Chapter 4

INTERNATIONAL EQUITY OFFERINGS

Since the mid-1980s, international equity offerings (a new issue of shares offered in several markets simultaneously) have experienced explosive growth. Government privatisation programmes fuelled this growth by increasing interest in equity investment in both developed and emerging markets. As the market evolved, so did the procedures surrounding the launch of an international offering.

International equity offerings are a relatively new phenomenon (i.e., since the 1980s). Although companies have raised funds outside their own markets for decades (centuries even), the first co-ordinated, simultaneous offering of shares in a domestic market with a separate international tranche targeted at foreign investors occurred in 1983.

This chapter outlines the reasons companies go to the extra effort and expense to sell shares internationally, highlights the key documentation, and describes the marketing and distribution processes used by investment banks in international equity offerings.

RATIONALE FOR INTERNATIONAL OFFERINGS

An issuer can sell shares exclusively to domestic investors or it may decide upon an international offering. The domestic offering is the route chosen for most smaller (i.e., under $100 million) flotations. It is generally cheaper and simpler to complete.

However, there are many reasons for an issuer to contemplate accessing international investors in its initial public offering. A broader shareholder base is likely to increase demand for its shares and, therefore, maximise the value of the offering. A company's international profile certainly will be increased by offering shares outside its home country which may benefit the company's business.

Another benefit (cited regularly in the late 1980s) was that international distribution of a company's shares was useful in merger and acquisition activity. The theory being that if a company's shares were well known outside its own market, it could use the shares as currency for international acquisitions. For example, Daimler Benz of Germany listed its shares on the New York Stock Exchange a few years before it acquired Chrysler Corporation. In addition, it was believed that widespread international shareholdings of a company's stock would reduce its vulnerability to hostile takeovers.

In certain industries, companies have found it beneficial to go to the international market because investors outside their domestic market value the securities more highly than do domestic investors. This may be because the international market has more experience of a certain industry, or because of temporary anomalies.

One example of this was the dual listing of many British cable television companies in London and on the NASDAQ market in the US in 1994 and 1995. Investors in America had much more experience of the cable TV industry than did those in Britain and were prepared to pay a higher price for the shares. Another example was the surge of international mining companies which listed on the Toronto Stock Exchange during the 1990s and 2000s, because companies perceived that the investors and advisors were more experienced and knowledgeable and would pay higher prices for mining company shares.

Other issuers have turned to international markets because their home market was too small to supply the funds required. This has occurred often in the Scandinavian markets and in the emerging markets of central and eastern Europe.

International investors

While the above section outlines the corporate drivers for international offerings, there is increasing pull, or demand, from institutional investors. There are several reasons for this, including:

- More securities and industries to choose from.
- Greater returns – many emerging markets provide higher rates of return than do more mature markets and some markets may not be as efficient as others, allowing professional investors an advantage.
- Reduction of risk – not all national stock markets advance (or decline) at the same time. Therefore, international diversification may reduce risk in a portfolio context.

- Liquidity – some institutions demand significant liquidity in their portfolios which can only be met by investing in the largest global companies.

Development of international equity offerings

International equity offerings received a significant boost in 1984 from the UK Government's privatisation of British Telecom (*BT*). Shares were offered in public offers in the UK, Canada and the US. BT shares were also distributed to investors in the rest of Europe and the Middle East. The Government took the decision to launch an international offering because it believed that the UK equity market was too small to absorb such a large issue without seriously affecting the price the Government would receive.

The offering was a huge success and the UK continued its privatisation programme through multi-tranche international offerings with the sale of British Gas, British Airways, British Petroleum, the ten water companies, the electricity industry and Railtrack.

The 1990s witnessed the emergence of US investors as one of the driving forces behind international offerings. This was caused by two factors: the reallocation of assets from domestic to international investments on the part of US institutional investors, and an easing of new issues regulation by the US securities regulators.

In 1990, it was estimated that US pension funds had approximately 3% of their total assets invested in

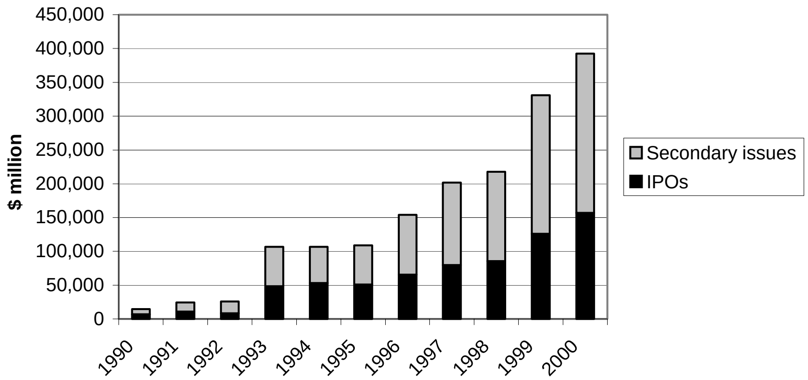

Figure 4.1 International equity offerings.

