Demystifying the IPO Process: Some Current Issues for Investors

This briefing outlines a number of points for current FCA consultation on premium listing, and raises emerging challenges relating to prospectus design and index inclusion especially in relation to climate-related risks.

This briefing outlines ShareAction’s concerns on the the Financial Conduct Authority’s (FCA) premium listing consultation (Consultation Paper CP17/21), the lack of climate related disclosure in prospectus and reserve reports and some specific issues relating to the commodity-heavy FTSE 100 index. The briefing is also designed to give an overview of selected aspects of the equity capital markets related to initial public offerings (IPOs) and secondary raisings, listing requirements and index criteria in the UK.

We have also included a short glossary of terms at the back.

Key takeaways

• Institutional investors need to carefully consider the potential knock on implications of the FCA’s proposed changes to the premium listing. If not carefully managed, we believe these proposals may have negative implications for the rights and protections of minority shareholders. Investors need to respond to the FCA by the 13 October 2017.

• Corporate advisers and lawyers as well as the regulators who write, design and approve prospectuses for primary or secondary debt or equity raises should be ensuring that strategic issues such as climate change and its implications for businesses are comprehensively covered in the risk sections of a prospectus.

• Reserve reports for the oil and gas sector and the categorisation of oil reserves should incorporate different climate change scenarios. Reserve reports ought to enable and help investors analyse and model a company’s prospects under different climate scenarios.

• In the light of the significant weighting in the FTSE 100 of commodity and oil and gas companies, FTSE Russell should consult on whether the criteria for FTSE 100 inclusion should move to include reporting requirements on climate-related reporting and governance. This approach might utilise the reporting framework proposed by the Financial Stability Board’s Task Force for Climate-related Financial Disclosures.

1. Listing rules

Premium vs standard listing

For any UK and foreign registered companies applying to be listed on the UK stock market there are a number of options. The ‘normal’ route for an equity issuance would be to apply for premium and standard listing.¹
A premium listing is available to equity shares issued by trading companies, closed and open-ended investment entities. Companies applying for a premium listing are required to meet the UK’s super-equivalent rules (higher than the EU minimum requirements) in terms of a range of measures that protect minority shareholders: corporate governance, size of free float, UK Takeover Code and pre-emption rights. For businesses, the benefits of meeting the premium listing requirements are: possible FTSE benchmark inclusion, a stamp of UK regulatory approval, potentially a lower cost of capital due to higher levels of investor confidence and access to a broader base of institutional investors.

A standard listing covers issuance of shares, Global Depositary Receipts (GDRs), debt and securitised derivatives. A standard listing allows issuers access to equity investors by meeting minimum EU standards on governance and minority rights.

These two categories were introduced by the FCA in reaction to corporate governance issues surrounding London listed but foreign domiciled commodity businesses such as ENRC plc, Bumi plc, and Nikanor plc. At the time, much of the discussion in the financial press highlighted the risks around the lack of corporate governance controls in the UK market. After the corporate governance issues surrounding one of these businesses became apparent, a leading institutional investor commented:

“(ENRC) has not been good for shareholders, the City of London or anyone. It more than anything highlights the dangers of buying into companies with poor corporate governance and a structure of control that resembles an oligopoly.”

Professor Julian Franks (London Business School) also commented:

“I think also that London with very good reason was worried about competition from other exchanges and about the number and size of their listings, so we probably allowed our rules to become too lax as a way of competing.”

The FCA is currently consulting on introducing a new premium listing category which is suited to the ownership, free float and governance structures of state owned enterprises. These enterprises may want to undertake partial privatisation through a share sale to international institutions. governance or free float (See below).

The current situation sees the UK market under increasing competitive pressure from other exchanges due to the Brexit process.

The FCA’s consultation process asks various questions relating to the proposed changes. The objective of the ‘new’ premium listing category is to increase the attractiveness of a UK listing to non-UK state-owned bodies. Due to free float and corporate governance issues, some of these businesses would not meet the existing premium listing standard. They would also be unlikely to be included within the FTSE indices due to issues relating to the country of incorporation.

