EQUITY CAPITAL MARKETS

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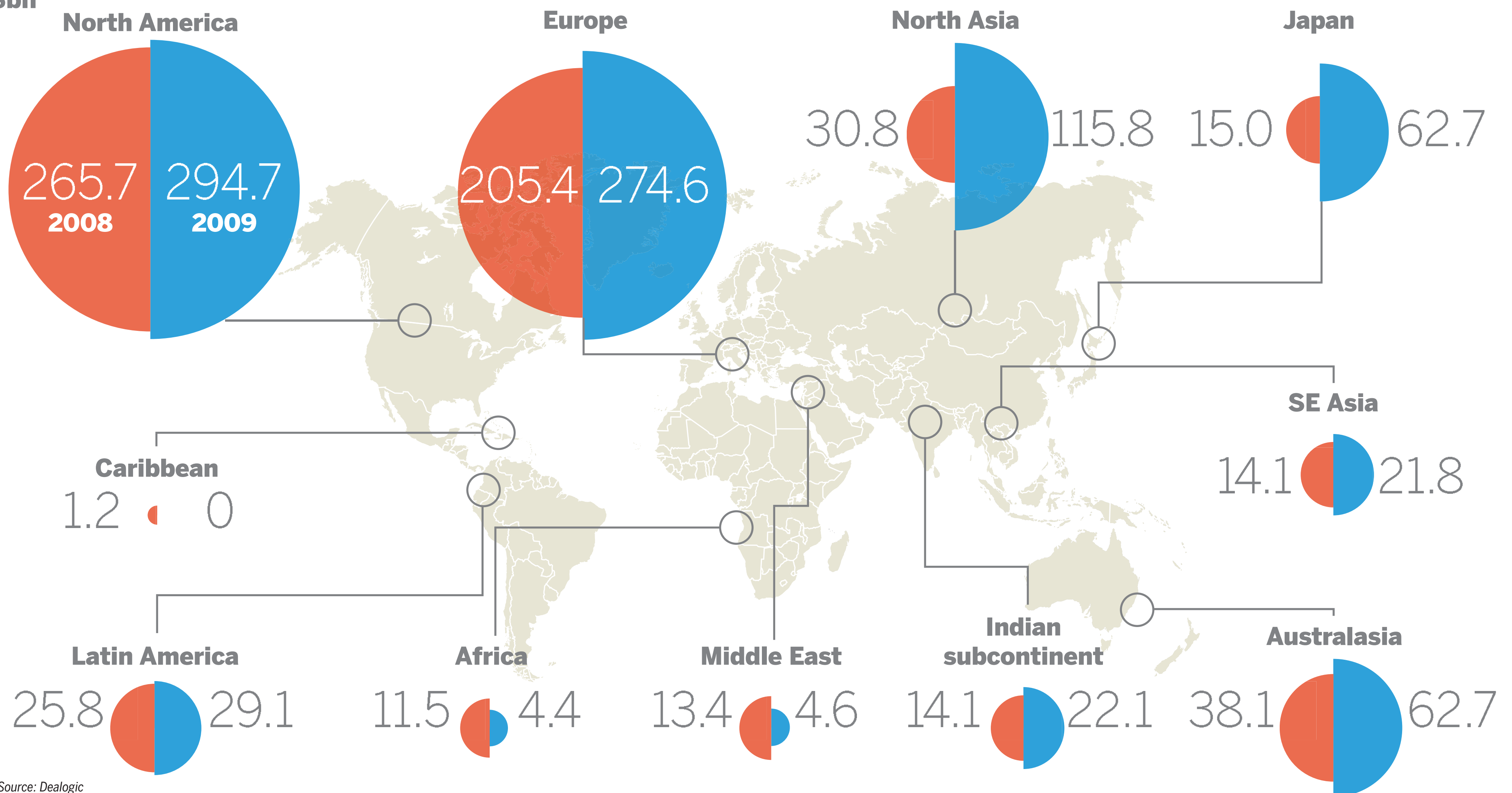

Floating – but no plain sailing

Bankers predict a raft of new issues although conditions are expected to stay choppy, writes Jennifer Hughes

A senior banker looked bemused: "What year-end break?" he asked. Equity capital markets began last year fearing the worst, as stocks around the world fell sharply. But companies' need to recapitalise and restructure their balance sheets prompted a slew of equity issuance that has shown no signs of slowing.

The numbers speak for themselves. Companies around the world raised equity worth $892.4bn last year – a 41 per cent jump on 2008. Of that, $314.5bn was placed in the last three months alone. This was a record for any quarter and three times the levels seen just a year previously. The surge has supported expectations that this year will be even bigger, as ECM bankers' holy grail returns: the IPO, or initial public offering.

