International and U.S. IPO Planning

A Business Strategy Guide

Frederick D. Lipman

International and U.S. IPO Planning

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To my partners at Blank Rome LLP, who gave me the time to write this book

Contents

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Introduction

Going public is the dream of many private companies, regardless of where in the world they are located. Founders of private companies can maintain their control positions in the public company and still sell their personal stock to diversify their investments. Public companies typically can raise capital more cheaply and easily than private companies, with far fewer operational restrictions. Much of the wealth of the Fortune 300 families resulted from their association with founders of public companies.

Although excessive U.S. regulation has sullied the initial public offering (IPO) dream of many smaller U.S. private companies, international IPO markets are still available and increasingly hospitable to IPOs of private companies located throughout the world. The Alternative Investment Market (AIM) of the London Stock Exchange, discussed in Chapter 9 of this book, has proven attractive to smaller private companies around the world, including smaller U.S. companies.

In an increasingly "flat" world,[1] private companies must consider global opportunities for IPOs in those countries with the highest valuation potential and the most hospitable regulatory environment. Although the U.S. markets are still very competitive on the valuation of private companies, they are not necessarily competitive in the regulatory environment, particularly for smaller public companies. Traditional U.S. IPOs with bulge bracket underwriters require post-IPO valuations substantially exceeding $100 million, and preferably at least $250 million, in order to be of interest to institutional investors and to be followed by securities analysts. Therefore, smaller private companies wishing to have a U.S. IPO must either use lower-tier underwriters or be merged into a public shell (Chapter 12) or a special-purpose acquisition company (SPAC, discussed in Chapter 13).

Warren Buffett has stated in his famous letter contained in the Berkshire-Hathaway 2007 annual report:

> Despite our country's many imperfections and unrelenting problems of one sort or another, America's rule of law, market-responsive economic system, and belief in meritocracy are almost certain to produce ever-growing prosperity for its citizens.

Although this may be true, other countries are developing a similar culture and in the future may be equally attractive.

In Chapter 1 we explore the pros and cons of a U.S. IPO, including why the U.S. IPO market has become less hospitable for IPOs of smaller private companies and what can be done to make the United States more internationally competitive. Although the country is very competitive in valuing IPOs, its regulatory structure is burdensome, particularly for smaller companies, compared to international alternatives, which are discussed in Chapter 9.

In Part One of this book (Chapters 2 through 8), we discuss advance planning techniques for both an international and a U.S. IPO, with the primary emphasis on U.S. IPOs.

Chapter 2 covers the necessity of developing an impressive management team and how to use equity incentives to attract and retain key executives. One-man or one-woman companies are not good IPO candidates. Underwriters want to see IPO candidates who use a team approach to management.

Chapter 3 discusses methods of growing the business to make the company attractive for an IPO. We note that future growth potential is the most important ingredient of an attractive IPO candidate and give examples of IPOs by companies with little or no revenue but great growth potential. Chapter 3 also discusses acquisitions and so-called *roll-ups* to increase the size of the company prior to an IPO.

Chapter 4 examines the necessity of having auditing or auditable financial statements, the lack of which will prevent an IPO. This chapter also covers the problem of when companies can recognize revenue for accounting purposes, which is a hot-button issue with the Securities and Exchange Commission (SEC) and has hindered many U.S. IPOs.

Chapter 5 discusses the necessity of changing business practices that may violate law well before an IPO, since these questionable business practices can prevent an IPO. We also examine in detail the increasing enforcement activities against violations of the U.S. Foreign Corrupt Practices Act and similar laws in other countries.

Chapter 6 reviews the defenses to a potential hostile takeover of the company that should be in place prior to an IPO. We give examples of provisions that can be inserted into the charter of the public company to deter unwanted suitors, including hedge funds and other activist shareholders.

Chapter 7 discusses the corporate governance mechanisms that should be in place well before an IPO target date, including the formation of an audit committee consisting of independent directors, the development of good internal controls, and a whistleblower policy.