In some ways, the new premium listing is being reviewed in a similar environment to the late 90s – early 00s. The current situation sees the UK market under increasing competitive pressure from other exchanges due to the Brexit process and the questions that raises about the future of London as a global financial market.

ShareAction believes that, if not handled carefully the proposed changes to the premium listing might result in an environment that threatens minority investor protections that have been introduced over the last 15 years. After the ENRC corporate governance issues came to light and resulted in significant loss of shareholder value, the ENRC chairman of one of those foreign-owned businesses with corporate governance issues said:

“The City...‘Has a remarkably short memory......These things go in 10-15 year cycles. Everything will loosen up again in a few years’ time.”

These corporate governance issues were approximately 10 years ago. We are concerned this may mark the loosening of corporate governance protectors.

There are already other mechanisms, other than standard or premium listing for foreign businesses wanting to access UK-based investors including listing a GDRs. These are issued by banks
For investors, the prospectus can provide key information on a company’s financial prospects, the governance structure, share structure and key risks.

2. Prospectus design

What is a prospectus?

The prospectus is the marketing document for a company or investment vehicle that wants to list on the UK market. The prospectus is approved by the UK Listing Authority (part of the FCA) and has a standard format. The process of approval is generally managed by the company’s legal or corporate advisers.

The prospectus is crucial to the listing process as it is used as the basis for the marketing presentation and is the document that is scrutinised by analysts to provide their initial IPO research. For overseas and family businesses, the prospectus is a key ‘verified’ document that equity analysts and investors can rely on when constructing a valuation of a business. They are usually available a month before the expected flotation date.

instead of adapting the premium listing, the FCA might try to replicate the American Depository Receipt (ADR) system ADRs are traded only on the US stock market and are separated into several different levels (I, II & III) depending on whether the business has met certain SEC financial reporting standards.

For investors, the prospectus should provide key information on a company’s financial prospects, the governance structure, share structure and key risks.

The Royal Mail prospectus’ is a (relatively) recent example of a high-profile prospectus which included:

- Current operations and principal activities
- Significant recent trends affecting the Group and the industries in which it operates
- Group structure
- Selected historical key financial information
- Description of class of the securities rights attached
- Key risks relating to the Group’s business
- Key risks relating to the legal and regulatory environment within which the Group operates
- Key risks relating to the Offer and the Ordinary Shares
- Reasons for the Offer and use of proceeds
- Selling Shareholder/Lock-up Arrangements

Risk section and relationship agreements

The risk sections are often the most revealing segments of a prospectus as they include current, historic and future issues as identified by senior management and advisors. The deliberate omission of key risks opens management up to future litigation. These risk disclosures are designed to be “specific to the issuers or the industry”, but can also relate to the structure of the listing.

A prospectus is also required for certain secondary equity raises. A recent example is the £750m secondary equity raise undertaken by Tullow Oil (FTSE 250 exploration and production business). The risk section in Tullow Oil’s prospectus outlines political, commercial and technical risk factors as well as those associated with Tullow Oil’s balance sheet and near-term trading. However there is no reference to the potential issues surrounding the implications of climate change policy and changing technology on oil price demand and subsequent oil price. Interestingly the Royal Mail risk section outlines in greater detail longer term structural risks such as electronic mail and different delivery systems. Risk sections are an important section of any prospectus. However, based on these examples, there seems to be little consistency in what is deemed material and the time horizon required.

Relationship agreements are often included in a prospectus in cases where there is a significant single (or group of) investor(s) who represent a
Index criteria

FTSE index inclusion

FTSE Russell publicise a series of indices that track the performance of groups of listed equities on the UK market. Each FTSE Russell index has a series of inclusion criteria that differ depending on the index (e.g. FTSE small cap ex investment trust, FTSE 250, FTSE 100). These indices are important as they are used to benchmark institutional investor performance in passive funds. They are used as a framework for passive (or quasi passive) funds and electronically traded funds (ETFs). The FTSE Russell indices are the predominant indices used by investors in the UK.

