GRG Remuneration Review

# Discounted Rights Issues Diminish LTI Plan Benefits

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## INTRODUCTION

Capital raising rights (CRRs) issues are a common occurrence which may increase in frequency as companies seek to bolster their balance sheets in the current global financial crisis. These share issues are normally at a discount to the market share price. Their impact is to dilute the value of executive incentive rights (EIRs) and executive incentive options (EIOs) held by executives as well as reduce future gains from share price growth under long term incentive (LTI) plans.

The rules that govern executive LTI plans typically adopt the Australian Securities Exchange (ASX) Listing Rules with respect to CRRs. However, they do not adequately address these impacts. In particular the ASX Listing Rules do not provide a practical response in the case of EIRs (performance shares/rights) as EIRs have a zero exercise price and the main alternative open under the ASX Listing Rules is a reduction in the exercise price. Alternative approaches need to be considered and LTI plans modified, before companies undertake CRRs issues, so that unintended negative implications for executives can be rectified.

## TERMINOLOGY

For purposes of this article the following terms and abbreviations have the assigned meanings:

| Term | Description |
|---|---|
| ASX | Australian Securities Exchange |
| Capital Raising Right (CRR) | Rights to shares that have been granted to shareholders of the company to allow them to acquire numbers of shares proportional to their shareholdings at a specified share price which is typically at a discount to the market share price so as to provide an inducement to exercise the rights. |
| Executive Incentive Option (EIO) | These are rights to acquire shares at an exercise price which is often at or close to the market value of a share when the options are granted. Such options are granted to executives as part of their remuneration packages. |
| Executive Incentive Right (EIR) | Rights to acquire shares at zero cost, which are granted to executives as part of their remuneration packages. Also known as ZEPOs and performance shares/rights. |
| LTI | Long term incentive |
| ZEPO | Zero exercise price option |



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## THE ISSUE

When companies raise capital they often choose to do so via a discounted rights issue to existing shareholders rather than via a share placement or a general offer of shares to the market. As will be shown later in this article, the holders of EIRs and EIOs will be disadvantaged relative to shareholders when CRRs are exercised. Hence, there is a need to consider what action, if any, should be taken to address this disadvantage for holders of EIRs and EIOs.

When an offer is via a share placement or general offer of shares to the market the relative positions of shareholders and holders of EIRs and EIOs are not affected. They are proportionally and adversely affected by the discount contained in the issue price but should benefit from the application of the additional capital to the business.

When a CRR issue occurs, the shareholders can take up their entitlements (subscribe to a new issue of shares) and gain the benefit of the discount. Holders of vested EIRs and vested EIOs usually have the choice of exercising their EIRs and EIOs, thereby receiving shares and then being able to take up their CRRs entitlement along with other shareholders.

Holders of unvested EIRs and EIOs do not receive entitlements to CRRs and therefore cannot acquire shares at a discounted price. Thus, they suffer a share price reduction due to the discounted issue and miss out on the benefit of the discount (see later example). In addition their relative equity stake in the company is diminished and therefore their potential for gain from future share price growth is also diminished.

The following example is used to illustrate the foregoing.

Example Assumptions:

| | |
|---|---|
| Number of shares on issue before CRRs issue | 100,000,000 |
| Share price before CRRs issue | $20.00 |
| Exercise price of CRRs | $16.00 |
| Shares issued as a result of the exercise of CRRs | 50,000,000 |

When the CRR issue occurs, the impacts on issued capital, share price and market capitalisation are shown in the following table.

| Aspect | Number of Issued Shares | Price | Capital Raised | Market Capitalisation |
|---|---|---|---|---|
| Position Before CRRs Issue | 100,000,000 | $20.00 | | $2,000,000,000 |
| CRRs Issue | 50,000,000 | $16.00 | $800,000,000 | |
| Position After CRRs Issue | 150,000,000 | $18.67 | | $2,800,000,000 |

The impact on the positions of holders of shares, EIRs and EIOs is shown in the following table. It should be noted that the immediate impact of the discounted CRRs issue is that there is a loss in the value of the shares (whether via a direct holding or an entitlement via a EIR or EIO) of $133,333 in the example. For shareholders, the loss can be recovered by taking up the CRRs entitlement and acquiring more shares at a price below the post CRR issue market share price i.e. at $16.00 instead of $18.67. The gain from this discount fully offsets the loss incurred in relation to previously held shares from a fall in the share price from $20.00 to $18.67.