Sources: Various.

non-US shares. By 1995 this figure had risen to approximately 8% and grew to 12% in 2001. In comparison, UK institutional investors typically hold approximately 25% of their portfolios in overseas equities and have done so for many years.

The growth of the market for international equity offerings is illustrated in Figure 4.1.

Regulation and documentation

If an offering of shares is made to the public in the US, a registration statement must be filed with, and approved by, the *Securities Exchange Commission* (*SEC*). The registration statement (Form F-1 for international companies) is similar to the UK's Listing Particulars, in that it contains a prospectus that is sent to potential investors as well as additional information for the regulators. The local market prospectus and US registration statement will have identical content if not identical form.

It is necessary to ensure that investors in all markets receive the same information.

SEC regulations require the registration statement to include a consolidated balance sheet, a 3-year consolidated income statement and a 3-year consolidated statement of cash flows, each certified by an independent accountant and prepared in accordance with US GAAP. This process can be very expensive and time consuming as companies comply with the financial disclosure requirements.

Compliance with US accounting rules can also throw up anomalies, such as when Daimler Benz listed its shares on the New York Stock Exchange. According to US GAAP, the company lost nearly $1 billion in the year prior to listing, but according to German accounting standards, it had been profitable.

A preliminary prospectus ('red herring') is circulated among prospective investors simultaneously with the SEC's review of the documentation. The review process typically takes from 4 to 6 weeks to complete. Once the SEC has approved any changes that have been required, the investment banks can sell the shares to investors.

Box 4.1 summarises the key parts of a US prospectus.

In most other jurisdictions, when shares are being offered in a foreign company to sophisticated institutional investors, separate prospectuses need not be produced, nor is the main prospectus reviewed by the regulators. In Japan, which was once a huge market for

Box 4.1 Key requirements of a US prospectus

(1) Front cover
Gives general information such as the issuer's name, type and amount of securities being offered and whether existing shareholders are selling any shares. If an IPO, it will state that there has been no public market up to now. It will also name the managers of the offering and the amount of their compensation and expenses of the issue.

(2) Summary of the Offering
Information regarding the company that is repeated elsewhere, details of the offering and expected timetable.

(3) Key information
Selected financial data, capitalization and indebtedness, and use of proceeds. This information is often included as part of the Summary and again immediately prior to Management Discussion and Analysis.

(4) Company information
Detailed disclosure of the company's history, business plan, organizational structure, operations and competition.

(5) Management Discussion and Analysis
Operating results, liquidity and capital resources, and trend information.

(6) Directors and senior management
Including details of their compensation, employees and share ownership.

(7) Major shareholders and related party transactions

(8) The offer and listing
Offer and listing details, plan of distribution, markets, selling shareholders, dilution and expenses of the issue.

(9) Risk Factors or Investment Considerations
Generally appears near the front of the prospectus. Each risk factor mentioned will also be disclosed and discussed in more detail in the rest of the prospectus.

(10) Description of securities other than equity securities
Debt securities, warrants and rights, American Depository Shares, etc.

(11) Financial information
Audited consolidated statements and notes to financial statements.

international shares, private placement rules allow the banks or brokers arranging the sale to approach up to 50 investors without requiring regulatory review. If the banks wish to approach more institutions, they must either apply for an exemption from the Ministry of Finance or file an offering document.

Depository receipts

Many US investors participate in international offerings by purchasing Depository Receipts (*DRs*) issued by foreign (non-US) companies. DRs are a convenient mechanism for transferring ownership, receiving dividends and taking care of other routine transactions in foreign securities. Far from being a recent innovation, the first DRs were issued by JP Morgan in 1927 for a number of Scandinavian corporations.

There are two main types of depository receipts: *American Depository Receipts* (*ADRs*) and *Global Depository*

Receipts (*GDRs*). ADRs are quoted and traded in US dollars in the US markets (either on an exchange or over-the-counter). GDRs may be quoted in US dollars, but also in pounds sterling and occasionally in another currency. GDRs are often listed in London or Luxembourg. The principles surrounding the operation of each are the same.

