Dual track and competitive IPOs

Introduction

The reasons for doing an initial public offering (IPO) are manifold. Companies go public to fund future growth, to promote public awareness and brand recognition, to facilitate employee retention, to turn shares into acquisition currency, but also, quite simply, to provide existing shareholders with an exit opportunity.

In IPOs *with* exit, two points are of particular importance to the selling shareholders: Deal certainty and best price. Dual track transactions seek to meet these concerns. By running an IPO and a trade sale auction process (more or less) in parallel, selling shareholders become less susceptible to capital market disruptions (which may delay or stop an IPO) or insufficient interest from potential trade sale buyers; at the same time, the investment banks managing the IPO process (but also potential trade sale buyers) are additionally incentivised in terms of valuation and offering terms. For these and other reasons dual track procedures have become increasingly popular in Switzerland and abroad, especially where private equity firms are involved as selling shareholders.

By contrast, the term *competitive* IPO does not allude to competition between different exit tracks; rather, the IPO candidate and its shareholders seek to wrest some control of the IPO process from investment banks and maximise value by way of creating competition amongst (potential) IPO syndicate members. In a competitive IPO, unlike traditional IPOs, not all banks are appointed to the syndicate at the beginning of the process. Instead appointments and fees are finalised later on in the transaction in a process designed to encourage competition between potential syndicate members and, *inter alia*, mitigate the risk of underpricing. Competitive IPO processes are thus not necessarily limited to IPOs with exit.

This article discusses some of the challenges and opportunities of dual track processes and competitive IPOs. While written from a lawyer's perspective, the focus is laid on the more practical rather than purely legal aspects. Because IPO candidates typically will not disclose the existence of a dual track or competitive IPO process, unless in the public domain I will abstain from quoting specific Swiss cases.

1. Dual Track – Challenges and Opportunities

In a dual track process, divesting shareholders put their bet on two horses, the potential IPO and the trade sale, whereby the winner will often only be known at a relatively late stage. Until then, the company and its management will face considerable challenges:

- The preparation for IPO will *exhaust significant resources at all levels of management.* Numerous offering documents (management and analyst presentations, pilot fishing documentation, offering and listing prospectus, etc.) require management's attention and input, both written and during tedious drafting sessions; a comprehensive data room has to be set up; historical and up-to-date financial information have to be prepared for inclusion in the offering documents; corporate organisation and governance must be brought to the standard of listed companies; numerous agreements with banks, auditors, advisors etc. have to be negotiated and executed; management needs to participate in pre-marketing efforts and intense road show meetings; etc.
- *Running a trade sale auction is not less demanding.* Potential buyers expect a comprehensive data room and access to management for due diligence; also, the target company will often conduct own pre-deal due diligence and make available extensive reports to potential buyers. Likewise, potential trade buyers will scrutinise the business plans prepared by target's management. Further, "stapled finance" (i.e. an acquisition finance package prepared in advance by seller's adviser for potential buyers) is quite common. Finally, once negotiations of the purchase agreement (SPA) have started, these may be conducted in parallel with different bidders.
- Last, but not least, management will be expected to successfully continue running the company in the same manner as before.

The synergies of the IPO and trade sale track, unfortunately, are limited and mainly relate to due diligence, preparation of the equity story and certain information documents.

Further challenges arise because IPOs follow a relatively standardised and fixed timetable whereas trade sales, whether or not conducted in form of an auction, typically are subject to deal specific dynamics. Reconciling these differences is not easy. For example, in the trade sale process, bidders will at a relatively early stage submit indicative offers which may quickly be followed by binding offers. If the offer is good selling shareholders will press for rapid signing of the SPA. By contrast, in the IPO the offer price will depend on market conditions and investor demand prevailing *on the pricing date*, i.e. only after completion of the listing process, roadshow and bookbuilding, which is possibly several weeks or months ahead. Thus, by its very nature the IPO process will almost inevitably lag behind the trade sale process, and once an attractive offer for a trade sale is on the table, keeping management and others focussed on, and motivated for, the IPO becomes difficult.