Developed world stock markets bottomed in March last year and by year-end, the FTSE Eurofirst 300 had gained almost 59 per cent while in the US, the S&P 500 added nearly 65 per cent.

Small wonder, then, that executives are once more considering the public markets when they mull over their options.

"There's a large and rapidly growing pipeline – actual volumes will depend on where buyers and sellers meet," says Chris Whitman, global co-head of ECM at Deutsche Bank.

Bankers began discussing IPOs with their clients in Europe last summer – talks that are only just now bearing fruit. However, other markets had already got going; Chinese companies raised $81.5bn last year and accounted for four out of the top 10 offerings. Overall, emerging markets accounted for almost three-fifths of all ECM volume in 2009.

But this year, European markets are expected to be much bigger, as private equity companies look to cash in on investments made before the crisis and which they have had to hold for longer than they planned because of the market turmoil.

In December, Gartmore, the asset management group, became the first private equity-owned company to float since the credit crisis began, but had to cut its pricing after markets were spooked by the Dubai debt crisis and Greece's fiscal problems.

"Private equity companies are sitting on some really beautiful assets – companies with proven track records and a history of strong management. These cases should be relatively easy to make to the equity investor community," says Mark de Graaf, head of western European ECM at ING.

Bankers for Medica, the private equity-owned French care homes group, are now building books for a sale of at least €250m of shares. Last month, Travelport, a travel services company owned by Blackstone, announced its intention to float.

But talk of a raft of new issues does not mean bankers expect the market to be plain sailing. Stock markets have recently wobbled and traders expect conditions to remain choppy. For IPOs – depending on investor sentiment – this could mean an unpredictable series of "windows", where the IPO market is genuinely open and valuations meet both investor and seller expectations.

"The IPO market may not be as strong as people expect it to be, since the economic outlook is reasonably uncertain," says Matthew Koder, head of global capital markets at UBS.

He warns that the stock market rallies that have made more IPOs possible are a "double-edged sword"; they have raised the expectations of sellers but these might not be met by investors who are in no mood to give much ground.

"After waiting this long to float, many sellers will be seeking very good valuations, but these may not be in line with what investors are prepared to pay," he adds.

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CHINESE IPOs Almost $60bn was raised last year through IPOs on the Shanghai, Shenzhen and Hong Kong exchanges. Now there are hopes for another busy year, writes **Robert Cookson Page 6**

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Investors aim to ride IPO wave

Private equity

Martin Arnold on the flotations that could fuel recovery

The London Eye operating company may float this year Alamy

What do the operator of Madame Tussauds waxworks museum, Denmark's telecoms operator, the UK's biggest private hospital group, and a world leader of interactive whiteboards have in common?

They are all being prepared for an initial public offering this year by their private equity owners.

Bankers say 20 to 30 private equity-owned companies in Europe are contemplating IPOs this year. Some buy-out executives say this expected wave of flotations could be a crucial factor in their industry's recovery from the crisis.

Stephen Schwarzman, Blackstone's chief executive, has told investors that his group plans to float eight companies this year. In the UK, Permira has promised to return a "wall of cash" to investors by floating or selling a number of its portfolio companies.

Private equity is expected to dominate the IPO market this year, after two quiet years. Private equity-backed IPOs raised $16.4bn globally last year, up from $11bn in 2008, but a fraction of the $55.8bn in 2007, according to Dealogic, the financial data provider.

Most of the flotation action by private equity last year was in the US, where 25 companies raised $8.5bn, and in Asia, where 25 companies raised $7.1bn. Europe, the Middle East and Africa produced only three private equity IPOs raising just $779m.

"Private equity groups are determined to show their investors the value creation they have achieved in their portfolios," says Matt Grinnell, head of financial sponsors in Europe, Middle East and Africa at Barclays.

Bankers say the best candidates for a stock market debut will offer investors a mixture of resilient earnings growth through the downturn, a manageable level of debt and sufficient size to provide a big free float.

> 'We do expect this to be a bumper year for private equity-led IPOs'

"The best IPO candidates are the companies that don't have an obvious strategic buyer, but are large enough to offer sufficient liquidity to public market investors and have held up well through the downturn," says Mr Grinnell.

Some of the biggest companies that private equity groups are preparing to float in Europe include Travelport, the travel services company; TDC, the Danish telecom group; and General Healthcare Group, the UK hospital operator.