DRs are issued by a 'depository bank' which holds the underlying shares in custody. The depository acts as a transfer agent for the DRs, distributes dividends in dollars (or sterling) and distributes corporate information, such as annual reports and accounts.

The advantages to issuers include the following: ability to access a broader shareholder base and increased liquidity outside the company's home market; enhanced ability to raise new capital in the US (with respect to ADRs) and internationally (with respect to GDRs). Academic research suggests that a company with an ADR listing can reduce its cost of equity by approximately 1% (see Chapter 9 for a discussion of cost of equity).

Companies that don't want to go to the expense and effort of a US public offering may elect to offer shares to institutional investors through a private placement.

The SEC's Rule 144a allows issuers to sell shares or ADRs to Qualified Institutional Investors (*QIBs*) which are large investing institutions. The SEC receives a copy of the prospectus used in a Rule 144a offering, but does not review or pass judgement on it. The introduction of

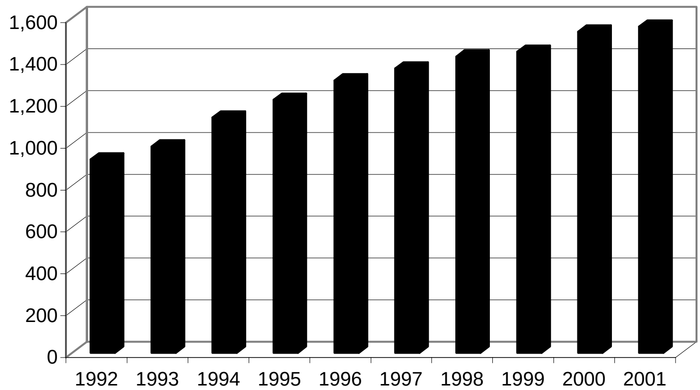

Figure 4.2 Number of DR programmes (1992–2001).

Rule 144a in 1990 was the event that led US investors to increase their participation in international offerings.

With the growth in importance of US demand and the influence of US investment banks, the international equity market has adopted many American techniques and practices, particularly with respect to marketing and pricing new issues.

Marketing, syndication and distribution

In international offerings, it is standard to assemble a group of banks (a 'syndicate') who each sell the securities being offered to ensure wide distribution of the shares. The participants in the syndicate are called *Managers*. Within each syndicate, there is a hierarchy, adapted from the Eurobond market: lead manager, co-lead manager, and co-manager. If there is more than one lead manager, it is customary to appoint one as the 'bookrunner' or global co-ordinator. There will be several managers in each geographic jurisdiction, depending on the size of the offering.

The bookrunner or global co-ordinator, is responsible for the documentation (in conjunction with the lawyers), due diligence, organising the roadshow and other tasks, just as the sponsor to a UK flotation is. It also controls the order book (hence the name), has the final say on the allocation of shares to investors and, therefore, is able to favour investors which place orders with it. There is fierce competition among investment banks to be the bookrunner on transactions.

From approximately 1993 to 2000, there was a tendency among issuers to appoint two or more investment banks as joint bookrunners, or co-global co-ordinators. Initially, a home-market investment bank was appointed in conjunction with a global investment bank. Since 2001, the number of global co-ordinators included in an offering has tended to decrease.

Co-lead, co-managers and managers do not participate in the preparation of the legal and documentation aspects of the offering. They are invited into the syndicate to add distribution by selling to as many potential investors as possible and to provide a research following for the company after the issue.

Offer structure

An international offering is typically divided into tranches: the domestic tranche, where shares are sold to investors in the company's home market and an international tranche. The international tranche is occasionally further sub-divided depending on the offering.

In the early days of international equity offerings it was not uncommon to have up to a dozen separate international tranches, each devoted to a single country. Banks participating in the Italian tranche of an international offering, for example, could sell only to investors in Italy. Current practice is to limit the number of tranches in order to allow the global co-ordinator more flexibility in allocating shares to the regions where demand is greatest.

Many Initial Public Offering (*IPO*s) and follow-on offerings employ a single global syndicate, where there are no separate tranches and the senior banks in the syndicate sell shares in whatever market they find demand (subject to local restrictions). This approach was first used in the third BT offering in 1993. Many bankers believe that global syndicates work better if the securities being sold have already been listed and have a wide following.