In the absence of an adjustment for holders of EIRs and EIOs they would be disadvantaged by not being able to participate (see later discussion of ASX Listing Rules). Thus, there is a case for an adjustment for holders of EIRs and EIOs. In the case of EIOs, this adjustment could take the form of a reduction in the exercise price of the EIOs of sufficient amount to offset the loss i.e. the exercise price could be reduced by $1.33333 per option ($20.00 - $18.66667). However, as rights have a zero or nominal exercise price there is no scope to reduce the exercise price. Therefore, the adjustment will need to take the form of additional grants as discussed later in this article.

| Aspect | Shareholder | EIRs Holder | EIOs Holder |
|---|---|---|---|
| Number of Shares, EIRs or EIOs Held | 100,000 | 100,000 | 100,000 |
| Market Value of underlying shares prior to CRR issue | $2,000,000 | $2,000,000 | $2,000,000 |
| Market Value of underlying shares after CRR issue | $1,866,667 | $1,866,667 | $1,866,667 |
| **Loss on Prior Shareholding** | **-$133,333** | **-$133,333** | **-$133,333** |
| CRRs Exercised | 50,000 | 0 | 0 |
| Value of CRRs acquired | $933,333 | $0 | $0 |
| Amount paid to exercise CRRs | $800,000 | $0 | $0 |
| **Gain on CRRs Entitlement** | **$133,333** | **$0** | **$0** |
| **Net Gain/Loss** | **$0** | **-$133,333** | **-$133,333** |

The other aspect that arises from the CRRs issue is that shareholders can maintain their relative equity in the company and can therefore derive the same proportion of the gain in the value of the company as reflected in future share price increases as they would have derived from their prior shareholding. However, holders of rights and options who are unable to participate in the CRRs issue will find their relative interest in future growth of the company will have been diluted by the CRRs issue. In the example, the holders of EIRs and EIOs had 0.1% (100,000 ÷ 100,000,000) interest in future growth in the value of the company prior to the CRRs issue but it reduced to a 0.0667% (100,000 ÷ 150,000,000) interest after the CRRs issue. This is depicted in the following table.

| Aspect | Shareholder | EIOs Holder | EIRs Holder |
|---|---|---|---|
| Market value of shares on which future growth in value will be determined | $2,800,000 | $1,866,667 | $1,866,667 |
| Benefit from say 10% future growth after CRR issue | $280,000 | $186,667 | $186,667 |

## OUTLINE OF ASX LISTING RULES

When there is a pro rata issue, there is a general provision (Rule 6.22.3) which caters for changing the exercise price or the number of securities that may be obtained when an option is exercised, and it applies if:

a) the terms of an option included a formula for
   - (i) adjusting the exercise price, or
   - (ii) the number of securities that may be acquired by exercising an option, and

b) the option was issued with the approval of ordinary shareholders, and

c) the option is not quoted on a securities exchange, and

d) the notice of meeting seeking shareholder approval of the issue of the option contained
   - (i) a report by an independent expert on the effect of the proposed change, and
   - (ii) a voting exclusion statement.

General market practice is that most grants of EIRs and EIOs would not satisfy the foregoing criteria and therefore the opportunity to use this provision generally does not apply. Therefore, it is necessary to either not make an adjustment or to apply the other more specific provision (Rule

6.22.2) which only allows adjustment to the exercise price. Reference should be made to the attachment to this article for a copy of the relevant ASX Listing Rules.

As an adjustment to the exercise price alone will not fully address the impact of a CRR issue and can only be applied to EIOs, not EIRs, it follows that an alternative approach needs to be considered. In this regard it should be noted that the ASX Listing Rules allow additional grants of options and/or rights provided that shareholder approval is obtained in relation to grants to directors if a new issue of shares is to be involved.

