

Why Europe Must Open Access to Equity Markets: Phase II

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In March 2011, we published *Why Europe Must Open Access to Equity Markets*.⁽¹⁾ We received a significant amount of feedback from this paper, with one point of common ground: Market participants are supportive of real estate companies having greater flexibility to raise equity in a shareholder-friendly and value-accretive manner.

To further explain our views, we reached out to many market participants: investors, real estate companies, proxy research firms, regulators and sell-side analysts. As a result of our continued research and dialogue, we believe there are practical options to improve the situation in a manner satisfactory to all participants. This update on our initiative to improve European real estate companies' access to capital endorses a plan of flexibility, whereby real estate companies have options to raise equity via: traditional rights offerings, accelerated rights offerings, rights offering without a backstop, an open offer with a clawback for existing shareholders, and through shareholder-approved offerings for which pre-emptive rights have been waived.

(1) See the Research Center at cohenandsteers.com for a copy of this paper.

Reality Sets In

Based on the response of market participants to our first whitepaper and on what we continue to see in the markets, we are resolved to help improve the methods by which European companies raise equity capital. We believe this is a moment in time when European investors will open the door to provide companies with greater flexibility to raise equity. Why?

- **The recognition that capital markets and investor allocations are becoming more global every day.** Look no further than Deutsche Boerse AG's pending acquisition of the New York Stock Exchange owned by NYSE Euronext. Foreign investors' ownership of European companies continues to grow. In a December 2010 paper entitled *Rights Issue Fees Inquiry* by Institutional Investor Council, foreigners owned 40% of U.K. equities at that time, while U.K. institutional ownership had declined to 40% from 60% in 1994. Without harmonization of regulatory and capital market practices, Europe seems destined to lose ground in the global marketplace.
- **The recognition that without recapitalization with true equity, the combination of high leverage, low labor productivity and an aging population represents a perilous set of economic conditions in Europe.** The full-blown sovereign debt crisis that has advanced from Greece to envelop Italy and Spain is now threatening the eurozone. We believe that, in addition to the ECB stepping up as bank of last resort together with fiscal union, deleveraging in Europe will require equity recapitalization of the banking system as well as of the connected sectors historically financed with debt, such as real estate. We already are seeing debt markets begin to narrow for real estate companies, as banks shrink their balance sheets, thus making attractively priced equity more important. Banks will provide less real estate financing going forward, increasing the reliance by REITs on public equity and debt markets.
- **The recognition that the merit-based, open architecture of the U.S. capital market is powerful.** That companies can raise equity in real time through ATMs (at-the-market offerings), or through one-day marketing offerings, is a meaningful competitive advantage by way of efficient access to low-cost equity capital. We believe that a more open architecture would help reduce the cost of raising equity in Europe.

The paper *Rights Issue Fee Inquiry*, noted above, found that since 2007 underwriter fees in U.K. rights offerings have ranged from 2.5%–3.5%, and that rights offering pricing discounts have ranged from 27%–38%. Large discounts are used to coerce shareholders to subscribe and to materially reduce risk for underwriters who backstop the offering. Our March 2011 whitepaper discusses in detail why these large discounts hurt shareholders.

One criticism of rights offerings has been that underwriters earn fees that are too high. To us, the simple solution to this criticism is to promote competition among banks and institutional shareholders. That is, let more bankers bid for execution without having to backstop, and open the offerings to new shareholders. This will facilitate more efficient price discovery for both bankers' fees and for pricing the shares. Frankly, focusing on the 2.5%–3.5% paid to bankers, while disregarding the discount necessary to price the rights offering, is missing the critical factor.

Discounts do matter, a point borne out by the fact this is a material negotiating point during the rights offer process. The rights offer process provides outside investors, or the underwriter, a call option to invest dilutively; this is the price to the company of certainty of execution, and is compensation for the risk the underwriter takes in providing this certainty. We find that, when considering the value of this option, rights offerings are as at least as expensive as other forms of equity issuance.

- **The recognition of the facts:** In the case of real estate companies, pre-emptive rights is one of several factors that have caused long-term under-performance of U.K. listed property companies relative to private real estate and relative to companies in markets without pre-emptive rights. Recent performance through the global financial crisis is summarized below.

EXHIBIT 1. LISTED REAL ESTATE RETURNS: UNITED STATES AND UNITED KINGDOM

	United States Cumulative Return US\$	United Kingdom Cumulative Return US\$	United States vs. United Kingdom
Bear Market (2007–2008)	-47.5%	-74.8%	+2,730 bps
Recovery (2009–2011)	+77.5%	+20.0%	+5,750 bps

As of December 31, 2011.

Past performance is no guarantee of future results. You cannot invest directly in an index.