Price setting, underwriting and bookbuilding

International offerings exclude a sub-underwriting group. International practice, adopted from the US, has been to undertake substantial pre-marketing or 'bookbuilding' prior to pricing. During the marketing period, investors indicate their demand for shares at different price levels: the order 'book'. Subsequently, the bookrunner, in discussion with the issuer, may vary the size of the issue or its price, or both, in an attempt to satisfy the level of indicated demand. The bookrunner then sets the price of the issue to maximise proceeds, while ensuring that there is unsatisfied demand, so that investors will purchase shares in the market following the offering.

In the US market when the issue is priced, underwriting commitments are made similarly to European practice. Typically, US issues are priced after the stock exchanges have closed for the day. Allocation of shares among investors commences that evening and continues the following morning prior to the opening of the exchanges. Once allocation to investors has been made, the investment bank's underwriting commitment expires. Thus, the underwriters are not exposed to fluctuations in the market – the underwriting period (i.e., the length of time for which the underwriters are at risk) rarely lasts 24 hours.

Increasingly, international issuers are opting to follow this offering procedure: set the price and make allocations on Sunday or when the home market has closed and commence trading the following morning. If there has been a public offering in the US, and that has been a major component of the issue, often trading in a European offering will not begin until New York opens (i.e., 2.30 p.m. in London).

In markets where a public offering to individual investors is mandatory, the offering is then open for a period of 1 to 3 weeks for the public to subscribe following the close of institutional bookbuilding. Trading will start perhaps 4 days later. This method can leave underwriters at risk for a considerable period.

In essence, UK and European underwriters in traditional offerings own the securities they have underwritten and are at risk for many days. In the American system, and increasingly internationally, managers (although, confusingly, they are often called underwriters) are purchasers and distributors of shares, taking a risk for only a matter of hours.

Fees and commissions

In international offerings commissions of 3.0 to 6.0% are common for corporate new issues. Privatisations generally have lower commissions. Usually, the larger the offering, the smaller the percentage commission. In international offerings, it is not uncommon for managers to pay their own expenses, including legal fees out of their commissions. In larger offerings, and in privatisations, the issuer may make a contribution to managers' expenses.

As competition among investment banks has intensified, so has downward pressure on the level of commissions. In 1997, large privatisations typically carried a total commission of slightly less than 3%. By 1999, some banks were willing to quote fees of less than 1%

of the transaction value for a large, prestigious privatisation. However, in the US, the standard fee for a small- to medium-sized ($50m to $150m) IPO has remained rock steady at 7.0%. By contrast, traditional UK fees for underwriting an offering are 2.0%.

Within the gross commission, or 'gross spread' to use the American term, fees are notionally divided three ways. Typically, 20% of the commission is called the *management fee*, which is meant to compensate the bookrunner for the work involved in organising the offering. Another 20% of the gross commission is called, somewhat misleadingly, the *underwriting fee*. All expenses incurred by managers in the completion of the offering are deducted from the 'underwriting' fee before it is paid. Usually, very little of the underwriting fee remains to be distributed to managers.

Finally, 60% of the gross commission is allocated to the selling concession, payable to the bank which sells the shares. The bookrunner has significant discretion on the allocation of shares and, hence, the selling concession among syndicate members. Typically, the bookrunner(s) will receive more than 50% of the total selling concession, ensuring that competition to win the bookrunner role is intense.

Underwriting and management fees are payable on the notional amount of stock that the syndicate member agrees to underwrite, while the selling fee relates to the amount of stock the syndicate member actually places.

AFTER THE NEW ISSUE

Stabilisation

Another feature of international offerings adapted from the US is the ability of the underwriter to stabilise the price of the shares immediately after pricing and allocation. Stabilisation is undertaken to facilitate the distribution of shares during the offering period and, typically, takes place for up to 30 days following allocation of the shares.

The lead manager may 'over-allot' shares (i.e., sell more shares than are being offered) to investors, thereby creating a short position in the market (i.e., the lead manager has sold shares which it doesn't own). If there is weakness in the price of the shares during the offering period, the lead manager can purchase shares in the market to 'fill' the short position, thereby creating demand for the shares and providing support for the market price.

To provide the lead manager and the underwriting syndicate with the maximum flexibility to support the offering in the aftermarket, it is typical for the company to grant a 'greenshoe' option. This option enables the underwriting syndicate to purchase additional shares (up to 15% of the total offering) from the company at the same price and on the same terms as the other shares offered for a period of 30 days. Therefore, if the share price rises in the month following the new issue, the lead manager would purchase shares from the greenshoe to cover its short position. If the share price falls, the greenshoe option is not exercised.