From the exiting shareholders' perspective, trade sales have two natural advantages if compared to an IPO exit. First, (strategic) trade buyers may pay a premium for potential synergies which cannot be achieved in an IPO. Second, trade sales permit a 100% exit which is unusual for IPOs; indeed, in an IPO major shareholders typically will be required to accept a lock-up for a certain minimum period. Thus, unless selling shareholders wish to speculate on future share performance they will normally prefer a full exit by means of a trade sale – sometimes even if the trade sale price is potentially lower than the IPO price. A publicly known example for this is the 2005 Cablecom IPO which was aborted after official launch and publication of the IPO prospectus due to a last minute trade sale bid by US company Liberty for approx. CHF 2.8 billion – nota bene a price which was at the lower end of the announced IPO offer price range.

Unsurprisingly, trade sales therefore tend to succeed over IPOs in dual track transactions. Are dual track transactions hence just a means to maximise the purchase price in a trade sale? In my view, no. First, the IPO track provides exiting investors with a valuable fall back position in case that a trade sale does not materialise (on satisfactory terms). Second, not all IPO candidates are equally suited for a successful trade sale and whether or not this is the case will rarely be known at the start of the exit process. Third, while price matters, responsible selling shareholders will, not least for reputational reasons, also be mindful to other stakeholders' interests, including those of management and employees, who may prefer the IPO. Finally, investment banks and other IPO advisers may be further incentivised to run an efficient IPO process if competing against a trade sale process.

However, based on the above, certain aspects merit particular attention when considering a dual track exit process:

- *Deal size:* Absent extraordinary circumstances, a dual track process will only make sense for a sizeable deal.

- *Internal organisation:* Typically, in IPOs a major part of the workload rests on the shoulders of the CFO who often will at the same time be assigned the role of internal coordinator and primary contact for the banks. As mentioned above, the dual track process will bind enormous management resources. Accordingly, the workload should be shared among several members of senior management. Also, a sufficiently senior person who is not the CFO should assume the role of the internal coordinator. If the company fails to properly organise itself, the advantages of a dual track process may quickly turn into serious risks.
- *Appointment of an external project advisor:* In particular where the company lacks the necessary internal resources, it may consider appointing an independent financial advisor to assist the company in the initial preparations for the dual track process and to thereafter perform the role of a coordinator in both tracks.
- *Appointment of two separate adviser teams:* The company should consider the pros and cons of appointing different banks and advisers for each track. Splitting the adviser roles reduces the risk of potential conflicts of interest and increases the likelihood of real competition; on the other hand, coordination may become more challenging.
- *Timing / Communication Policy:* Swiss IPOs typically include, amongst others, the following milestones: Presentation to analysts, investor "pre-sounding", distribution of research reports to potential investors, "intention to float" press release, investor education, publication of preliminary offering prospectus / announcement of details of the IPO (including offer price range), road show/bookbuilding and pricing, start of trading on SWX. The period between the intention to float press release and pricing may reach up to 4 weeks or more. Although legally permitted until pricing of the IPO, once the intention to float has been formally announced the IPO candidate will normally wish to avoid a last minute abort of the IPO; on the other hand, the company (and its selling shareholders) continue to find themselves in the dilemma that the IPO and the IPO offer price will only be certain some 4 weeks later. Therefore, a company cannot avoid that a potential trade buyer will present a competing trade sale bid, e.g. once the company has published the IPO offer price range but prior to final pricing of the IPO (Cablecom). Nonetheless, in my view the dual track timetable should at least be planned such that the trade sale process is either successfully terminated or abandoned before the public announcement of the IPO. In other words, the dual track should in my view not be stretched too far.