Chapter 8 covers two topics of importance in IPO planning. First, we discuss the possibility of creating insider bailout opportunities before the IPO so that some of the proceeds from the IPO can be directly or indirectly received by insiders. Second, we discuss the necessity of taking advantage of IPO windows, including IPOs in the same industry or certain IPO fads that occur from time to time.

Part Two of this book (Chapters 9 and 10) covers international IPOs. In Chapter 9 we discuss the methodology of structuring an IPO for a U.S. company. We review the mechanics of forming a foreign holding company and avoiding the burdensome reporting requirements of SEC rules as well as costly provisions of the Sarbanes-Oxley Act of 2002 (SOX). We also explore in detail in this chapter an AIM public offering as well as public offerings on other international stock markets, such as the Growth Enterprise Market (GEM) of the Hong Kong Stock Exchange. Chapter 9 also contains a comparison of the costs of an IPO on Nasdaq and on the AIM and a comparison of post-IPO costs on both exchanges.

Chapter 10 deals with the U.S. federal income taxes of international IPOs by U.S. companies and therefore complements Chapter 9.

Part Three of this book (Chapters 11 through 15) describes both traditional and nontraditional IPOs in the United States.

In Chapter 11 we describe in detail the typical IPO process in the United States, with an example of an underwritten public offering and the costs of doing so.

In Chapters 12 through 15 we discuss alternatives to the traditional U.S. IPO that may be of interest to small businesses. Chapter 12 covers reverse mergers into public shells, which is an alternative (albeit risky) for smaller private companies that wish to become part of a publicly held company.

Chapter 13 deals with the very recent phenomenon of forming publicly traded special-purpose acquisition companies (SPACS) with significant capital and having the private company merge into the SPAC.

Chapter 14 deals with Regulation A offerings, which permit private companies to raise up to $5 million over a 12-month period. Chapter 15 covers the so-called SCOR (small corporate offering registration) offering, which permits private companies to raise up to $1 million over a 12-month period.

Appendix A of this book contains a list of the international stock exchange Web sites that can supply valuable listing information to those companies considering an international IPO. Appendix B contains selected responses we received from a survey we conducted of the international stock exchanges.

NOTES

1. Thomas Friedman, *The World Is Flat* (New York: Penguin Books, 2006).

International and U.S. IPO Planning

Chapter 1

Pros and Cons of a U.S. IPO

The New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq) are the most prestigious stock markets in the world and are likely to remain so for the next five years. However, they are facing increasing competition from foreign stock exchanges.

A private company considering an initial public offering (IPO), regardless of where in the world the private company is located, should first consider the NYSE and the Nasdaq for an IPO because these stock markets are well regulated and highly liquid and have strong corporate governance standards. For private companies that will have, after an IPO, a market valuation of over $250 million, these prestigious U.S. exchanges are the first places to consider. However, this is not necessarily true for smaller private companies (whether U.S. or international) planning an IPO, as discussed later in this chapter.

We begin the discussion of the pros and cons of a U.S. IPO by considering two topics:

1. Underwriter spreads and underpricing

2. IPO offering expenses and post-IPO compliance expenses

We then review the increasing international competition with U.S. IPO markets, particularly for smaller IPOs, and the reasons why smaller companies may wish to consider an international IPO as an alternative. Finally, we suggest changes that can be made to the U.S. regulatory structure to make it more attractive for smaller IPOs.

UNDERWRITER SPREADS AND UNDERPRICING

Underwriter spreads,[1] or "discounts," in the traditional U.S. IPO market typically run approximately 7%. Strong IPOs may have underwriter discounts less than 7%; weak IPOs may have underwriter discounts higher than 7%. The term "underwriter discount" refers to the excess of the IPO public offering price for the stock that is sold by the underwriter to the public over the price paid to the company for that stock by the underwriter. For example, if the IPO public offering price is $20 per share, and the price that the underwriter pays to the company is $18.60, the $1.40 difference is the 7% underwriter discount.

