Certain issues relating to raising funds from external investors

Equity/Preference Share Mix

It frequently happens that an external investor, or investors, contributes much more to the company's share capital than the initial ordinary shareholder who are owner-managers, and who wish to retain control and a substantial majority stake.

Shares may not, of course, be issued at a discount (Companies Act 1985. S.100), which means less than their nominal value, but does not mean less than their market value. But issue at a less than market value may create certain adverse taxation consequences. If this is planned, then tax advice should be sought at any early stage.

Ordinary Shares (Equity)

What often happens on a substantial external investment is that external investors contribute cash to subscribe for (say) a total of 20% of the ordinary shares, so that they share in the growth of the company and benefit only on a company sale or flotation. If they have over 25% of the ordinary shares, then they can block the passing of Special Resolutions which need a 75% majority, so 25% may be regarded as a maximum for external investors.

Alternatively, the external investors could pay (say) £5 share premium for every £1 ordinary share, so that the company could have the extra cash, but the original owner - managers would not surrender their control. But it is hard to see the attraction of this to an external investor.

There is also the possibility that the external investors would have no votes attaching to their (separate) class of ordinary shares, so that they could not block Special Resolutions, etc. if they had more than 25% of the ordinary (equity) shares. They would only be entitled to any dividends declared on ordinary shares and to any realised profit on sale.

Preference Shares

These usually provide a fixed guaranteed dividend coupon to be paid out of available profits. If there are insufficient available profits, then the dividend is accumulated to following years, when there are adequate profits to pay it out.

This provides a fixed return to the investor each year, assuming available profits, and he waits for a flotation or trade sale or sale back to the original investors to realise the value of his investment in ordinary shares.

Example, with very hypothetical figures.

1. Newco has 1000 £1 shares authorized, 100 issued to owner-managers. External investors want to subscribe £1m. One method (among many) would be as follows:

			£100
Existing ordinary shares		10%	
Owner-managers subscribe for extra ordinary shares	£700	70%	
External investors subscribe for ordinary shares	£200	20%	
	£1000		

External investors subscribe £999,800 for Preference Shares @ 4% gross dividend p.a. which would be a gross dividend return of £39,992 p.a., assuming profits were available to pay it.

On a sale/exit for (say) £5m, in total, the price would be allocated as follows:

Sale of Preference Shares at par	£ 999,800
Ordinary Shareholders	
Owner-managers (80%-800 shares @ £1/share)	3,200,160
External investors (20%-200 shares @ £1/share)	800,040
	£5,000,000

or

Owner-managers (for a £800 investment)	£3,200,160
External investors (for a £1m investment)	£ 1,799,840
	5,000,000

So for the external investors in this, they would have earned a 4% dividend each year on their £999,800 Preference Share investment and no dividend on their £200 ordinary share investment. On sale or flotation of the company they would get their £999,800 back, plus a fabulous return of £800,040 on their £200 investment in ordinary shares.

If it was required that the Preference Share dividend be rolled up and paid out after (say) 5 years or on an earlier sale or flotation, then (subject to tax advice) it may be better to convert the annual dividend each year into additional Preference Shares to be issued, rather than increasing the company debt.

Second-Stage funding,

The (by then) existing Preference Shareholders might wish to be given the opportunity to subscribe for more ordinary shares, at not less than par value, at the same time as contributing for more Preference Shares.

Third-Stage funding

Other external investors could then be approached for investment, and these might have to pay a share premium for an investment in ordinary shares, as well as subscribing for Preference Shares.

Conclusion

There is a wide variety of choice available for structuring the investment from external investors. This needs to be thought through by the Board in conjunction with the Company Financial Advisers, and with fund-raising sources who would be likely to know what would be likely to be acceptable to knowledgeable investors.

OFFERS TO THE PUBLIC - finding external investors

Conventionally, any "offer to the public" for investment has to be by way of prospectus, which is lengthy, expensive and time-consuming. One needs to examine the Public Offers of Securities Regulations 1995 (the POS Regulations) to see if any exemptions are available.

Regulation 6 of the POS Regulations makes clear that a person "offers securities to the public" in the United Kingdom if, to the extent that the offer is made to persons in the United Kingdom, it is made to the public. The paragraph then goes on to make clear that an offer to **any** section of the public, is to be regarded as made to the public.

The difficulties encountered in applying the old Companies Act provisions invariably arose in determining the number of people to whom an offer could be made, before the offer could be said to have been made to enough people to constitute an “offer to the public.”

Exemptions

Regulation 7 of the POS Regulations provides a series of ‘safe harbours’ from the prohibition on “offers to the public” by providing that, in the specified circumstances, there will be deemed **not** to be an offer to the public in the United Kingdom. There would therefore be no requirement for a prospectus, if one or more of the exemptions is met. The key exemptions relevant in this case are as follows:

(a) The offer is to not more than 50 persons, the 50 including (probably) the original shareholders.

(b) The offer is to a restricted circle of persons whom the offeror reasonably believes to be sufficiently knowledgeable to understand the risks involved in accepting the offer. Information supplied by the offeror is to be disregarded in testing this degree of knowledge, **except for** any information supplied by the offeror about the Company.

(c) The offer is to members of a club or association where the members have a common interest with each other and with what is to be done with the proceeds of the offer.

(d) The offer is to persons whose business involves them in acquiring, holding, managing and disposing of investments or who it is reasonable to expect will acquire, hold, manage or dispose of the investments for the purpose of their business.

Summary

Extreme care must be taken in preparation or publication of any documentation inviting inward investment. Failure to comply might result in being required to pay back the investment and any other relevant compensation and, in under the criminal law, up to two years in prison, or a fine, or both.

So if there were verbal or written exaggerated potential earnings claims, or “no-risk guarantees,” these are likely to fall foul of the strict rules regulating solicitation of investments.