 million	—	—	*14*	8.2
£3–5 million	*1*	1.0	*9*	5.4
£5–10 million	—	—	*20*	4.4
Over £10 million	*4*	1.5	*39*	3.9

Future developments

The changes in The Stock Exchange will have important implications for new issue techniques in the United Kingdom. The change in The Stock Exchange's rules to allow 100% outside ownership of member firms has made possible the development of well-capitalised UK securities houses, incorporating banking, corporate finance, and broker/dealing activities. It has also opened the door to the participation of a number of large foreign securities houses and banks in the UK stock market through wholly-owned subsidiaries. In the new highly competitive market which followed the removal of minimum commissions and the introduction of the new structure at the end of October, firms will be keen to use their stronger capital bases to compete for business in the new issues market. One possibility is that they may underwrite issues, on competitive terms, bearing the risk themselves without arranging for sub-underwriting by the investing institutions. The issuing houses are increasingly likely to go one step further than this and carry out bought deals—a technique which is commonly used in the United States and which has started to be used in the United Kingdom. In a bought deal, a securities house purchases the whole issue from the company before placing it with investors. Such activities can only be carried out by well-capitalised firms with substantial placing power because they are potentially at risk for the whole amount until the stock is placed—although much of the risk can be laid off using various hedging techniques. The difference between a bought deal and a traditional UK placing lies in the timing and the exposure of the issuing house involved. In a placing, although the issuing house will technically purchase the whole of the issue and then place it with investors, it does not generally go on risk for the whole amount because it will have had time to pre-place almost all of the issue. This is in contrast to a US bought deal where the issuing house does not pre-sell the securities. The whole block of stock is taken on to the firm's book and it is then placed in the market.

The change in The Stock Exchange's pre-emption requirements may facilitate the development of a range of new types of issue method for existing quoted companies—although this will depend on the extent to which investors, particularly the large institutions, agree to waive their pre-emption rights. For existing quoted companies, it is possible that bought deal arrangements could be combined with shelf issue techniques which are also a feature of the US market. The shelf issue system in the United States dates from March 1982 when the SEC adopted Rule 415. Under this rule, well-established companies which meet the SEC's detailed criteria are able to pre-register securities which they expect to be issued within a two-year period by supplying the SEC with all the documentation necessary to gain permission for the securities to be issued. Once the registration is complete, the securities can be priced and sold at any time—as long as there has not been a fundamental change in the issuer's business. An issue can be brought off the shelf and sold within a matter of hours.

In the United Kingdom, a rights issue can easily take as long as three weeks to complete. The Stock Exchange takes around two weeks to assess whether the prospectus and other documentation for an issue complies with their requirements. It might be possible for a company to clear the documentation with the Quotations Department in advance of a specific intention to issue stock. But difficulties would be posed in the United Kingdom by the requirements to provide detailed statements on working capital and indebtedness. Full reliance could not be placed on statements prepared six months or so previously and the up-dating of these statements just before an issue was taken off the shelf would lead to delay, preventing companies from taking advantage of a sudden improvement in market conditions. This does not cause a difficulty in the United States because the shelf issue procedure is only open to well-established companies, which generally make detailed quarterly returns on their financial standing to the SEC. The information is publicly available, enabling investors and analysts to keep abreast of any new developments. This makes additional statements at the time of an issue unnecessary. It is possible that similar arrangements could be introduced here for any companies that wished to make use of a shelf issue arrangement.

The greater competition between large well-capitalised issuing houses, with the introduction of new techniques, should lead to some reduction in the expenses on new issues. One of the notable features of the current structure is the extent to which the charges for the issuing house, broker and sub-underwriters are fixed, with the issuing house receiving some 2% to 2¼% and passing on ¼% and 1¼% to the broker and sub-underwriters respectively. This means that there is almost no allowance in the fee structure for the different risks entailed in different issues. It is remarkable that the fees charged by the issuing houses and sub-underwriting institutions are almost identical for offers for sale, where the company is coming to the market for the first time, and rights issues, where the company is already quoted, even though the risks entailed in underwriting the latter must be substantially less. In a rights issue there is an existing share price on which to base the price of the issue. Clearly the value of the shares is not simply equivalent to the market price of the existing shares, because it depends upon the use to which the company will put the funds raised—if the company invests the funds in assets earning the same return as the existing assets the price should be the same. But the existing share price provides the benchmark. The sub-underwriters do carry the risk that they will have to take up any stock if the price of the existing equity falls below the price of the rights issue in the period of three weeks or so up to the acceptance date. But they are given a substantial degree of protection by the significant discount to the existing share price at which rights issues are made.

One possible reason for the substantial sub-underwriting fees for rights issues is the power of the large institutions in the UK market. Almost 60% of listed equities are in the hands of the institutions and a large proportion of those holdings is concentrated in the hands of around twenty large institutions, who may benefit disproportionately from the sub-underwriting fees. Before the change in The Stock Exchange's rules, companies were constrained from turning to foreign markets by the need to secure a favourable vote of their existing shareholders on the terms of each non-rights issue.

The costs of an underwritten rights issue in the United Kingdom are broadly similar to the costs of a shelf issue for a prominent quoted company in the United States, but the composition of the costs is rather different. In the United States, the costs on a £60 million shelf issue arranged using a bought deal might amount to around 3¾%,[(1)] made up of a 3% fee to the issuing house, underpricing (included as a cost because the shares are sold to the general public) of ¼%[(2)] and other issuer expenses of less than ½%. In contrast, a UK rights issue of about the same amount might cost 3¼%, made up of underwriting fees of 2¼% and other expenses of 1%. It is notable that the US houses, for a fee which is only modestly larger than the total fees paid to the UK financial community (for underwriting and sub-underwriting), bear substantially more risk. They take the whole issue on to their own book and are prepared to price the issue very close to the market. The very small discounts or even premiums which are common on bought deals for existing quoted companies in the US markets mean that any unexpected price movements following the issue date could lead to substantial erosion of the issuing houses' profits on the deal, but this is a risk they are willing to take, or are able to hedge, at least partially.

The greater awareness on the part of managements of the costs of various issue methods, which will be a feature of the new competitive environment, will probably lead them to weigh up the benefits and costs of traditional underwritten rights issue arrangements, compared with those of deep discount rights issues and also bought deals. The deep discount rights issue is likely to be the cheapest and the bought deal the quickest method of raising funds. The favoured method for a particular company will depend upon its particular circumstances.

(1) 'The Rule 415 experiment: Equity Markets'. Sanjai Buagat, M Wayne Marr and G Rodney Thomson. *The Journal of Finance*, Vol XL, No 5. December 1985.

(2) [(last trade price/public offering price) − 1] × 100