Source: FTSE EPRA NAREIT Indexes.

- **The recognition that real estate companies are missing an opportunity to consolidate real estate ownership in Europe and capitalize on the de-leveraging of private real estate ownership.** Examples of securitization opportunities include: the liquidation of German open-end real estate funds; the recapitalization and privatization of German rental apartments; and the pending recapitalization of property financed by 600 billion euros of both CMBS and CRE loans that mature over the next several years.
- **The recognition that real estate companies deserve special dispensation because their businesses are highly capital intensive and the REIT rules require the majority of earnings be distributed as dividends.** Our view is that Europe can adopt the best features of capital-raising techniques around the world and improve access to capital, while acknowledging that pre-emptive rights are part of corporate law and recognizing that pre-emptive rights are part of European shareholder culture.

A Flexible Approach to Raising Capital

We respect corporate law and pre-emptive rights, and we support strong corporate governance and shareholder-friendly market practices. To help balance all objectives and work within a culture of pre-emptive rights, we endorse an approach of flexibility whereby companies can improve upon a foundation of raising capital through pre-emptive rights by: 1) pursuing accelerated rights offerings compressed to as little as three days; 2) pursuing rights issues priced at the market and without sub-underwriting (the backstop) along with an open offer for unsubscribed shares and 3) allowing shareholders to vote for waivers of pre-emptive rights under certain conditions designed to protect shareholders.

First, we endorse the movement afoot, approved in Belgium and under consideration in the U.K., to execute accelerated rights offerings in a three-day timeframe. This will allow better price execution, as less market risk would result in a narrower discount, and the more conventional offering timeframe would foster broader access to non-shareholder investors. These accelerated rights offerings would preserve the important right of pre-emption and facilitate more efficient access to capital—certainly a “win-win” for both companies and shareholders.

Second, we advocate the use, in non-distressed situations, of at-the-market rights offerings without a backstop in conjunction with an open offer. An example of companies becoming more aware of the cost of discounted rights issues and the related cost of capital is the recent equity offering by Deutsche Wohnen, the German apartment company.

Deutsche Wohnen recently executed a capital increase of 20% of its existing share capital via an at-the-market rights offering, which was not backstopped and was executed in two weeks. The deal offered shareholders the right to subscribe at a price closer to the market—then enabled new shareholders to participate if rights were not taken up. This makes Deutsche Wohnen the first German real estate company in recent history that has structured a rights issue with no underwriting backstop. These transactions should result in a narrow discount compared with the more commonly accepted 27%–38% discounts that are applicable for underwritten rights issues.

We believe this structure is an improvement as it: 1) reduces the discount to market pricing; 2) mitigates downward pressure on a company’s share price; 3) speeds time to market; 4) provides the opportunity to bring in new shareholders and 5) reduces underwriting (backstop) fees. Essentially, this structure enables companies to raise money at a modest discount to their prevailing stock price, while still offering their shareholders the pre-emptive right to participate. This form of offering has a more open architecture and enables the market to set the price. Importantly, the company specified the short-term and long-term uses of proceeds. We applaud Deutsche Wohnen and their bankers for their creativity with this offering.

Finally, we offer a roadmap of conditions under which Cohen & Steers would waive its pre-emptive rights. These conditions are meant to address the primary concerns that have given rise to the strong culture of pre-emptive rights in Europe.

Cohen & Steers Pre-Emptive Rights Waiver Voting Roadmap

- Create a more flexible approach to raising capital that benefits companies and investors:
 - Reduce time for execution
 - Reduce the discount to market for pricing
 - Reduce sub-underwriting (backstop) fees and other costs/expenses
- Approve the waiver of pre-emptive rights for up to a reasonable percentage of capital stock (20%–50%) if:
 - Upon request of the waiver, management provides a statement on the general use of proceeds and why the company believes the waiver is beneficial to shareholders
 - At the time of share issuance, management provides a specific statement on the use of proceeds and benefit to shareholders
 - The discount to buyers of up to 5%–10% is limited to the last price or 10-day VWAP (exclusive of banker underwriting spread)
 - Management has a history of disciplined and accretive capital allocation
 - There are no insider shareholders with more than 25% ownership
 - The opportunity allows shareholders to remove the waiver at each AGM

The Real Cost of Rights Issues

The frequent defense of the rights issue process that “the discount doesn’t matter” has always baffled us. We and other investors know through experience that the deeper the discount, the larger the negative impact on the share price and company value. It is also the case that the level of discount is a key variable in the negotiations between companies and underwriters. Said simply, if the discount doesn’t matter, why have one?

