How Shareholders Benefit From ‘Follow-On Offering’ Trend

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Nathan Briggs, a partner in the asset management practice at Ropes and Gray. Read the Q & A below as Nathan discusses the burgeoning trend and inner workings of 'follow-on offerings' – where closed-end funds raise additional capital and add to their outstanding shares – and the mostly positive impact these actions have for shareholders.

Nathan Briggs

The podcast can be found on AICA’s website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Nathan Briggs, a partner at Ropes and Gray is here and we’re discussing follow-on offerings, which means you’re about to learn something now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator’s brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry. from users and investors to fund sponsors and creators, if you’re looking for excellence beyond indexing, The NAVigator’s going to point you in the right direction. And today we’re discussing the surge and changing landscape of follow-on offerings, which means additional offerings made after a closed-end fund’s IPO to

raise additional assets. It's something that most average investors and advisors don't pay much attention to, but my guest Nathan Briggs pays a lot of attention to. He's a partner in the asset management group at the law firm Ropes and Gray, and you can learn about him and the firm at RopesGray.com. You can learn more about closed-end funds generally at AICAlliance.org, the website for the Active Investment Company Alliance. Nathan Briggs, thanks for joining me on The NAVigator.

NATHAN BRIGGS: Thank you, Chuck. Happy to be here.

CHUCK JAFFE: Nathan, we need to start with a bit of an explanation of follow-on offerings, but also why this is happening. Because I think most people think of closed-end funds and go, "Yeah, you get a fixed number or shares and you go off and do it, and you trade a premium or discount." They don't really think about this secondary offering and how it works, and there's a couple of different forms. We're seeing more of it. Why are we seeing more, and how does it work?

NATHAN BRIGGS: So thanks for having me. I guess first I'll just start by noting a few of the different forms as you said, and just talking a little bit about what follow-on offerings are. So as you mentioned, follow-on offerings are a way that closed-end funds can raise assets after they've already done an IPO. So maybe they've been in existence for a few years, there's additional appetite for the fund strategy and the manager sees a way that it can grow the fund's assets to benefit the shareholders and the fund, and also the manager as well. There are typically three types of follow-on offerings. The first and probably the most common is what's called an at-the-market shelf offering, often referred to as an ATM. That's basically a way that a fund can trickle new shares onto the exchange into the market with very little, if any, impact on the price. So you as an investor, if you go buy shares of a closed-end fund on the New York Stock Exchange, you won't necessarily know whether you're buying existing shares from a third party who's selling it or newly issued shares from the fund. A second type of offering is called a rights offering, and that's a way that funds will raise additional capital by offering rights to existing shareholders, give the shareholders the ability to exercise those rights and purchase a pro rata portion of additional shares at a share price. And rights offerings are interesting because of all the follow-on offerings they are the one type of offering that allows a fund to issue shares at a discount to NAV, which we can talk a little bit more about if we have time. And then the last form of follow-on offering, by far it's the less

common form, but it's an underwritten one-time follow-on offering. And this is much more akin to an IPO where the fund goes out, finds and underwriter, the underwriter builds a syndicate, there may be a brief marketing period, and they do a one-time raise to get a chunk of change. That's less common, because as you can imagine, an immediate influx of capital like that can put downward pressure on the market price. So there's a lot more sensitivity around the analysis around whether it's good for shareholders, whether it's good for the fund, and whether the manager will be able to invest that capital immediately following the offering.

CHUCK JAFFE: Now as I understand it, not every closed-end fund can simply say, "Hey, I want to do a follow-on offering" no matter what form it is. A, why is that? And B, is there anything in these offerings that would be considered either particularly good or bad for investors? I mean, how should investors react if they see that, "Hey, there's a follow-on offering to a fund that I'm interested in"?

NATHAN BRIGGS: Yeah, that's right, so not all funds can do a follow-on offering. The starting point in general is that a fund has to be trading at a premium to do a follow-on offering. So just to give you a sense, currently there are about 470 listed closed-end funds out there, about a third of them are trading at a premium and about 15% of them are trading at a sufficient enough premium to also account for a sales commission. And what that means is that only about a third or fewer funds right now could actually do a more traditional follow-on offering. And the reason for that is under the Investment Company Act the SEC wants to ensure that funds can go out and issue more shares that would be dilutive to existing shareholders. And that's to your second question, I think there is initially some concern by shareholders when they see a fund announcing that it's doing a follow-on offering, and the reason for that is that I think there's concern that it could potentially put downward pressure on the current market price. That said, a central part of follow-on offerings is board involvement and discussion between the manager and the board. The manager has to provide very robust analysis and rationale for why it's good for existing shareholders. And really that is the central point, that the board and the manager typically come to the conclusion that even though there may be a short-term downward impact on the market price, in the long term it's better for shareholders because typically it's going to be accretive to NAV, so the value of the existing shareholders shares on a NAV basis will actually increase.