Others are Merlin Entertainments, the theme park operator behind the London Eye and Madame Tussauds; Medica, the French hospitals group; Promethean, an interactive whiteboard maker; and Quick, the French fast food chain.

"We expect a bumper year for private equity-led IPOs; at least 20 mandates have been handed out in the past three months," says Fotis Hasiotis, head of financial sponsors in Europe at Bank of America Merrill Lynch.

However, with the rally in equity markets losing steam, bankers say early IPO candidates, such as New Look, the UK fashion retailer, face pressure to cut back their often aggressive valuation targets.

"It is unclear whether all these are going to get out and get done at valuations that private equity determine to be attractive," says Mr Hasiotis.

This pressure from investors was evident in the fourth quarter, when almost a third of the private equity-backed IPOs were priced below their target range, including Gartmore, the biggest European IPO by private equity for two years.

Some institutional investors have a dim view of buying companies from private equity owners, after the poor performance of IPOs such as Debenhams, the department store chain and Myer Holdings, the Australian department store floated by TPG last year. Gartmore has also seen its shares drop below their already-reduced flotation price.

But the overall picture is positive. Between 2000 and 2009 the average private equity-backed IPO rose 17.3 per cent after three months, according to Dealogic.

Another problem for private equity groups is that many of their companies have too much debt.

In some cases, such as Travelport, the IPO is meant to fix this by repaying debt with the proceeds rather than letting private equity cash out.

In other cases, such as Acromas, the merged AA Saga group, debt could be a barrier to floating, as the capital needed to shrink debt would dilute private equity ownership to an unacceptably low level, bankers say.

This creates its own problems, as private equity groups find themselves holding big stakes in publicly listed companies, something many of them are unfamiliar with.

Floating - but plain sailing cannot be guaranteed

Continued from Page 1

Russell Julius, global head of equity capital markets at HSBC, also fears that the already high expectations can only lead to disappointment.

"I just wonder whether or not the gap between buyer and seller can close fast enough," he says.

The existence of such a gap was made clear last November when Hochtief, the German construction group, pulled an €1bn IPO of its infrastructure business for lack of investor interest in its stated price range, which it refused to reduce.

Mr Julius questions, too, whether companies in developed markets will be able to convince investors of their prospects, given the widespread expectation of weak economic growth – particularly in key markets such as the UK, where data showed last week that the country only just crawled out of recession at the end of last year.

"There's a lot more interest from investors in recovering equity stories than in growth stories, given this low-growth environment," says Mr Julius. "It's not binary – issuance won't be zero – but I think the hype means the market could disappoint."

The fact that this is a buyer's market means most companies will run a dual-track approach, looking for a strategic buyer while preparing for an IPO. Last week, Bridgepoint sold its Pets at Home business to rival private equity firm KKR after a fierce bidding war persuaded it to drop plansfor an IPO.

But this style will not work for everyone, and private equity companies with a big portfolio of assets to offload will have to tread carefully for fear of upsetting investors.

"Institutions don't like having done their internal homework only to find themselves squeezed out of a deal. You can only do that so many times," says Mr de Graaf.

If the IPO wave does not quite come off, the bankers will be looking to last year's rush to raise secondary capital. Although slower, and in smaller sizes than the mammoth offerings from weakened companies seen in 2009, the trend is not dead, as companies continue to restructure their balance sheets and scale back their debt.

"UK companies kicked off the wave of recapitalisation, so to an extent they enjoyed a first-mover advantage," says Mr de Graaf.

He warns that executives should not wait too long if they have equity to raise, because of the competition they will face.

"The longer any company waits, the more selective funds become. Looking for good opportunities, a fund might go into the first wave, but after that it may become much more selective, as in same cases they will have to sell existing holdings to invest in new ones, and that can be a harder proposition."

One active area could be disposals of blocks of shares, as companies continue to restructure and streamline their balance sheets to pacify investors

"It's not just about raising capital but about increasing balance sheet transparency in general.

"If you've got a lot of complicated shareholdings that aren't properly understood by the market, you may as well monetise them," advises Mr Koder at UBS.

Knowing your rights is a serious issue

PRE-EMPTION

Kate Burgess on a concept that is gaining ground beyond Europe

Ask shareholders which rights they treasure most highly and many say it is their right to pre-emption, which protects their holdings from being diluted by new share issues.

Many countries impose rules on share issues, forcing companies to tell existing shareholders of their plans or give existing shareholders the right of first refusal of new shares.

Last year 1,012 companies across the world raised $196.3bn via rights issues, according to Dealogic, the data provider. Three-quarters of this sum was raised in Europe.