In contrast, it has been reported that underwriter discounts in a number of foreign IPO offerings are as low as 2%. (See Exhibit 1.1 on international underwriter spreads; although somewhat dated, it is still relevant.) Although this is a major cost differential, particularly in a large offering, it can be justified in some cases by the higher valuation for the company obtained in the U.S. market and the better distribution of the shares sold in the IPO. Likewise, if the U.S. underwriter provides greater after-market support for the stock, this could also justify the greater underwriter discount.

One study in 2002 found that although foreign issuers pay more to get a U.S. lead bank to arrange a bookbuilding IPO, they also end up with lower underpricing. (Underpricing is the percentage difference between the price at which the IPO shares were sold to investors—the public offering price—and the price at which the shares subsequently trade in the market.) The higher U.S. underwriter discount is generally more than offset by savings in the underpricing, which is the amount of money left on the table by the IPO company.[2] A 2004 study found

Exhibit 1.1 Spread Levels in IPO Markets around the World Based upon 10,990 IPOs

	Mode Spread		Gross Spread (%)
Countries	Level (%)	Relative Frequency	Median
Australia	4.00	21.2%	4.0
Hong Kong	2.50	94.8%	2.5
India	2.50	86.0%	2.5
Indonesia	3.50	27.3%	3.5
Malaysia	2.00	88.8%	2.0
New Zealand	nm	nm	5.5
Philippines	3.00	65.4%	5.5
Singapore	2.50	55.7%	2.5
Thailand	3.00	42.9%	3.0
Total Asia Pacific	**2.50**	**66.7%**	**2.5**
Austria	3.00	18.5%	3.5
Belgium	2.50	66.7%	2.5
Denmark	4.00	25.0%	4.0
Finland	4.00	25.0%	3.8
France	3.00	34.0%	3.0
Germany	4.00	38.6%	4.0
Greece	3.00	40.0%	3.0
Ireland	nm	nm	3.3
Italy	4.00	18.2%	4.0
Netherlands	3.25	13.0%	3.7
Norway	4.00	28.6%	4.1
Portugal	3.25	16.7%	3.5
Spain	3.50	26.5%	3.5
Sweden	4.50	14.8%	4.3
Switzerland	4.00	33.3%	4.0
United Kingdom	6.00	8.9%	3.6
Total Europe	**4.00**	**15.6%**	**4.0**
Canada	6.00	18.3%	6.5
United States	7.00	43.0%	7.0
Total North America	**7.00**	**39.8%**	**7.0**

Source: Journal of Financial and Quantitative Analysis, Vol. 38, No. 3, pp. 475–501 (September 2003); Social Science Research Network, www.ssrn.com/.

that underpricing is reduced by 41.6% on average when U.S. banks and U.S. investors are involved. Even after the higher underwriter discount charged by U.S. underwriters is subtracted, one study estimated that 73% of issuers would have been worse off had they chosen foreign banks and foreign investors.[3] However, it is not clear that the U.S. IPO has any significant underpricing advantage when compared to an IPO on the Alternative Investment Market (AIM) of the London Stock Exchange, as discussed in Chapter 9.

An interesting study of U.S. IPOs found that the higher the selling concession made by the underwriter to the selling group of investment bankers, the higher the IPO offering price and consequently the lower the underpricing. This study suggests that IPO candidates should be looking for underwriters that provide generous selling concessions to the selling group.[4]

Underpricing varies from country to country and is markedly lower in some countries, such as Denmark, Luxembourg and certain South American countries,[5] and is markedly higher in China. The average underpricing of Chinese IPOs is 247%, the highest of any major world market.[6]

IPO OFFERING EXPENSES AND POST-IPO COMPLIANCE EXPENSES

IPOs in the United States typically have significantly higher offering expenses than international IPOs. Legal and accounting fees, printing, and other related expenses are substantially higher in the United States than in many other countries. Chapter 9 contains a 2006 comparison of IPO offering expenses on AIM versus a Nasdaq IPO that indicates that the Nasdaq IPO expenses are more than $1.8 million higher than the AIM IPO expenses.[7] However, the legal and accounting expenses quoted in 2007 for AIM offerings are, as a result of the devaluation of the U.S. dollar, in the neighborhood of $400,000 to $1 million each and therefore do not significantly differ from U.S. legal and accounting expenses.[8]