But also managers typically want to do a follow-on offering because it's an attractive market. Meaning they can take that additional capital, go invest in high-performing securities, securities that are going to be beneficial to the fund's income stream, and therefore hopefully either allow the fund to maintain its dividend for the long term or in certain circumstances maybe even result in an increase to the dividend. So ultimately I think it's good for shareholders.

CHUCK JAFFE: Which is good news, because if I understand correctly, this is not something that typically shareholders have to vote on. Here we are talking about an esoteric thing, and anybody who's a stockholder in a corporation would think, oh wait, that might be a change to the charter that has to come through a proxy. This is not something that as a general rule the fund has to ask my permission of.

NATHAN BRIGGS: That's right. There are some scenarios where under NYSE rules shareholders would be required to vote. For example if the fund is going to be issuing a significant percentage of the outstanding shares, more than 20% of its outstanding shares. There also may be some funds out there that have shareholder voting requirements in their charter documents, although I think that would be pretty rare. As a practical matter, if shareholder approval was required, the cost of getting shareholder approval would outweigh probably the benefits, at least the short-term benefits, and it's something that the board and the managers probably would avoid.

CHUCK JAFFE: A lot of this activity that we're talking about is really the fallout from fund reform.

NATHAN BRIGGS: Yeah.

CHUCK JAFFE: Some changes in the industry. Is that pushing this? Or is this more a case of the fund sponsors going, "Hey, there's more opportunity here"? What is driving it? And if I'm a shareholder, again, okay, it's not dilutive so I'm not thinking it's a bad thing. But is this like a statement of strength being issued by management, like if I see this I'm going, "They really believe in this space"?

NATHAN BRIGGS: All very good questions. I think it's a confluence of a number of factors. Right now there was probably about a five-year lull in closed-end fund offerings, both IPOs and follow-on offering. I think around 2019 or so we've seen a number of things happen. One, there's been a dramatic increase in interest in alternative assets, private credit, real estate,

loan originations, those types of things that are very, very conducive to the closed-end fund vehicle. Then around the same time we have managers coming out with new offering structures where managers are much more likely to pick up some of the offering costs, if not all of the offering costs, so that makes it more attractive to shareholders. And then on top of that we have the closed-end fund offering reform in 2020, and frankly the very attractive market that came out of Covid, post-Covid in 2020, all coming together to make follow-on offerings much easier to do. They can now do them in the same way that operating companies can do them. That hasn't been the case historically, and it's been frankly just a very significant barrier to doing closed-end fund follow-on offerings, so that's out of the way. And the market is very attractive, and it's absolutely a show of strength. It's a sign that the strategy of the fund, there's demand for the strategy, and it's a way for managers to take advantage of attractive market opportunities. And basically their analysis is, look, there's demand for this strategy, and if you're a shareholder, it may be your fund and they think this is a really good strategy, there's a lot of opportunity out there and so what are our options? We can either launch a new fund using that strategy, it's going to be a significant cost and it'll take six months or so to get the syndicate together and get the fund launched. Or in a couple of weeks we can do some additional offerings on this strategy, this existing strategy with this existing fund, at a much lower price and benefit shareholders in a much quicker manner.

CHUCK JAFFE: Nathan, great stuff. Thank you so much for helping explain it and helping us learn something today.

NATHAN BRIGGS: My pleasure. Thanks for having me, really appreciate it.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yes, that's me and you can learn all about my hour-long weekday show on your favorite podcast app or by going to MoneyLifeShow.com. To learn more about interval funds, closed-end funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest, Nathan Briggs, a partner in the asset management group at the law firm Ropes and Gray, which you can learn about online at RopesGray.com and on Twitter @RopesGray. The NAVigator podcast is new every Friday, and yes, we will have holiday editions all the Fridays of this year, so enjoy the holidays and stick with us. And until we do this again next week, happy investing everybody.

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