On 16 April 2014, the Singapore CFO Institute conducted a Special Interest Group discussion on the topic of capital raising. The discussion addressed the considerations that a CFO might face when raising capital, examined the methods available and covered a range of related issues. To help guide the discussion, the group was provided with a case study of Genting International’s capital raising effort in the development of an integrated resort under Resorts World Sentosa. Mr. Choo Chek Siew, Group Financial Officer of ComfortDelgro Corporation Limited, led the discussion.

This paper summarises the key points of the discussion.

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CONSIDERATIONS A CFO MIGHT FACE WHEN RAISING CAPITAL

Basic considerations
CFOs should consider the following in a capital raising exercise:

- Purpose of the fund-raising
- Amount to be raised
- Repayment and related obligations
- Terms and tenure
- Security required

"One of the lessons I have learned is that you must match your tenures...you can't have long-term assets funded by short term bonds. Similarly, if you have short-term needs, you should not fund them with long-term liabilities."

- Mr. Choo Chek Siew

Timing and market circumstances
Market liquidity and investors’ appetite for risk, can have a dramatic effect on whether a company raises capital successfully. The company should also deploy the capital quickly after raising it, as that will reduce the cost of fund-raising in 4Q 2007.

Referring to the case study, Genting PLC’s fund-raising exercise was successful primarily because of the excellent timing. Genting listed when Singapore’s GDP growth was very high and most of its fund-raising activities closed just before the sub-prime crisis.

The company's stage of development
The company’s own status will affect its success in fund-raising. For example, Genting is a very well known company in Malaysia, but in Singapore in 2005, it was considered a startup.

The strong reputation of the parent company will favourably affect Genting's fund raising reception in the market. The RWS project stirred up considerable interest as Genting successfully handled this by positioning RWS as an integrated resort rather than a pure casino play.

"In Genting’s case, investors came in on faith that something would happen, because in 2004 and 2005 it was a penny stock, even making losses in the years immediately before opening...for investors, it was a massive bet. But I think that the integrated resort concept caught the imagination of investors."

- Mr. Lim Chuang

The type of industry
The type of industry involved in raising capital and its risk dynamics will also affect the success of capital raising eg. highly regulated, cash generative companies will find it easier to raise funds.

Articulating the company's needs
During an IPO, capital raising involves explaining the reasons for fund-raising to the investing public. The CFO needs to take up an active investor relations role near the start of the fund-raising effort in order to provide investors with all the relevant information. However, companies should be careful to provide information that is already publicly available and the CFO should avoid promoting their own stocks.

"A company's financial strategy is not stand-alone. It is a part and a subset of the business strategy, all one with the business plan."

- Mr. Lim Chuang

SOURCES OF FUNDING

Sources of pre-IPO funding
Before an IPO, a company’s sources of funds include:

- Bilateral loans
- Existing shareholders / strategic investors
- Government grants
- Internal sources
- Bonds

The success of a company issuing bonds pre-IPO depends heavily on several factors including the company’s reputation, the project it is working on, the existence of government or major shareholder backing and the nature of its industry. For example, companies involved in essential services will find good support from the investor community. Ultimately, however, most companies will have to balance a trade-off between the type of funds raised and the cost of the funds.

"Whether you use bonds depends on the project you are working on, and also depends on how bond subscribers view the company. You need a good reputation, or bonds can be very costly."

- Mr. Sam Kwai Hoong
Sources of funding during an IPO

Companies that undertake large scale projects, such as real estate developers will find it difficult to raise debt, as they typically do not have significant cash flow until the project is completed, where the revenue potential then is sufficient to pay the debt. In the case study, Genting’s cash flows were initially negative, but the size of the RWS project and the way it was positioned made it attractive to the market. Genting’s funds raised initially were mostly equity or equity-linked in nature. Although more expensive, it was necessary to build up its equity base for future raising of debt.

The question of a backup plan

Companies that raise funds before the project was approved, as Genting did when it went IPO before receiving approval for the RWS project, should plan for alternative sources of funding based on a worst-case scenario. If, for example, Genting had delayed its IPO and been caught in the financial crisis, the company would have had to rely on its relationship with the banks to raise funds through debt which is likely to be expensive as the capital base would have been weak. However, it should be noted that Genting is a special case of the integrated resort model was initiated and approved by the government.

“The government’s involvement with Genting was a very important show of commitment which enhanced the chances of the project being approved manifold. Hence this underpinned the confidence of Genting to proceed with the IPO before receiving the approval for the RWS project. It was a strategic decision for the government to embark on the building of the integrated resorts in Singapore. Government backing is necessary for success.”

- Mr. Choo Chek Siew

METHODS OF RAISING CAPITAL

Medium-term notes (MTN) vs. bonds

Medium-term notes are set up as a standing programme that may last several years or may even be perpetual.

Once approved, they can go to the market under the MTN programme within 24 hours and can be used for any purpose, thus providing great flexibility. However, medium-term notes are time-consuming and costly to set up. Companies should therefore use such programmes for raising a larger sum, to take advantage of economies of scale. This allows them to cultivate a relationship with the banks so that future fund raising exercises can be facilitated.

In contrast, bonds are a one-time issue and each bond issue must be explained to the market separately, but they are less costly to set up.

The use of zero-coupon convertible bonds

Zero-coupon convertible bonds can end up less costly than regular bonds in terms of interest, but timing also plays a key role in the success of the exercise. In the case of Genting, the majority of bondholders converted their bonds into shares within six months of issue because the share price had shot up sooner than expected so that the interest cost to Genting was reduced. At that time, bonds were very popular and investors took advantage of that, allowing Genting to gain equity at debt cost.