Just over 100 UK companies raised $65.2bn in 2009 and 245 continental European companies $82.8bn, says Dealogic. This accounts for about two-thirds of all cash calls in the region.

But few shareholders elsewhere take these rights more seriously than those in the UK, where protections have developed over centuries to stop managers transferring wealth from the owners of companies to new investors.

Market historians have found references to rights issues in the UK in 1719 and they were going strong by 1900 and pre-emption is now enshrined in UK company law.

The UK system stands out in two ways. UK investors' rights are separately valued and even shareholders who do not take up their entitlements to new shares are paid something for their rights.

Second, the system is designed to treat all shareholders equally. The Association of British Insurers, which is responsible for the government-backed guidelines on rights issues, distinguishes between rights issues found in many parts of the world and fully pre-emptive rights issues in the UK, which give existing shareholders first refusal of new shares.

The UK imposes some of the toughest constraints on companies raising funds. There are, for example, restrictions on how deeply new issues are discounted as well as a 5 per cent limit on "disapplication" – the amount of shares a company can sell without talking to shareholders.

Evidence of just how jealously British shareholders guard their rights to participate equally in share issues came last year with the brouhaha over Rio Tinto's attempt to raise $19.5bn via a deal with Chinalco.

Investors were furious at the deal, which would have doubled the Chinese state-owned aluminium company's stake in Rio to 18 per cent at what investors said was an over-generous price. Rio was forced instead to opt for a $15.2bn rights issue and a joint venture with rival BHP Billiton.

As Legal & General Investment Management – the UK's largest investor – stiffly reminded the board at the time: "Shareholder pre-emption rights are paramount".

"Pre-emption is an article of faith in the UK," says Daniel Epstein, a partner at law firm Allen & Overy.

It contrasts sharply with the US, where pre-emption was restricted by state legislation in 1930 and does not feature in the company law of Delaware, where most US companies are incorporated.

In the US, managements can sell what they want to the highest bidder and investors have limited protection from their actions.

> Market historians have found references to rights issues in the UK in 1719

Elsewhere round the world, from Canada to Egypt and Australia, some form of pre-emption exists but the procedures and levels of protection differ.

In Egypt, say lawyers, companies can fulfil their obligations to investors by informing them of an issue in a local newspaper. Investors do not have tradeable rights. "There is an entitlement understood as a right but there is no mechanism for monetising it," says Mr Epstein.

Even in Europe, pre-emption varies. The concept has been enshrined in European law since the 1970s. But as Paul Myners, now City minister, said in a 2004 government-sponsored report, the provisions in the 2nd Company Law Directive "are relatively permissive and hence there is some variation between the regimes in different Member states".

In the UK, regulators and shareholders argue that tight rules on pre-emption give investors confidence, which helps companies to raise capital at a lower cost, compared with share issues elsewhere.

Placing shares in the US costs an average of 5 per cent or more, compared with 3 to 4 per cent in the UK.

US bankers say they charge more because the market includes more private investors with small holdings – marketing to a diverse shareholder base costs more than to big investment groups based in one or two cities.

That said, the UK's rights issue process has not gone unchallenged. US bankers have long complained that the system is protracted and the requirement to send out wads of documents ahead of a shareholder vote and then give investors time to trade their rights introduces risk.

Their worst fears came close to being realised in 2008, during a series of rights issues at the height of the financial crisis, notably that of HBOS. It prompted a shake-up of the guidelines to speed up the system and make it more flexible.

Today, UK investors' commitment to pre-emption remains as strong as ever. They claim it is the quid pro quo for backing companies needing their money to replace debt with equity, strengthen balance sheets or expand.

The pre-emption concept is gaining ground in other jurisdictions. In Japan, pre-emption rights issues were almost unknown. But as struggling companies last year found they needed to raise equity in more flexible ways, calls for share issues that protect shareholder rights have gained support, from the Tokyo stock exchange, among others.

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A company strengthens its foundations

HeidelbergCement

Daniel Schäffer explains the restructuring

In early 2009, HeidelbergCement looked like a high-profile loser in the financial crisis: debt-laden and about to be taken over by banks.

Just 10 months later, the German cementmaker could claim to have become a trailblazer both for Europe's equity capital and its high-yield markets.

Its transformation from problem child to market leader within a year is a good example of a successful restructuring of a heavily indebted company.

Buoyed by easy access to debt, HeidelbergCement in 2007 embarked on an expensive acquisition of UK rival Hanson, which lifted net debt to €14.7bn. Disaster ensued when the industrial empire of Adolf Merckle, HeidelbergCement's main shareholder, collapsed in late 2007.