The Tel Aviv Stock Exchange claims that the legal, accounting, printing, and public relations costs for its IPOs are only $155,000 and annual maintenance costs (excluding directors' and officers' [D & O] insurance) are only $260,000.[9] IPO expenses on the Bombay Stock Exchange in India are estimated to be 65% to 75% lower than U.S. costs.[10]

Except for small public offerings, offering expenses are only a very small percentage of the net proceeds of most IPOs. The tendency for U.S. IPOs to be less "underpriced" than international IPOs may make up for all or some of the difference in these offering expenses. However, the advocates for AIM IPOs dispute the assertion that their IPOs have any greater underpricing than U.S. IPOs (see Chapter 9).

The post-IPO regulatory compliance expenses are also significantly higher in the United States than internationally. These post-IPO compliance expenses are usually not material for large-capitalization (cap) IPOs. For companies having a post-IPO market value of less than $250 million, these expenses can be material. These expenses can become very material for companies having a post-IPO market value of less than $100 million. For example, it has been estimated that, annually, the cost of being a $200 million market cap public company on Nasdaq is more than $1.4 million higher than the annual cost of an AIM public company.[11]

INCREASING COMPETITION TO U.S. IPO MARKETS

The competitiveness of the U.S. public market has been seriously challenged in recent years.[12] For example, during the dot-com boom the European IPO market attracted more IPOs in the years 1998 to 2000 than the U.S. stock markets.[13]

According to a report by the Committee on Capital Markets Regulation, the competitiveness of the U.S. public markets has deteriorated significantly in recent years.[14] The report states:

> Whereas 43 foreign companies cross-listed in the U.S. without raising capital in 2000, only 4 did so in 2007 through September. In 2006, six

> foreign companies cross-listed in the U.S. The obvious inference is that foreign companies see diminishing value in bonding to U.S. standards.

In addition, through October 2007, a record of 56 foreign companies delisted from the NYSE.

According to the report, in 1996, 8 of 20 of the largest global IPOs were in the United States, whereas none of the 20 largest global IPOs was conducted in the United States in 2007. IPOs of U.S. companies abroad increased from 0.1% during the 1996 through 2005 period to 4.3% in 2007.

One can argue that the growth of economies outside of the United States is a significant contributor to the growing international IPO competition. However, that is not the only reason. The Sarbanes-Oxley Act of 2002 (SOX) has given the U.S. markets a bad international reputation.

One commentator has stated:

> The now-infamous Sarbanes-Oxley Act in the United States . . . created massive barriers to fraud but, in its wake, a negative environment for the US exchanges. The cost for issuers of compliance with Sarbanes-Oxley reached such a high level that those with a choice started to abandon US equity markets.[15]

The poor reputation of SOX internationally is mostly undeserved, with one major exception and several minor ones. The major exception is the provision of Section 404 that required an auditor attestation report on internal controls. That provision initially caused major cost expenditures by public companies, primarily as a result of poor regulatory implementation (which has now, it is hoped, been corrected), but unfortunately seriously damaged the international reputation of SOX. Some U.S. audit committee chairpersons currently believe that Section 404 of SOX actually has been of significant benefit to their companies by forcing the improvement of internal controls.

According to the report of the Committee on Capital Markets Regulation, as illustrated in Exhibit 1.2,[16] through the third quarter of 2007,

Exhibit 1.2 Share of Global IPOs (Narrowly Defined) Captured by U.S. Exchange

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007*
Total Number of Global IPOs	105	118	85	112	136	45	47	54	122	192	237	209
Number of Global IPOs Listed on a U.S. Exchange	61	57	41	52	74	10	3	5	28	28	34	32
% of Total Number	55.8%	48.3%	48.2%	46.4%	54.4%	22.2%	6.4%	9.3%	23.0%	14.6%	14.3%	15.3%
($ billions)												
Total Value of Global IPOs	32.3	46.8	25.2	45.4	43.1	15.1	3.7	12.4	21.5	40.5	97.8	
Value of Global IPOs Listed on a U.S. Exchange	24.9	34.3	15.6	34.4	35.3	7.6	2.5	4.9	9.2	4.5	10.8	8.5
% of Total Value	77.3%	73.3%	62.0%	75.8%	81.8%	50.6%	67.1%	39.5%	42.7%	11.2%	11.0%	13.8%

*2007 data through September.