"Looking at Genting’s milestones for fundraising, it seems that convertible bonds were the flavour of the month at the time. Was that by design?"

- Mr. Wayne Law

Equity vs. debt

Cost of raising equity is more expensive than cost of debt. Debt is cheaper than equity interest payments which are tax deductible as opposed to dividends, which are not. Companies with good credit and a good project in line are generally more suited to raising funds. Lenders of debt will receive interest regardless of profitability whilst dividends are paid only if a company makes profit.

When choosing equity, CFOs will typically want to discuss with existing shareholders, especially the controlling shareholder to solicit support and commitment. They should also take into consideration the company’s debt-equity ratio, as a higher average ratio will expose lenders to more risk.

For both equity and debt, the strength of a company’s balance sheet will often determine how successful fund-raising is. Companies that have a low starting capital base, raising equity will improve the balance sheet.

"Start by looking at how well capitalised your balance sheet is. With stronger balance sheet, the more likely you are to get money from the market...if you look at the instruments Genting issued, all of Genting’s actions were positioned to improve the balance sheet."

- Mr. Choo Chek Siew
Syndicated loans

Syndicated loans tend to be expensive in the short term but less costly in the long term, as the company is tapping the entire market for banks. In the case study, Genting had to turn to the banks as during the sub-prime crisis, the US Quantitative Easing and government bail-outs suppressed bond yields thus forcing companies to resort to loans. The syndicated loan fund-raising at Genting was successful mainly because of government support for the RWS project. Also because the RWS project includes theme parks and other attractions, it was able to raise loans at a lower credit spread compared to Las Vegas Sands which was more of a casino.

Perpetual bonds

Perpetual bonds are considered more equity than bonds. As such, investors do not get a favourable return as it is priced as debt. However, they were popular with the market in early 2012 as bond issues dried up and liquidity in Singapore increased as Singapore was being marketed internationally as a safe investment destination. Genting successfully raised capital through perpetual bonds when it was the “flavour of the month” during this period.

When to consider a rights issue

Although a rights issue is more costly than debt, it is useful for increasing equity on the balance sheet without diluting existing shareholders. However, a rights issue is usually resorted to when the company does not have a strong cash flow to service interest and debt repayment. For companies that rely on cash flows in the future as Genting did, it is better to concentrate on raising equity.

Secondly, the discount over market share price needs to be substantial enough to incentivise take up. The discount offered depends on market appetite.

Thirdly, the company should get the support of existing shareholders to take up their share of rights. A major consideration for rights issues is whether dividends post-rights can be maintained or grown, otherwise share price can be pressured down. Institutional shareholders will typically scrutinise the company’s projects closely before taking up their rights. It is therefore very important to articulate the purpose of the rights issue to shareholders.

"Shareholder psychology is always that borrowing from banks is better than asking existing shareholders for funds. The discipline of having to pay interest forces management to have to generate enough cash flow. So you need to spend a lot of time explaining and convincing them of the merits of rights."
- Mr. Choo Chek Siew

RELATED ISSUES

Sources of risk

CFOs need to be aware of the risks their companies face during fund-raising. These risks may be macroeconomic, political or even driven by business strategy. Genting, for example, pushed to open RWS before MBS despite being awarded the project later, in spite of being hit by the Indonesian ban on sand exports during the financial crisis.

Underwriting: a necessity?

With the support of key shareholders, underwriting becomes less necessary. However, most CFOs will choose to pay to have deals underwritten because it acts as a bankers’ guarantee. The exception will be if the CFO is very confident of complete take up.

The cost of underwriting may go as high as 1.5% excluding hidden costs. CFOs who go for underwriting need to ask the banks for the full details of the costs involved and possibly negotiate for lower costs.

"Most companies won’t take the risk of not having underwriting unless it’s so expensive that it sticks out like a sore thumb. But as a CFO, I would almost always choose the underwritten deal."
- Mr. Choo Chek Siew

Advantages of getting a credit rating

When raising capital, companies may want to consider obtaining a rating. The advantages of doing so are that rated instruments will generally reduce the cost of borrowing and provide a better image in investors’ eyes. A rating also makes information about the company more accessible, broadening the investor base. Having a strong parent eg. Temasek, does provide the ‘halo’ glow.

On the other hand, working with rating agencies can be costly and time consuming. Companies are also expected to disclose a great deal of information to the rating agencies. Ratings will need to be refreshed periodically and covenants are more onerous with rated instruments.

"It can actually be quite a hassle to deal with the rating agencies. Rating houses have their own methodologies, people in the agency come and go."
- Ms. Cheng Ai Kim
Negotiating covenants

Negotiating covenants is one of the most important issues in raising funds. Often, covenants become increasingly onerous in proportion to the amount of capital being raised, especially if the company gets a rating. CFOs need to balance the banks’ requirements with the company’s interests.

Some of the covenants to be negotiated are:

- The liquidity ratio
- The debt-equity ratio and other gearing ratios
- Shareholder changes
- The sustainability of dividends and whether they can be increased
- Interest coverage
- Acquisitions and disposals: some banks require companies to seek their explicit permission for acquisitions or disposals
- The negative pledge clause

Costs involved in raising capital

The costs involved in raising capital include:

- Credit spread
- Commitment fees
- Upfront arrangement fees
- Management fees
- Underwriting fees
- Legal fees: it is possible to use the same law firm as that for the bank to save costs, but the teams working with each party must remain independent.

Besides bank costs, the company will incur marketing costs including advertorials, roadshows, and raising publicity at international fund-raising circuits. There are also costs such as agent bank fees, SGX listing fees and trustee fees. The CFO also needs to negotiate break-funding penalties and pre-payment penalties.
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