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Closed-End Funds | An analysis of the closed-end fund market

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Rights Offerings

A closed-end fund (CEF) may sometimes offer rights to raise capital. The purpose of this report is to review the basics of such a corporate action, its consequences, and how shareholders may decide to respond to it.

An existing CEF may raise additional capital by offering rights, which gives existing shareholders the right (but not an obligation) to purchase additional shares of common stock at a discount to net asset value (NAV). The additional supply of shares often causes NAV dilution, especially for non-participating shareholders, and a wider discount. Each shareholder is offered an amount of rights proportional to the amount of shares they hold as of the record date. After receiving the rights, the shareholder will be allowed to subscribe to the offering and can purchase additional shares. Each additional share will require a certain amount of rights plus a subscription price, both of which are specified by the terms of the offering. The mechanics of a rights offering may best be illustrated by a hypothetical example in the table on the next page.

Suppose a CEF with 20 million shares outstanding is trading at a 20% discount based on a $10 NAV and an $8 market price. Assume that the CEF's sponsor would like to increase the fund's size and has chosen to do so by initiating a rights offering. Under the terms of the offering, each shareholder will receive one right for each share held as of the record date. Furthermore, each shareholder can subscribe to purchase one additional share with each five rights held at the subscription price, which according to the offering is set at 95% of the average market price on the last five days of the offering period. If we assume a first scenario where the market price is still around $8 at the expiration of the rights offering (normally the price will decline as discussed later in a second scenario, all else held constant) and also assume the offering is fully subscribed, 4 million shares would be sold to subscribers. This would raise an additional $30.4 million for the CEF (4 million shares times $8 times 95%). As is illustrated in the table, net assets would be $230.4 million, shares outstanding would be 24 million, the new NAV would be $9.60 (a decrease of 40 cents per share post rights offering), and the discount to NAV would be a narrower 17%. For simplicity, we will ignore any expenses related to the offering.

NAV Dilution

Rights offerings dilute NAV when the new shares are issued below NAV, and they are accretive to NAV when the new shares are offered above NAV. It is usually the case that the existing valuation falls after a rights offering is announced — i.e., a premium narrows or a discount widens — because the supply of shares increases. Referring back to the hypothetical example above, if the market price in a second scenario declines to a lower $7 (instead of the $8 in Scenario 1) because shareholders anticipate NAV dilution, $26.6 million would be raised, and the NAV would be diluted more substantially to $9.44 after the offering. The resulting valuation would be a 26% discount, which is wider than the pre-rights offering discount of 20%.

Please see page 3 of this report for Disclosures.

Table: Hypothetical Rights Offering	
Terms: Each shareholder will receive one right for each share held. With five rights, one can purchase one new share at 95% of market price.	
Prior to Rights Offering	
Number of Shares Oustanding Prior to Rights Offering	20,000,000
Total Net Assets	$200,000,000
NAV	$10.00
Market Price	$8.00
Discount	-20%
Scenario 1: Effect of Rights Offering *(assuming fully subscribed)*	
Assumes the market price averages $8 for the final five days of the subscription period.	
Capital Raised	$30,400,000
Shares Issued as a Result of Rights Offering	4,000,000
New Total Net Assets	$230,400,000
New Share Count	24,000,000
New NAV	$9.60
New Discount to NAV	-17%
Scenario 2: Effects of Rights Offering *(assuming fully subscribed) — greater NAV dilution*	
Assumes the market price averages $7 for the final five days of the subscription period.	
Capital Raised	$26,600,000
Shares Issued as a Result of Rights Offering	4,000,000
New Total Net Assets	$226,600,000
New Share Count	24,000,000
New NAV	$9.44
New Discount to NAV	-26%

Source: Wells Fargo Advisors

Transferable Rights

Additionally, another factor shareholders should consider during a rights offering is whether they are receiving transferable or non-transferable rights. Transferable rights can be sold in the market at the prevailing price. Shareholders who do not wish to subscribe to the rights offering (because they can't or don't want to increase their position to the fund) may instead sell the rights, which may help them partially offset any NAV dilution. Non-transferable rights, however, have no market value and cannot be sold. Non-subscribing shareholders may experience the full effect of NAV dilution.

Shareholder Action

Investors need to consider each rights offering to identify the benefits of participation. However, shareholders should consider the possible actions to minimize the disadvantages and maximize the advantages of such a corporate action. Rarely is it prudent to do nothing. First of all, if existing shareholders want to buy more shares of the CEF, they should subscribe to the rights offering and use cash to purchase additional shares at a discount. Alternatively, those shareholders who do not have the cash or the desire to purchase new shares can sell their transferable rights to reduce the effects of NAV dilution. Lastly, if the rights are non-transferable, shareholders could sell existing shares to later repurchase additional shares to minimize NAV dilution.

Conclusion

Shareholders should be aware when a CEF issues rights and its implications on NAV and valuation (i.e., premium/discount) to decide on the most appropriate course of action.

Disclosures

Closed-End Funds (CEFs) are actively managed and can employ a number of investment strategies in pursuit of the fund's objectives. Some strategies may increase the overall risk of the fund and there is no assurance that any investment strategy will be successful or that the fund will achieve its intended objective. A CEF has both a market price and net asset value (NAV), and these two values and their respective performances may differ. Changes in investor demand for a particular fund may cause the fund to trade at a price that is greater (lower) than it's NAV, creating a share price premium (discount) to its NAV. CEFs are subject to different risks, volatility, fees and expenses. Many CEFs can leverage their assets to enhance yields. Leverage is a speculative technique that exposes a portfolio to increased risk of loss, may cause fluctuations in the market value of the fund's portfolio which could have a disproportionately large effect on the fund's NAV or cause the NAV of the fund generally to decline faster than it would otherwise. The use of leverage and other risk factors are more fully described in each closed-end fund's prospectus under the heading "Risks."

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