## ADDITIONAL SHARES OR RIGHTS ALTERNATIVE

An alternative would be to grant shares or rights with a value equal to the discount and for those shares to vest in proportion to which the relevant EIRs or EIOs vest and are exercised. Thus, the discount would only be provided to the extent to which the EIRs or EIOs are subsequently converted into shares. In the example, the grant of shares or rights would have a value of $133,333.

Although the leverage provided by the shares would be less than that provided by the exercise of the CRRs it would be more than what would occur from a reduction of the exercise price of the EIRs and EIOs.

If the shares are provided via on-market purchase then no shareholder approval would need to be considered. However, if new issues were to be used then issues to directors would need shareholder approval and consideration would need to be given to obtaining shareholder approval for the plan so that issues would not count towards the 15% annual new issue limit.

The relative positions of shareholders and EIR and EIO holders in relation to an additional grant of shares assuming various share price movements, are shown in the following continuation of the previous example.

| **Aspect** | **Shareholder - Additioal Equity via CRR** | **EIR Holder - With Additional Shares (1)** | **EIO Holder - With Additional Shares (1)** |
|---|---|---|---|
| Number of Shares, EIRs or EIOs Held | 50,000 | 7,142 | 7,142 |
| Amount paid to exercise CRRs | $800,000 | $0 | $0 |
| | | | |
| **Gain or Loss if Share Price Moves to:** | | | |
| $10.00 | -$300,000 | $71,416 | $71,416 |
| $15.00 | -$50,000 | $107,123 | $107,123 |
| $16.00 | $0 | $114,265 | $114,265 |
| $18.67 | $133,333 | $133,333 | $133,333 |
| $20.00 | $200,000 | $142,831 | $142,831 |
| $25.00 | $450,000 | $178,539 | $178,539 |
| NB: (1) Replacing a loss of $133,333 with shares having a market price of $18.67 results in a grant of 7,142 shares. | | | |

It should be noted that the EIR and EIO holders will be advantaged relative to shareholders if the share price falls below $18.67 but disadvantaged if the share price rises above $18.67.

## ADDITIONAL OPTIONS SOLUTION

A solution which would place holders of EIRs and EIOs in much the same position as shareholders would be to make an offer of options to holders of EIRs and EIOs on similar terms to those of the CRRs entitlement. In the example the offer would be of options with an exercise price of $16.00 the same as the exercise price of the CRRs. However, these options would only become exercisable if the EIRs or EIOs were to be exercised after having first vested. This would place the holders of EIRs and EIOs in much the same position as shareholders in that they would have to contribute capital to access the discount benefit and they could only do so in relation to shares that they have acquired. Between the time when CRRs are exercised and when the options are exercised the holders of EIRs and EIOs would be advantaged by the delay in needing to fund the exercise price and disadvantaged by being unable to lock in, by sale of shares, the benefit of the discount.

For executives who are not directors the options can be granted without the need for shareholder approval. However, the option plan would need shareholder approval if option grants are not to be counted towards the 15% annual share issue limit.

For directors the grant of options would need shareholder approval unless market purchases are to be used to source the shares needed when the options are to be exercised.

The foregoing approach addresses both the discount aspect and the leverage aspect of CRR issues for holders of EIRs and EIOs.

The relative positions of shareholders and EIR and EIO holders in relation to an additional grant of options assuming various share price movements, is shown in the following further continuation of the previous example.