For a business looking to float on the UK market with a market capitalisation greater than approximately £3bn, inclusion into the FTSE 100 is often the objective. FTSE Russell stipulates that members of the FTSE 100 index must have premium listing (i.e. meet the criteria outlined above), UK incorporation, and meet certain free float criteria. The FTSE 100 is a truly international index attracting a wide range of businesses whose activities better reflect more the global economy than the UK’s GDP. Its largest constituents generate relatively a small percentage of profit and revenue in the UK. The London market also has a history of attracting commodity businesses.

Many indices are often dominated by a small number of stocks or sectors. For example the UK index has a high weighting in commodity sectors (see chart below).

FTSE 100 membership is attractive as it brings benefits such as better liquidity, guaranteed index fund buyers and easier access to the top tier of institutional investors.

In the case of the FCA proposals on a new category of premium listing, FTSE Russell have been keen to highlight that membership requires a number of other criteria. These criteria (liquidity, country of incorporation, free float and primary listing) will often be difficult, if not impossible, for foreign state-owned enterprises to meet.

Relative to other national indices, the FTSE 100 has a particularly high weighting in commodity and integrated oil sectors. These sectors have material risk issues relating to possible climate change regulation, changes in technology and consumer consumption patterns. As many passive (and quasi passive) investors have holdings that replicate the FTSE 100, it would seem a sensible step for FTSE

Commodity sector weighting in selected equity markets

<table>
<thead>
<tr>
<th>Commodity Sector</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>35%</td>
</tr>
<tr>
<td>Metals &amp; Mining</td>
<td>30%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Deutsche Boerse
Russell to consult investors as to whether they believe the index constituents ought to incorporate climate related material risks in their standard reporting process. With the final report of the FSB’s Task Force for Climate-related Financial Disclosure, businesses now have a framework to structure such reporting so comparisons and progress can be monitored.

4. IPO process

What is the UK initial public offering process?

The process of an initial public offering can take a period of years and involves several specific steps. These will tend to be standard across all markets, though the role of advisers and regulatory may change.

These steps include:

- Appointment of key financial, corporate and legal advisers
- Preparation of the financial accounts to meet appropriate international standards and provide pro-forma historic data
- Selection of key financial market and share structure
- Development of investment proposition and discussions with cornerstone investors – institutional and, where appropriate, industrial
- Establishment of suitable corporate governance structures (entrepreneur, private equity or state entity to standard board with non executives)
- Establishment of any relationship agreements and tax structures (for commodity business - reserve estimate and analysis)
- Decision on the use of proceeds
- Development of an equity proposition
- Marketing to institutional investors and writing of equity research initiation notes
- Discussions over pricing and allocation of shares to interested institutions

Many early stages of this process are largely confidential and occur on a bilateral basis with negotiations and discussion between the company’s management, advisers, the FCA and key institutional investors.

Cornerstone investors

It is worth mentioning the potential role of cornerstone investors. A cornerstone investor will generally be involved in the IPO process at an early stage and possibly have invested in the business pre-IPO. Cornerstone investors will generally be institutional or strategic investors who can provide some support to the process. They will often be involved in pre-marketing (early stage marketing presentations by senior management) and provide advice on pricing, the investment proposition, market/governance structure, balance sheet/gearing and dividend policy. Cornerstone investors will make a (informal or formal) commitment to support the IPO.

This commitment is ‘in exchange’ for other perceived or actual benefits such as treatment in the allocation process.

In the case of some industries and IPOs, the management and its advisers will often invite strategic industrial cornerstone investors. Some sector specific cornerstone investors might also include institutional investors such as Fidelity, Blackrock and sovereign wealth funds.

The presence of cornerstone investors provides reassurance to the broader institutional investor base that the valuation and investment proposition has been given the ‘stamp of’ approval by industry ‘insiders’.

Valuation and pricing

The pricing and valuation should be thought of as separate processes.

