BUDDLE FINDLAY

Capital raising in the time of COVID-19

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24 April 2020

The COVID-19 pandemic will have an unprecedented impact on the global economy. With more people moving online and relying on digital platforms to shop, entertain and work, there will be some companies seeking growth capital in order to transition to the new environment. On the other hand, many New Zealand businesses will face liquidity challenges in the months ahead and will be looking to strengthen their balance sheets (on an emergency basis) to get through this crisis. Companies may consider:

- Seeking additional debt funding from their current bank or a new bank. This option may be unavailable for some, particularly those that are already highly leveraged and/or where the COVID-19 environment has had a drastic impact on the value of asset backing and/or earnings
- Raising capital from existing shareholders. Much depends on the appetite and/or capacity for existing shareholders to fund significant cash quickly. For many companies, this will not be feasible
- Raising debt or equity capital from a new strategic investor (or investors). This article focuses on that option – and more particularly, on negotiating with a private equity or special situations investor.

Below is a high-level overview of how a strategic investor might structure an investment in a company, the key terms of the investment to be negotiated, and the legal framework that may apply.

Investment structure

There are a number of ways to structure an investment in a company seeking cash to bolster its balance sheet. An investor might choose to invest in:

- Ordinary shares
- Preference shares (which would rank ahead of other shares in the company in relation to the distribution of surplus assets on liquidation, the distribution of proceeds on an eventual trade sale and potentially also in relation to payment of any dividends). Preference shares may be convertible into ordinary shares on a trade sale in order to give the investor an enhanced return
- Warrants (entitling the investor to shares upon exercise of the warrant, which may in turn depend on satisfaction of certain criteria)
- Convertible debt (a loan with a right to convert into equity at a later date) which may be unsecured or secured (typically ranking behind any existing secured bank funder)
- Straight debt (again with or without security over the company's assets)
- A combination of the options above or special features. For example, warrants are often combined with other instruments to give an 'equity kicker'.

A strategic investor is likely to have its own preference for structuring the investment with an eye on exit in the medium term. A company raising capital in an emergency situation will want to ensure that the proposed structure secures the cash that the company needs upfront and for the foreseeable future, has no unintended tax consequences and is fair (given the circumstances) to the company and its current shareholders.

Key points to negotiate

Any company raising capital in the time of COVID-19 should expect everything to be up for negotiation, particularly if the company is seeking capital with any sense of urgency:

- **Valuation**: Companies should expect that the economic uncertainty resulting from COVID-19 will be factored in to any investor's assessment of the company's value. Recent capital raising examples in the public market indicate that discounts are expected; for example, Kathmandu undertook its capital raise at a 51% discount to the last closing price of its shares, and Auckland Airport's $1.2b raise is at a 11% discount to the last closing price of its shares (which have dropped 45% from the start of this year)
- **Board seats**: An investor may seek the right to appoint one or more representatives to the company's board, to give that

investor a degree of control and influence over the company and access to the company's information. Board appointment rights will often be proportionate to the stake the investor will acquire in the company

- **Rights to access information**: An investor may seek access to company information such as budgets and business plans, board papers and management accounts. This will be particularly important for investors not benefiting from a formal board appointment right
- **Investment protection rights**: An investor is likely to negotiate rights to protect its investment – for example, veto rights over key decisions relating to the company such as a change in business direction, acquisitions or disposals, budgets and business plans, an increase in debt level and the issue of further securities. An investor may also seek anti-dilution rights, so that if the company raises capital at a lower valuation in future, the investor is topped up to hold the number of securities it would have held had that lower valuation been used to price its investment
- **Exit rights**: For private companies, an investor will require some basis to require all shareholders to sell the company in order to achieve a maximum valuation. A 'drag along' right (combined with a 'tag along' right to join in with any major shareholder selling in the future) will be a common requirement of any strategic investor.

Any company raising capital should enter negotiations with an investor with an idea of where the company stands on the matters above, but also with an open mind, accepting that the size and urgency of the funding required, the market conditions, and the costs and the availability of alternative sources of funding will inevitably have an impact on the company's negotiating position.

Relevant legislation

Any company raising capital must comply with the relevant legislation. The legislation that applies to a capital raise will depend on the nature of both the company and the investor (including the investor's country of location).

Putting aside compliance with foreign securities laws that regulate capital raising from sources offshore, the issuer must comply with New Zealand's securities legislation (the Financial Markets Conduct Act 2013) where financial products are offered in New Zealand. For an emergency capital raise, we expect companies will be looking to rely on a Schedule 1 exclusion to the Act, rather than issuing a product disclosure statement. For example, companies may seek investors who meet the definition of 'wholesale investor' in the Act.

Listed issuers will have additional considerations. Unless the company is willing to seek shareholder approval for the capital raise, then assuming it is not looking to raise capital from existing shareholders under a pro rata issue or a share purchase plan, it will need to comply with the placement cap under the NZX Listing Rules. This placement cap has been increased to 25% (up from the usual 15%) through the NZX's recent class exemption (which recognises that the impact of COVID-19 means many companies will need to be able to raise capital quickly).

Any company raising capital from an investor who is an overseas person will also need to be conscious of New Zealand's overseas investment (OIO) regime.

- If the company has a relevant interest in sensitive land and an investor (alone or together with its associates) will acquire a 25% or more ownership or control interest in the company, or increase an existing 25% or more ownership or control interest, or will acquire an ownership or control interest in the company that results in the company being 25% or more overseas owned or controlled, then consent to the capital raise will be required under the Overseas Investment Act 2005
- Consent will also be required if the investor and its associates acquire a 25% or more ownership or control interest in the company, or increase an existing 25% or more ownership or control interest, and the consideration paid in the capital raise, or the value of the company and its 25% or more subsidiaries' assets, exceeds the relevant threshold for significant business assets under the Act (typically NZ$100m, but higher thresholds apply for certain investors from Australia, Canada, Japan, and other specified countries or territories).

If OIO consent is required for a capital raise, this will have a significant impact on timing for the raise. Listed issuers may benefit from some proposed law changes to the Overseas Investment Act due to be enacted prior to the upcoming election.

Companies should be conscious of the OIO regime if their investors are overseas persons, even if the investor is not subscribing for shares in the company. For example, if an investor is advancing a loan to a company with sensitive land, any proposed security arrangements will need to be closely analysed to determine whether OIO consent is required.

Concluding remarks

We expect many companies to seek capital in the months ahead, and urge all such companies to turn their minds to capital raising at an early stage. There will be many decisions for boards to make – not only when to raise capital and how much, but where to seek it and how to structure the investment. There is no 'one size fits all'. We recommend that boards plan appropriately and engage advisors in good time, to give the company the best chance possible of negotiating a beneficial deal in the age of COVID-19.

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