| Aspect | Shareholder - Additioal Equity via CRR | EIR Holder - With Additional Options (1) | EIO Holder - With Additional Options (1) |
|---|---|---|---|
| Number of Shares, EIRs or EIOs Held | 50,000 | 50,000 | 50,000 |
| Amount paid to exercise CRRs | $800,000 | $800,000 | $800,000 |
| | | | |
| **Gain or Loss if Share Price Moves to:** | | | |
| $10.00 | -$300,000 | $0 | $0 |
| $15.00 | -$50,000 | $0 | $0 |
| $16.00 | $0 | $0 | $0 |
| $18.67 | $133,500 | $133,500 | $133,500 |
| $20.00 | $200,000 | $200,000 | $200,000 |
| $25.00 | $450,000 | $450,000 | $450,000 |
| NB: (1) If the market price of a share falls below the exercise price of $16.00, the options will not be exercised and therefore the loss will not be incurred. If the options are exercised and the market price of the share subsequently falls and the shares have not been sold then the same loss will be incurred as in the case of other shareholders. | | | |

It should be noted that shareholders and holders of EIRs and EIOs will be in the same position except if the share price falls below the CRR issue price of $16.00 before the options are exercised.

## ACTION REQUIRED

Most EIR and EIO plans contain provisions which indicate that in the event of a CRRs issue the EIRs or options will be adjusted in accordance with the ASX Listing Rules. Boards need to consider whether this provision remains relevant and, if not, then:

- the rules of the EIR or EIO plan may need to be amended to specify that no adjustment will be made to the EIRs or EIOs in the event of a CRR issue,
- provision needs to be made to enable additional grants of options, shares or rights to be made to holders of unvested EIRs and EIOs – this may require amendment to a current plan or the introduction of a new plan, and
- a company policy should be adopted as to the approach that will be taken in relation to CRRs.

Unless a CRRs issue is being contemplated, the foregoing need not be a priority but it should be addressed particularly in the case of EIR (performance shares/rights) plans.

## ATTACHMENT - ASX LISTING RULES

**Rule 6.19** provides that an option must contain a statement:

a) of the rights that the option holder has to participate in new issues without exercising the option, or

b) that the option holder cannot participate in new issues without first exercising the option.

**Rule 6.20** provides that an option must not confer the right to participate in new issues without exercising the option except if either:

i) the option was issued under a pro rata issue to all shareholders, or

ii) the option was issued with the approval of ordinary shareholders and is not in a class of quoted options, the option holder can participate in new issues at the same time and price as the holders of the underlying securities in accordance with the terms of the option.

The notice of meeting must have contained a report by an independent expert on the effect of the proposed right of participation, and a voting exclusion statement.

**Rule 6.21** provides that an option must not confer the right to a change in exercise price, or a change to the number of underlying securities over which it can be exercised:

a) if the option confers a right to participate in new issues without exercising the options, and

b) unless the right is permitted under Rule 6.22.

An option's terms must contain a statement of any rights an option holder has to a change in the exercise price of the option, or a change to the number of underlying securities over which the option can be exercised.

**Rule 6.22** provides that an option may confer the right to a change in its exercise price, or a change to the number of underlying securities over which it can be exercised, in any of the following cases.

Rule 6.22.1 deleted

**Rule 6.22.2** If there is a pro rata issue (except a bonus issue) to the holders of the underlying securities, the exercise price of an option may be reduced according to the following formula.

$$O' = O - \frac{E[P - (S + D)]}{N + 1}$$

| | |
|---|---|
| O' = | the New exercise price of the option |
| O = | the Old exercise price of the option |
| E = | the number of underlying securities into which the option is Exercisable |
| P = | the average market Price per security (weighted by reference to volume) of the underlying securities during the 5 trading days ending on the day before the ex rights date or ex entitlements date. |
| S = | the Subscription price for a security under the pro rata issue. |
| D = | the Dividend (in the case of a trust, Distribution) due but not yet paid on the existing underlying securities (except those to be issued under the pro rata issue). |

| | |
|---|---|
| N = | the Number of securities with rights or entitlements that must be held to receive a right to one new security. |

**Rule 6.22.2A** As an alternative to using the formula in rule 6.22.2, if the option was issued with the approval of holders of ordinary securities, and is not in a class of quote options, the exercise price or number of underlying securities may change if there is a pro rata issue (except a bonus issue) to the holders of the underlying securities in accordance with the formula contained in the terms of the option. The notice of meeting must have contained a report by an independent expert on the effect of the proposed change, and a voting exclusion statement.

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