"Our refinancing strategy was in tatters, as investors and banks worried that Merckle's woes would spread to us," a senior executive of the group says.

Bernd Scheifele, chief executive, was quick to react: with the help of Morgan Stanley, the group initiated a refinancing that in June last year converted short-term debt to long-term.

With the refinancing in place, management quickly went on a roadshow to London, Boston and New York.

Investors showed sympathy – with one caveat. "They said: great story, pro-cyclical business, and a discount to peers. But then they always added that the large share overhang is a no-go," a banker involved in the transaction recalls.

The family of the late Mr Merckle and its banks owned almost 79 per cent of the shares, and it was clear they had to sell to meet the debts of the family empire.

'Some banks have blackmailed us shamelessly – we did not want . . . this again'

The way out was a combined primary and secondary placement that helped to open up the fragile European equity markets in September 2009 and was the largest rights issue in Germany for six years.

HeidelbergCement's banks sold €2.3bn in new shares plus €2.1bn from the Merckle family, offering investors 96 per cent of the market value of the group.

Fewer than 20 managers prepared the rights issue and subsequent bond sale. "There was no need for committees and Mr Scheifele could be reached 24 hours a day," one member of the team recalls.

HeidelbergCement looked to the UK and the US for investors, as it became clear that German shareholders were too risk-averse for the highly indebted company.

The cementmaker identified September as the best month, when there was no insecurity over quarterly results. An offer period of six days created demand and the rights issue was heavily oversubscribed – more than 400 investors ordered more than €10bn in shares.

Management decided not to delay the second step of the recovery – a €2.5bn bond sale four weeks later. This was heavily oversubscribed too, despite being the first large high-yield transaction in Europe since the crisis shut this part of the market.

At the end of last year, HeidelbergCement had cut net debt below €8.5bn, some €6bn less than just after the Hanson acquisition.

Analysts say the company still has too much debt, given the shaky prospects of the construction industry. "The leverage of HeidelbergCement for the time being remains high," says Falk Frey, credit analyst at Moody's.

But the company is upbeat that strong cashflow will bring down further the debt pile. To reduce the dependency on bank lending, it issued another €1.4bn of bonds this January. This brought the term debt down to €700m.

One lesson for executives is to become independent of bank financing. "Some banks have blackmailed us shamelessly – we did not want to experience this again," comments a HeidelbergCement executive.

The other lesson is to keep an ear to the ground. "In a crisis, the perception of the capital markets is all that counts, regardless of how solid the business model of a company is," Mr Scheifele recently said in an interview with the FT.

Old-school financiers step in to boost trust

Boutiques

Miles Johnson on the returning vogue for independent advisers

The modern investment banker must be specialised, but his bosses often want him to think like a factotum.

From a once simple brief to provide advice and underwrite securities, the range of services available has expanded into a vast menu, ranging from leveraged finance to investing with clients in proprietary private equity deals.

But after a crisis that felled some of the most illustrious names in banking, the simplicity of the old-school "gentleman financier" is again in vogue.

Bowler hats and umbrellas may be gone, but an increasing number of would-be issuers are turning to small, boutique advisers to work alongside banking behemoths in their quest to resurrect stock market listings scuppered by the credit crunch.

"More companies considering initial public offerings now engage independent advisers alongside the larger banks," says David Wilkinson, IPO leader at Ernst & Young.

"Generally speaking, management teams have never run an IPO process before. Independent advisers can help them select their bookrunners, their reporting accountant, their lawyers; and most of all provide good advice, as they are much more familiar with the IPO process."

A number of independent ECM advisers has won roles on recent prominent IPOs. Ondra Partners, a boutique set up by a cadre of former Lehman Brothers bankers, completed its first significant IPO mandate with the listing of UK fund manager Gartmore in December last year. Hawkpoint, an advisory house linked with Collins Stewart, is advising Fairfield Energy on its planned London IPO, while Lilja & Co, run by veteran banker Robert Lilja, has a long history of working on big flotations in central Europe.

The listing process can be a bewildering one for companies. While chief executives can make numerous acquisitions during their tenure, the average management team is likely to go through the process of an IPO only once.

Typically small, specialised, and often partner-owned, the key tool in the independent advisers' armoury is the pledge to dispense impartial advice to management teams attempting to enter the brave new world of the public company.

Modern investment banks are large, often sprawling entities that generate their business by serving the needs of investors and companies at the same time. It is this dual role, the boutique bankers argue, that means large investment banks can fall prey to conflicts of interest during the IPO process.

