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UK-Listed Issuers Under Financial Stress Gain Latitude in Secondary Capital Raisings

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Key Points

- Updated guidelines allow London-listed issuers to raise up to 20% new capital on a non-preemptive basis, which may be used to strengthen their working capital position.
- Issuers nonetheless need to approach non-preemptive offerings with sensitivity, given the dilutive effect for existing shareholders.
- Close attention must be given to the substance and timing of disclosures to the market, particularly when an issuer is in financial difficulty.

As the U.K. faces what the Bank of England recently described as "very challenging" times, with the possibility of the U.K.'s "longest recession since records began," issuers listed on the London Stock Exchange should pay close attention to updated guidance on secondary capital raisings as well as disclosure and governance considerations.

Capital Raisings

In the aftermath of the 2007-09 global financial crisis and during the COVID-19 pandemic, many listed issuers sought to shore up their balance sheets through secondary capital raisings. As we confront a possible economic downturn in 2023, issuers considering raising funds to meet their working capital needs through the secondary capital markets should carefully consider new rules related to the U.K. preemption rights regime.

What are preemption rights? Preemption rights give existing shareholders the right of first refusal on the issuance of new shares. This is considered an important safeguard to protect existing shareholders against dilution. The U.K.'s Pre-Emption Group, representing a range of listed issuers, investors and intermediaries, is responsible for setting recommendations. While not legally binding, the recommendations are generally followed by the market.

Revised guidance. The recommendations were updated in November 2022 following the U.K. Treasury's UK Secondary Capital Raising Review, which was published in July 2022. (See our *2022 Insights* article "Wide-Ranging Reforms of UK Capital Markets: A Watershed Moment?") In line with the latitude the Pre-Emption Group offered at the height of the COVID-19 pandemic, the revised recommendations generally allow for the annual disapplication of preemption rights up to a limit of 20% of a company's issued share capital (double the previous 10% threshold), consisting of: (i) 10% of the company's issued share capital on an unrestricted basis, and (ii) 10% for an acquisition or specified capital investment.

The Pre-Emption Group suggests a number of actions an issuer should consider taking as part of a non-preemptive offer, including making the issue on a "soft preemptive" basis. Soft preemption (in the context of a placing of shares) is where the bookrunner allocates shares to investors in accordance with a policy that seeks to preserve the principle of preemption so far as is practical, to replicate the existing shareholder base (recognizing that not all shareholders will be able to participate).

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For each 10% limb, companies can seek authority to disapply preemption rights for up to an additional 2% of a company's

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issued share capital as a "follow-on offer" to retail shareholders and other investors who were not allocated shares in the soft preemptive issue. This should meet the objective of encouraging retail participation in non-preemptive offers and further guard against the dilutive effect and price impact of a discounted offer.

(For perspective on secondary capital offerings in the Hong Kong market, see "HKEX Initiatives Present Opportunities Even in a Down Market.")

Disclosure of Information

Disclosures become a particular focus of regulators and investors during periods of economic stress. On an ongoing basis, listed issuers must pay particular attention to making timely and accurate disclosures. Under the U.K. Listing Rules, an issuer is required to take reasonable steps to establish and maintain adequate procedures, systems and controls to enable it to comply with its continuing obligations, which includes its disclosure requirements and corporate governance infrastructure. In addition, the Listing Rules require a premium listed issuer (which meets the exchange's most stringent standards) to act with integrity toward its shareholders and prospective shareholders.

A true picture of an issuer's position. An issuer must take reasonable care to ensure that disclosures to the market are not misleading, false or deceptive and do not omit anything likely to affect the import of the information. With an uncertain economic outlook, disclosures to the market (whether periodic or *ad hoc*) must reflect a true picture of an issuer's trading position (*i.e.*, its financial and operational status).

It is imperative that an issuer's personnel avoid adopting aggressive accounting policies to overstate the company's financial performance. Warning signs from internal financial reports highlighting disparities between actual revenues and those reflected in budgeted forecasts or reports of material financial risks and exposures should be escalated to the board and audit committee. Boards and senior management should challenge forecasts and ensure that market expectations are managed in light of pressures on profit margins caused by higher costs in supply chains.

Disclosures of inside information must be made as soon as possible, unless there are recognized grounds for delay, which can include a delay to protect the legitimate interests of the issuer. The U.K. Financial Conduct Authority has stated that a company should not delay disclosure of:

- the fact that it is in financial difficulty or of its deteriorating financial condition (a permitted delay would only relate to the fact or substance of the negotiations to deal with such a situation); or
- information about its financial condition on the basis that its position in subsequent negotiations to deal with the situation (such as in respect of a rescue refinancing) will be jeopardized.

Companies experiencing financial difficulties that are uncertain about what information to disclose or when should consult their professional advisers. Companies should avoid adopting a wait-and-see approach, hoping for a recovery in financial performance or other offsetting news before updating the market.

(For a discussion of directors' duties when a company is in financial difficulty, see "How Directors Can Manage the UK Supreme Court's 'Balancing Exercise' in Difficult Times.")

In Sum

The board of directors and senior management team have primary responsibility for safeguarding the company's assets for and on behalf of shareholders. Non-executive directors have a particular role in the oversight of the executive management team, being one step removed from the operations of the business.

(See also "A Playbook for Borrowers Facing Economic and Debt Market Pressures.")