Source: Dealogic.

NOTE: According to Renaissance Capital (www.ipohome.com), Visa's record $17.9 billion U.S. IPO in March 2008 helped the U.S. increase its total IPO proceeds to 33% during the first six months of 2008; however, excluding Visa, the remaining 16 U.S. IPOs captured just 7% of global IPO proceeds during this period.

15.3% of global IPOs were listed on a U.S. exchange, compared with an average of 51.1% in the period from 1996 to 2000. Similarly, U.S. exchanges have captured just 13.8% of the total value of global IPOs to date in 2007, compared with an average of 74.0% in the period from 1996 to 2000.

The report of the Committee on Capital Markets Regulation goes on to discuss the increasing trend of U.S. companies listing their IPOs only on a foreign exchange, as illustrated in Exhibit 1.3.[17]

The only positive trend reflected in the report of the Committee on Capital Markets Regulation is the increase in the value of ''Rule 144A IPOs,'' which is defined as IPOs by foreign companies *privately* offered in the United States pursuant to Securities and Exchange Commission(SEC) Rule 144A. As noted in the report:

> . . . the Rule 144A market is not subject to SEC regulation under the '34 Act (including the Sarbanes-Oxley Act) and the standard of liability is lower than in the public market . Moreover, because access to this market is restricted to large institutions, the risk of securities class actions is generally lower.

In effect, the foreign companies are willing to raise capital in the United States only if they are exempted from SEC reporting requirements and SOX.

The report of the Committee on Capital Markets Regulation is further supported by statistics from the World Federation of Exchanges.[18] Exhibit 1.4 is an excerpt from a chart in the annual report of the World Federation of Exchanges on the number of newly listed companies by each exchange. The chart reflects the growing importance of the London Stock Exchange, Shanghai Stock Exchange, and the Hong Kong Exchanges. Because these figures include IPOs and listings of investment funds, they significantly overstate the actual dollar amount of IPOs of operating companies, particularly for the NYSE.

Some have argued that the decline in the IPO market share of U.S. securities exchanges is due to the greater number of capital choices available to U.S. private companies. It is true that a foreign private

Exhibit 1.3 Share of U.S. IPOs Listed Only on Foreign Exchanges

	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007*
Total Number of U.S.-Domiciled IPOs	497	398	300	459	341	119	157	129	263	232	189	163
Number of U.S.-Domiciled IPOs Listed Abroad Only	1	0	2	0	0	0	2	1	5	8	12	15
% of Total Number	0.2%	0.0%	0.7%	0.0%	0.0%	0.0%	1.3%	0.8%	1.9%	3.4%	6.3%	9.2%
($ billions)												
Total Value of U.S.-Domiciled IPOs	28.0	32.5	37.5	65.7	62.6	45.2	41.7	44.7	65.9	55.1	44.2	57.4
Value of U.S.-Domiciled IPOs Listed Abroad Only	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.5	0.5	2.5
% of Total Value	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.9%	1.1%	4.3%

*2007 data through September.

Source: Dealogic.

company wishing to raise capital in its home country may be forced into an IPO solely because of the lack of local private equity resources. However, an equally plausible explanation is that there is no easily accessible IPO market in the United States for smaller companies and that the costs and burdens of a U.S. IPO substantially exceed those of any other country. Thus, small U.S. private companies wishing to obtain growth capital are forced to seek private equity financing.

Private equity is not necessarily the best alternative to grow a private company. By their nature, private equity funds will tend to place lower valuations on their investee companies than the IPO marketplace, may have shorter exit horizons and different objectives from the founders of these investee companies, and may take control of the private company away from the founders, leveraging the company with significant debt. The presence of a strong IPO market permits founders and other entrepreneurs to retain control of the public company after the IPO, and to grow the company with less dilutive public equity. More important, an active IPO market serves a social purpose by permitting the public, including persons who could not qualify to invest in private equity funds, to invest in new growth companies.