Independent advisers, which are usually paid a flat rate by their clients, say they have less incentive to push forward with deals if the timing or circumstances could damage the interests of a company.

"I don't think conflicts of interest are a result of devious practices, they are built into the system," says Henrik Schliemann, managing director at Hawkpoint. "Large institutional investors pay more fees to bulge bracket banks than their corporate clients, so it is only natural for investment banks to serve the interests of these large institutions over those of individual corporate clients."

Boutiques, however, cannot run IPOs on their own, they must work with international investment banks that use their vast distribution reach to sell the issue to investors. In turn, the independent advisers often play a big role in advising clients which banks they should decide to take on board by presiding over "beauty parades" – a role that can lead to conflict between boutique and bulge bracket.

"I have worked on deals with independent advisers that have been difficult, as, often, they want to make life tough for the banks to show they are doing their job," says one banker. "But they can also make the whole process easier. Having one in the room during pitches can help keep everyone honest."

Independent advisers will try to ensure pitching banks are realistic on valuations, according to Adam Gishen, head of capital markets at Ondra Partners.

He says: "Banks will usually tend to be bullish on valuation when pitching for business. Independent advisers should be more realistic, with the best ones able to add value through corporate finance, debt restructuring and equity capital market advice, giving the issuer clarity at every step of their IPO process".

Robert Lilja: stresses importance of a functioning aftermarket

Once a syndicate for initial public offerings is in place, independent advisers can provide a filtering mechanism for companies being bombarded with different opinions.

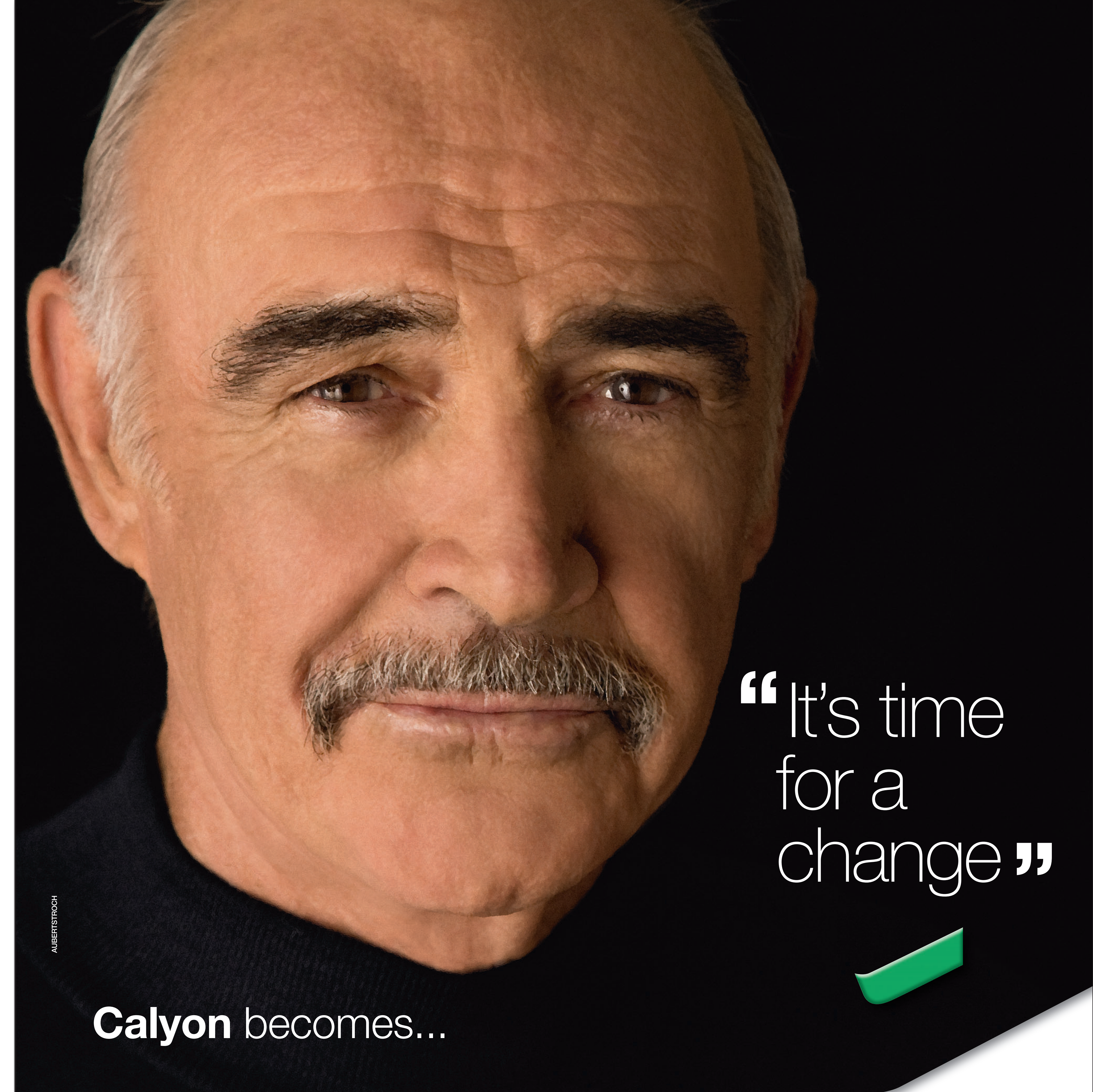
"For transactions that are quite sizable, banking syndicates tend to be large, so one role of an independent adviser is to filter and distil the different advice being offered to the company," says Mr Gishen.