The ‘valuation’ process is influenced by the press, buy and sell side equity analysts, and corporate advisers. It is generally informed by the prospectus and - in the case of the oil and gas sector - a reserves report. Often analysts will produce a range of valuations based on a series of different assumptions and valuation metrics.

For large IPOs it is often the case that the company signs up a large number of investment banks as sub advisers. These banks will all undertake connected equity research and hope to generate subsequent advisory and trading fees. The success of the IPO is in the clear interest of these advisors. The ‘pricing’ process is the three-way negotiation between institutional investors, the company’s advisers and management to determine a final float price. This may or may not be in the original valuation range set by advisers and depends on factors such as demand, management expectations and equity market conditions.
The valuation and pricing process involve:

1. Publication of the prospectus and, for commodity businesses, reserve analysis
   • Including key data about historic financial performance on a pro forma basis
   • This information will provide the key input to analyst and investor equity models
2. Publication of pre-IPO equity research
   • Regulatory rules have introduced Chinese walls between equity analysts and corporate advisers to ensure a fair access to management and information
   • Equity analysts will use a range of valuation tools to generate various valuation estimates
3. Management presentations and discussion with investors
   • This process will start to refine the expected valuation range and be informed by current equity market conditions, oil price, expected demand, size of the offering, quality of management and strength of the book build (demand for shares)
   • This pricing discussion will often result in investors placing orders dependent on pricing e.g. if the price is X then my order is Y however if the price is X+1 then my order is Y-5

The final stage of this pricing process is a critical juncture, and often when the process is called off or postponed. This might be because of equity market volatility or because management has different valuation expectations to participating institutions. An example of this is the privatisation and flotation of BP in the late eighties. In 1987, unlike current practice, pricing was set significantly before the first day of trading. The flotation coincided with Black Monday resulting in significant losses for institutional investors and underwriting banks as pricing was set in better market conditions.\(^\text{11}\)

Since the nineties, the process has changed and current corporate advisers try to ensure the needs of investors (to be perceived to be getting a fairly priced product compared to other options) and sellers (gaining the levels of liquidity and enabling the business to access equity markets going forward) are both met.

Secondary capital raises (where the business is already listed) have a different process - which recognises and protects the rights of existing equity holders - but the principles are broadly similar.

What happens if it fails?

Failure can mean a range of different outcomes. Sellers (management, private equity, state institutions) may want to cancel the proposed raising as the price is below initial expectations. Buyers (institutional investors) may deem the IPO to be a failure if they receive a lower allocation than expected as the issue is over-subscribed (or there is too much demand).

The key risk for the IPO proceeding is that macroeconomic events negatively impact liquidity and investor confidence. Under these circumstances the issue size may be scaled back, postponed or other options explored eg. a private placement with a number of key ‘cornerstone investors’ as an initial step to a delayed IPO.
Glossary

Free-float

The shares available to be traded easily by investors. It will often exclude shares held by insiders such as management, governments, founders or private equity.

UK Takeover Code

City Code on Takeovers and Mergers (the “Code”) has been developed since the seventies to represent a set of standards for takeovers of quoted businesses. Some elements have a statutory basis following the introduction of the Takeovers Directive (2004/25/EC) (the “Directive”) by means of Part 28 of the Companies Act 2006 (the “Act”).

Minority Shareholder

This is broadly defined as a shareholder who does not exert control over a company. Minority shareholders have certain statutory rights under the Companies Act 2006.

UK Listing Authority

The UKLA is the part of the FCA that manages the listing process.

Proven, Probable & Possible Reserves

Three categories of oil and gas reserves that have differing levels of commercial and geological feasibility.

ENRC plc, Nikanor plc & Bumi plc

Three UK quoted commodity businesses that had various corporate governance failures.

Secondary capital raise

The process by which a quoted business raises capital from existing or new shareholders.

2. Ibid.


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About ShareAction

ShareAction (Fairshare Educational Foundation) is a registered charity that promotes Responsible Investment practices by pension providers and fund managers. ShareAction believes that Responsible Investment helps to safeguard investments as well as securing environmental and social benefits.

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