Exhibit 1.4 Exchange Listings

			Newly Listed Companies 2007	
Exchange	(US$ millions) Initial Public Offering	Total	Domestic Companies	Foreign Companies
Americas				
American SE	N/A	92	71	21
Bermuda SE	N/A	6	0	6
Buenos Aires SE	234.1	5	5	0
Colombia SE	4,597.1	7	7	0
Lima SE	0.0	15	8	7
Mexican Exchange	888.0	63	4	59
Nasdaq	16,192.6	153	128	25
NYSE Group	60,385.8	126	84	42
Santiago SE	230.2	6	4	2

São Paulo SE	27,834.2	70	64	6
TSX Group	7,369.5	408	381	27
Asia Pacific				
Australian SE	16,725.5	292	276	16
Bombay SE	9,642.8	136	136	0
Bursa Malaysia	317.4	22	22	0
Columbo SE	0.0	0	0	0
Hong Kong Exchanges	37,485.9	84	82	2
Indonesia SE	1,976.3	22	22	0
Jasaq	688.6	49	49	0
Korea Exchange	3,170.0	98	96	2
National Stock Exchange India	7,874.1	201	201	0
New Zealand Exchange	316.7	9	7	2
Osaka SE	179.5	28	28	0
Philippine SE	412.1	11	11	0
Shanghai SE	57,770.0	25	25	0
Shenzhen SE	5,670.7	101	101	0
Singapore Exchange	5,159.8	76	20	56
Taiwan SE Corp.	566.1	30	30	0
Thailand SE	332.6	13	13	0
Tokyo SE Group	N/A	68	65	3
Europe—Africa—Middle East				
Amman SE	606.9	18	18	0
Athens Exchange	15.8	4	3	1
BME Spanish Exchanges	21,726.2	192	191	1
Börsa Italiana	5,930.8	33	33	0
Budapest SE	9.5	3	1	2
Cairo & Alexandria SEs	866.8	20	20	0
Cyprus SE	279.9	4	4	0
Deutsche Börse	N/A	65	62	3
Euronext	13,329.9	46	30	16
Irish SE	2,159.9	9	7	2
Istanbul SE	3,372.8	9	9	0
JSE	0.0	62	54	8
Ljubljana SE	1,233.0	4	4	0
London SE	50,026.2	411	270	141
Luxembourg SE	265.7	20	1	19
Malta SE	42.4	2	2	0
Mauritius SE	0.0	7	6	1

(*Continued*)

Exhibit 1.4 (*Continued*)

Exchange	(US$ millions) Initial Public Offering	Total	Newly Listed Companies 2007 Domestic Companies	Foreign Companies
OMX Nordic Exchange	6,057.4	94	90	4
Oslo Bors	1,778.4	30	24	6
Swiss Exchange	1,265.7	N/A	N/A	N/A
Tehran SE	505.4	9	9	0
Tel Aviv SE	2,707.4	64	61	3
Warsaw SE	5,486.4	105	93	12
Wiener Börse	2,337.1	9	7	2

COMPETITION SOURCES

Competition to U.S. exchanges arises primarily from three sources:

1. The London Stock Exchange (AIM), Hong Kong Stock Exchanges, Shanghai Stock Exchange, and other major foreign exchanges.
2. The use of Rule 144A IPOs. These private sales of equity securities to large institutional investors by both foreign companies and U.S. companies are thereafter listed for trading on alternative nonpublic markets, such as the GS Tradable Unregistered Equity OTC Market (GS TRuE) sponsored by Goldman Sachs & Co.
3. The difficult regulatory, legal (including litigation), accounting, and activist shareholder environment in the United States, which adversely affects the IPOs of smaller companies in particular.

The increasing prominence of foreign stock exchanges was illustrated by the announcement in July 2008 that the common shares of NYSE Euronext Inc., which owns the NYSE, would also be listed on the Shanghai Stock Exchange at the same time its common shares are traded on a European and U.S. exchange.[19]