Ensuring a client will be well serviced in the aftermarket is as important as the preparation work, according to Mr Lilja. This will often mean advising issuers to pick banks with strong research and sales teams.

"We need to make sure the company ends up with the right shareholders, and that there is a functioning aftermarket," he says. "The syndicate below the top banks also needs an incentive to make a market in the shares so there is not a monopoly of trading held by only one or two banks."

While large investment banks will continue to dominate, the re-emergence of the boutique adviser serves as a reminder that personal relationships and trust are still among the most valuable commodities in banking.

Both boutiques and investment banks need to work together. "It is all about people in our business," says Mr Lilja. "There are still very good and trustworthy people in the large banks. This all shows that the importance of the individual has increased."



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Showing his metal: Rusal's Oleg Deripaska at the Hong Kong Stock Exchange last week for the company's debut AP

Bumper year raises expectations for 2010

Chinese IPOs

Robert Cookson on the prospects for new listings in Shanghai, Shenzhen and Hong Kong

At the beginning of 2009, things were not looking promising for initial public offerings from Chinese companies, not least because regulators had stopped approving flotations on mainland stock exchanges.

Few expected that 12 months later the Shanghai, Shenzhen and Hong Kong exchanges would have secured almost $60bn through IPOs – more than double the amount raised in the US, the world's traditional IPO hotspot.

The end of Beijing's nine-month IPO suspension in June unleashed a wave of listings in Shanghai and Shenzhen, while companies also rushed to Hong Kong to take advantage of rallying stock markets and surging inflows of international capital.

Now, with markets still buoyant, bankers, investors and corporate executives are hoping 2010 will be another bumper year for China IPOs.

For the time being at least, the same mix of conditions that triggered last year's boom appear to remain in place: credit is still cheap,especially in China; investors remain bullish on Chinese growth; and there is still a vast number of Chinese companies looking to raise capital through IPOs.

As a result, most analysts expect that this year's IPO markets in mainland China and Hong Kong will be on a par with 2009 and may even be bigger. Others argue that, like early last year, the consensus view will again prove to be wrong.

PwC, the professional services firm, predicts that IPO funds raised in China's domestic A-share market will exceed Rmb320bn (US$46.9bn) in 2010, compared with Rmb188bn in 2009, and that companies will raise some HK$300bn (US$38.5bn) in Hong Kong, up from HK$243.7bn in 2009.

The estimates are based on official announcements and press reports of planned IPOs, as well as mathematical projections based on data from previous years. For its estimates, PwC has assumed that markets will be relatively stable in 2010.

Edmond Chan, a partner in PwC's Hong Kong office, predicts that large amounts of foreign money will continue to flow into the Hong Kong market, helping support the 60 new listings – including five "mega-size" deals – he forecasts for 2010.

Mr Chan says the vast majority of Hong Kong IPOs will come from Chinese companies, but a higher proportion than last year will originate further afield.

Already this year, Rusal, the aluminium group controlled by Russian oligarch Oleg Deripaska, has raised US$2.2bn in Hong Kong – the first Russian group to be admitted to the exchange.

Among other big deals in the pipeline, AIG is in advanced preparations for a Hong Kong listing of its flagship Asian life assurance unit, American International Assurance, which is expected to raise US$10bn-US$20bn.

"There are funds available in the market that can support these kinds of deals," says Mr Chan.

For the A-share market, PwC expects 15 large companies will list on the Shanghai exchange, while 130 more will list on the Shenzhen SME board and the Chinext board for start-ups.