2. Competitive IPOs

In a standard IPO, the lead manager(s) and possibly other underwriters involved in the IPO are appointed at the beginning of the process. In a competitive IPO, the syndicate members, their roles and remuneration are not finalised until later on in the process. Until then a transaction advisor will prepare the company for the IPO and coordinate the process (in a less aggressive set-up, one but not all lead managers will be appointed at an early stage). Pending formal appointment, potential syndicate members will participate in the IPO process on a no-mandate basis and provide input on valuation, equity story, offering structure, etc. – in some cases they may even prepare pre-IPO research. This maintains competitive pressure on the potential syndicate members as not all the firms involved in the competitive IPO process will be appointed to the syndicate after the initial phase.

One of the reasons why issuers may favour competitive IPOs is that it arguably gives them greater control over the IPO process and greater leverage over the investment banks involved. Moreover, it is sometimes argued that competitive IPOs reduce the risk of underpricing.

From the investment banks' perspective, competitive IPOs create potential new conflicts of interest – particularly around the preparation of pre-deal research and pre-marketing activities. Such concerns must be taken seriously. Competitive IPOs should therefore be carefully timed and managed, *inter alia*, to assure compliance with applicable rules on independence of financial research (in Switzerland namely the Swiss Bankers Association Directives on the Independence of Financial Research of 2003; in addition, foreign law rules will apply for international syndicates). Also, some investment banks have adopted more restrictive internal rules which may prohibit them from participating in the IPO process on a no-mandate basis beyond a certain stage (e.g. pre-IPO research reports). Furthermore, investment banks which take on a lead manager role will need to comply with their due diligence requirements which may no longer be possible without causing delays if such bank is appointed too late in the process.

Fully fledged competitive IPOs will generally not be suited for small or medium size IPOs. The running of a competitive IPO requires a high degree of sophistication and organisational resources at issuer level. Small and mid size IPO candidates will therefore in my view often be better served if at least appointing an experienced lead manager at an early stage instead of spending time and efforts in trying to (potentially) maximise value through a complex competitive IPO process. The situation may be different in large size IPO involving sophisticated issuers and selling shareholders.

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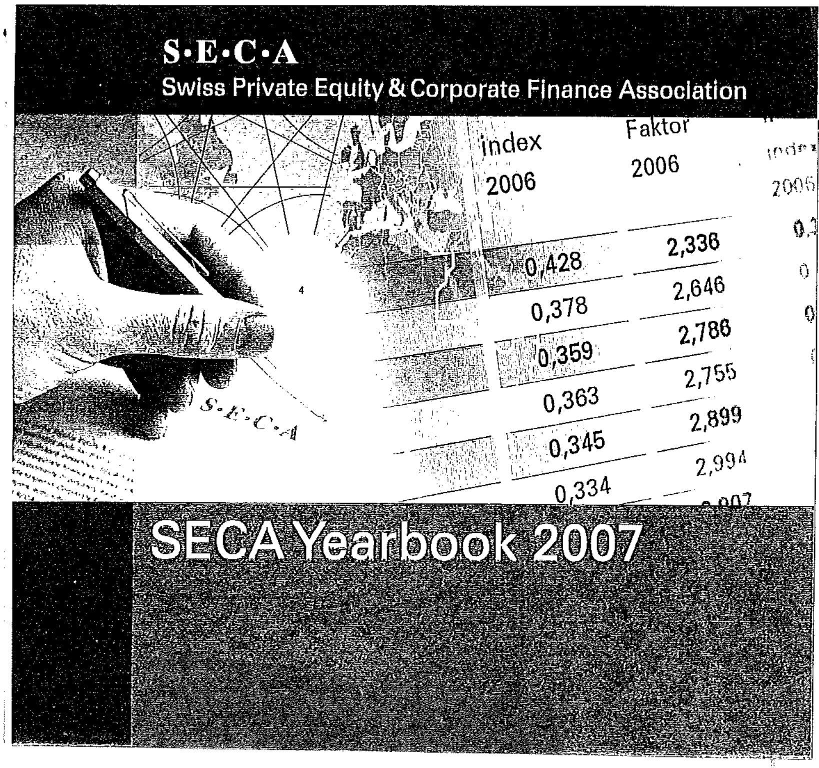

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