Understanding Stock Rights

What Does Stock *Rights* Mean?

1) A stock rights offer is a means for a company to raise funds by giving current stockholders the chance to purchase new shares issued by the corporation at a predetermined price (normally less than the current market price) in proportion to the number of shares already owned. Rights are issued only for a short period of time, after which they expire.

2) Cash-strapped companies can turn to rights offers to raise money when they really need it. In these rights offerings, companies grant shareholders a chance to buy newly offered shares usually at a discount to the current trading price. Let's look at how rights issue work, and what they mean for all shareholders.

The Rights Offer and Why It's Used

A rights issue is an invitation to existing shareholders to purchase additional new shares in the company. More specifically, this type of issue gives existing shareholders securities called "rights", which give the shareholders the *right* to purchase new shares at a discount to the market price on a stated future date. Those who decide to hold shares of a company issuing rights, will automatically be entitled to subscribe (or choose not to) if they hold through the ex-date. The company is giving shareholders a chance to increase their exposure to the stock at a discount price. Companies typically use rights offers to pay down debt or use such funds for company expansion plans, especially when they are unable to borrow more money from other sources.

How Rights Issues Work

So, how do rights issues work? The best way to explain is through an example.

Let's say you own 10,000 shares in Nihao Mines, each of which is worth Php15.00/share. The company now needs to raise cash to cover its necessities. Nihao therefore announces a rights offering, in which it plans to raise Php500,000,000 by issuing 500 million shares to existing investors at a price of Php1.00/share. It does this by giving a five-for-one rights issue. In other words, for every 1 share you hold, Nihao will offer you another five shares at a deeply discounted price of Php1.00. This price is 93% less than the Php15.00 price at which Nihao stock was trading for.

As a shareholder, you essentially have two basic options when considering what to do in response to the rights issue. You can (1) subscribe to the rights issue in full, or (2) ignore your rights. Here we look how to pursue each option, and the possible outcomes.

1. Take up the rights to purchase in full

To take advantage of the rights issue in full, you would need to spend Php1.00 for every Nihao share that you are entitled to under the issue. As you hold 10,000 shares, you can buy up to 50,000 new shares (five shares for every one you already own) at a discounted price of Php1.00/share, estimated at an additional investment of Php50,000. These new rights shares may only be sold during its scheduled listing date, or Dec 11, 2009 for Nihao.

The market price of Nihao will likely adjust after the rights issue is complete on the Ex-date. The value of each share will be diluted (or diminished) as a result of the increased number of shares issued. To see if

the rights issue does in fact give a material discount, you need to estimate how much Nihao’s share price will be diluted.
In estimating this dilution, remember that you can never know for certain the future value of your expanded holding of the shares, since it can be affected by any number of business and market factors. But the theoretical adjustment that the share price will result to after the rights issue is complete on the ex-rights day - is possible to calculate. This price is found by dividing the total price you will have paid for all your Nihao shares by the total number of shares you will own. This is calculated as follows:

10,000 existing shares at Php15.00	Php150,000
50,000 new shares for cash at Php1.00	Php50,000
Value of 60,000 shares	Php200,000
Ex-rights value per share	**Php3.33** (Php200,000/60,000 shares)

So, in theory, as a result of the introduction of new shares at the deeply discounted price, the value of each of your existing shares will decline from Php15.00 to Php3.33. But remember, the apparent loss on your existing shareholdings will be offset exactly by the gain in share value on the subscribed new rights. The new shares cost you only Php1.00, but with the current market value now at Php3.33, this reflects a corresponding gain.

2. Ignore the rights issue
You may not have the Php50,000 to purchase the additional 50,000 shares at Php1.00 each, so you can instead allow your rights to expire or not take it. *This however is not normally recommended if the price of the rights is lower than the present market price.* If you choose to do nothing, your shareholdings will be diluted thanks to the new shares being issued at a discount –this will effect a drop in the price of your stock and merit a direct loss from Php15.00 to Php3.33. On that circumstance when the rights offer price is higher than that of the market price, you may also decide not to get the offer and instead simply buy the corresponding shares off the regular board since it is cheaper.

Take Careful Note:
It is awfully easy for investors to get tempted by the prospect of buying discounted shares with a rights issue. But it is not always a certainty that you are getting a bargain. But besides knowing the ex-rights share price and details, you need to know the purpose of the additional funding before accepting or rejecting a rights issue. Be sure to look for a compelling explanation of why the rights issue and share dilution are needed as part of the recovery/expansion plan. Sure, a rights issue can offer a quick fix for a troubled balance sheet, but that doesn't necessarily mean management will address the underlying problems that weakened the balance sheet in the first place. Shareholders should be cautious and should think about whether they would hold a stock through the ex-date period or not... holding through the ex-date is more likely a commitment to subscribe as saying ‘no’ to the subscription after the ex-date is tantamount to accepting a potential loss.