It is hoped that the last great state-owned Chinese bank could come to market this year. Agricultural Bank of China has been planning to float shares for years but bankers say it may finally raise as much as US$10bn in Shanghai in 2010, potentially tapping Hong Kong for funds too.

> Investors will be particularly choosy when it comes to the real estate sector, analysts say

In another significant development, China is expected, for the first time, to allow foreign companies to float in Shanghai this year. PwC expects five companies will do so in the coming months.

Of course, for all these deals to go ahead, stock markets will have to avoid any severe bouts of turbulence.

"The IPO market will generally be open, we expect, throughout the year, and the issuance will be more spread out," says Kester Ng, JPMorgan's head of Asia-Pacific equity capital and derivatives markets.

He adds: "There won't be a complete shutdown as in the second half of 2008 and the first half of 2009."

Nonetheless, Mr Ng believes investors will be more price-sensitive in 2010 than they were in the second half of 2009, when markets did little but rise.

"The easy macro play was played out last year," he says. "Now it's back to choosing the right company at the right price."

Investors will be particularly choosy when it comes to the real estate sector, analysts say, following the raft of property companies that did IPOs last year. But investor indigestion is likely to extend far beyond property companies, some analysts believe.

"All sorts of companies are queuing for money but I'm not sure the market is as receptive as last year," says Andy Xie, an independent economist based in Shanghai.

Mr Xie says the boom in Hong Kong IPOs in 2009 was largely driven by huge inflows of money, as global investors boosted their exposure to China, taking advantage of low interest rates and the falling US dollar.

"The big reallocation happened last year," he says. In 2010, he says, the flows will be smaller, especially as central banks start to tighten monetary policy. Indeed, China's central bank took its first tentative steps to tighten monetary policy three weeks ago.

Why it still takes courage to go Dutch

Lina Saigol
THE REAL DEAL

If there is one thing that stays constant in banking, it is the cost of an initial public offering.

No matter how ravaged the economic landscape becomes, the fees banks charge their clients for taking a stock public never seem to come under heavy pricing pressure.

In the US, fees to take a company public have stayed at an average 6.7 per cent of the proceeds of the offer. That compares with banks in Europe, which bill their clients an average of 3.2 per cent, and Asia, where underwriters typically pocket about 2.5 per cent of the proceeds.

But while many companies grumble in private about paying such high costs, few have had the courage to challenge the status quo.

Those which have, have had little success.

Take Google. Six years ago, the internet search engine group tried to break Wall Street's hold on the lucrative IPO business when it shunned the traditional book-building process in favour of pricing the offering via a Dutch auction.

In an auction, the price of an IPO is set after collecting bids from investors, including small investors, and determining the highest price at which all the shares can be sold.

The logic behind such an approach is that it would allow all investors to bid for Google's shares directly, rather than leave it to an investment bank to decide on the price of the shares and who should receive them – usually their biggest institutional clients.

It also reduces the amount of underwriting fees, which in theory should ensure the company gets a larger share of the proceeds of an IPO.

Critics, however, warned that an auction could risk setting an unrealistically high price for Google's shares, since there would not be enough stock available to meet the massive demand from private investors captivated by the prospect of a new dotcom gold rush.

Google's technique flopped in the event and it underpriced the shares. Bankers drummed home the message that money saved in underwriting fees was dwarfed by the amount Google left on the table through the underpricing.

It is a painful argument to swallow, especially given the behaviour of banks during the dotcom boom of 1998-2000.

Back then, critics accused them of underpricing IPOs to curry favour with the institutional buyers, effectively failing to maximise profits and leaving money on the table.

Jay Ritter of the University of Florida found that an aggregate $62bn was left on the table in US IPOs carried out between 1999 and 2000. That is not exactly a small amount of money to miss out on.

But it seems ego and reputation of management is more important than the fees they pay.

> Companies will often overlook paying high fees in return for cheaper lines of credit

An IPO or capital raising can be one of the most critical transactions a chief executive attempts. That means most would rather pay premium fees to the top tier of banks which have the distribution and sales support networks needed to ensure the success of a deal, than pay lower fees to a second-tier bank and risk a failed debut.

Another reason why IPO fees are rarely challenged is that companies will often overlook paying high fees for high-margin products in return for cheaper lines of credit from their lenders.

But following President Barack Obama's proposals to reform the US financial services industry and shrink the size and scope of banks' balance sheets, this practice could soon be consigned to history.

To that end, companies looking to go public this year may be in a stronger position to negotiate better fee structures with their underwriting banks. Failing that, they can always try a Dutch auction.

Bottom line:

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