The reason a discount exists is to compensate the underwriter for taking the risk of backstopping the placement. More risky issuers need to accept a larger discount. The discount has value because it gives the underwriter the potential right to acquire a significant stake in the company at a discounted price (and very typically at a discount to intrinsic value) in case investors do not take up their rights. In effect, the underwriter gives the company certainty of execution by granting it a deep out-of-the-money put (the underwriter will backstop the issue at the discounted price), and receives a deep in-the-money call option (the ability to buy shares at a discount to TERP, the theoretical “ex-right” price) from the company to compensate for the underwriting risk.

This option has value and, as post announcement the shares and rights are traded by investors other than existing shareholders, there is a value transfer between existing and new shareholders. This is part of the reason a company’s share price tends to underperform the market after the rights issue process has been announced and unfolds. In practice, this arbitrage is normally borne out by hedge funds and other investors taking advantage of this economic opportunity. First, they would sell shares or short a company as the rights issue process begins (often the tea leaves can be read well in advance of any formal announcement). Then they would cover by buying the rights more cheaply as they reflect the lower stock price that eventuates.

While taking up the rights themselves is not value-destructive, the real impact is on the value of the investor’s initial investment—due to the value transfer from the option inherent in the rights issue underwriting process and the fall in company value that almost always occurs in a rights issue process. As such, we believe the discount does matter; the higher the discount, the more value will be lost.

For a company whose objective is to raise 20% of its value through a -30% discounted rights issue (with a 85% take up probability), the net option value is equivalent to 5% of the amount of capital raised. On top of the underwriters fee of 3%, this equates to an all-in cost of 8%. The example below serves to illustrate this point.

EXHIBIT 2. EVALUATING REAL COST OF RIGHTS OFFERING

Company Initial Market Capitalization	\$10,000	TERP	\$0.93
Shares	10,000	Probability of Take Up	85%
Share Price	\$1.00	Exposure to Underwriter	\$300
Capital Raise Amount	\$2,000	Underwriter’s Call Option Value	(\$102.01)
Rights Issue Price	\$0.70	Company’s Put Option Value	\$2.31
Discount	-30%	Net Option Cost as a % of Capital Raised	-5%

Option values are derived using the p option formula using a 40% volatility and 1.5% risk-free rate and assuming a time of three months.

If the discount is less, such as the usual 2% to 4% discount in a normal placement, the option value is minimal. Hence there is no free lunch—the full cost of a rights issue at 8% is the same or more than the all-in cost of a placement of 7% (-3% price discount plus 4% underwriting spread).⁽¹⁾

Unfortunately, however, there are other costs involved in rights issues, including the significant amount of time and energy for the management of the company and its shareholders. If investors are unable to come up with the additional capital required to exercise their rights, the need to tail swallow (sell your rights) means giving up the discount to intrinsic value of the company, another form of dilution. Furthermore, the discounted rights-issue process limits the ability of a company to issue equity at a premium to intrinsic value, and hence create value. Instead, having to protect against potential dilution makes rights issues a coercive process; the choice is taken away from the shareholder, and that value is transferred to the underwriter.

Next Steps

As for next steps, we are pursuing the following and encourage shareholders and companies to join us:

- Lobby real estate companies to speak up and tell their shareholders and proxy research/voting firms why the value of their company would be enhanced by improved access to the equity markets. Using the roadmap offered in this paper, companies should write open letters to all shareholders to make the case for these capital-raising options. Companies should also have one-on-one meetings with their largest shareholders to explain their need for capital-raising flexibility and a lower cost of capital.

(1) Source: “Follow-On Offerings 2011 YTD U.S. REITs”, Wells Fargo Securities, December 9, 2011.

- Discuss capital-raising options and the Cohen & Steers pre-emptive rights waiver voting roadmap with market participants in the press, at industry conferences, at shareholder meetings and at one-on-one meetings. Shareholders, companies, the European Public Real Estate Association (EPRA), proxy voting research firms and pre-emptive rights advocates should all get involved.
- Work with companies that have strong corporate governance practices in place, as well as a need for capital, to place proposals to waive pre-emptive rights under the aforementioned conditions on the agenda for shareholder meetings.

We call upon all market participants to focus on this initiative for real estate companies. We have no agenda other than to help increase the value of our real estate holdings in Europe and allow these companies to grow in a rational, value-added fashion. Only with this foundation can the public market for real estate companies grow and prosper in the new normal environment of lower leverage and less credit availability.

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Risks of investing in real estate securities

The risks of investing in real estate securities are similar to those associated with direct investments in real estate, including falling property values due to increasing vacancies, declining rents resulting from economic, legal, tax, political or technical developments, lack of liquidity, limited diversification and sensitivity to certain economic factors such as interest rate changes and market recessions. No representation or warranty is made as to the efficacy of any particular strategy or fund or the actual returns that may be achieved.

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