

RAISING EQUITY CAPITAL

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To float or not to float? . . .**Some firms are keen to float on the London Stock Exchange . . .**

In 2000 easyJet set out its ambitious plans to grow seat capacity by 25% per year until it is the largest airline flying inside the European Union. It ordered new 737s with a list price of £890m. easyJet has to find a massive amount of money to fund its ambitions. With this in mind in November 2000 it sold 72.45 million new shares to outside investors and became listed on the Official List of the London Stock Exchange. The shares were priced at 310p and £195m was raised for the company. The new shares represented 27.8 percent of the enlarged equity capital. The remainder was held by easyJet's chairman, Stelios Haji-loannou, his brother and sister, Polys and Celia, and Ray Webster, the chief executive, who held 1.04 percent. Stelios Haji-loannou, the Greek entrepreneur, founded the airline in 1995 with backing from his father's shipping fortune.

Some firms are desperate to leave the London Stock Exchange . . .

Richard Branson, Alan Sugar, Andrew Lloyd Webber and Anita and Gordon Roddick have demonstrated deep dissatisfaction with their companies' quotation. Mr Branson floated the Virgin Group in 1986, then bought it back in 1988. Lord Lloyd Webber bought back his Really Useful Theatre Group in 1990 four years after floating. Alan Sugar had made plain his dislike of the City and its ways, and was particularly annoyed when investors rejected his 1992 offer to buy the Amstrad group for £175m. Anita Roddick, co-founder of Body Shop, which floated in 1984, for many years made no secret of her desire to free herself of the misunderstanding and constraints imposed by City Folk, who she once described as 'pin-striped dinosaurs'.

And some firms are content to raise equity finance without being quoted on an exchange.

Professor Steve Young, a specialist in information engineering at Cambridge University, became a millionaire by commercializing speech recognition software in the early 1990s. His project proceeded very nicely without a stock market quotation.

Initially his invention was licensed to a US company by Cambridge University. In 1995 the business was further developed by the creation of a UK company, half of which was owned by the US company. The other half was jointly held by the university, Professor Young and fellow academic Phil Woodland.

To grow further they needed 'venture money'. First, the US and UK companies combined and then the merged group took \$3m from Amadeus Capital Partners (venture capitalists). By 1999, with 60 staff, the company, Entropic, was in need of more equity capital. Venture capitalists offered \$20m, but here the story takes a strange twist. Young thought that it would be wise to have some of the shares bought by corporate investors. Microsoft was approached; they said they were not interested in making small corporate investments. A few weeks later, however, Microsoft telephoned and offered to buy the whole company instead. The deal is secret, but is thought to be worth tens of millions of pounds. Professor Young has returned to full-time academia a richer man and grateful for the existence of venture capital funds.

Sources: easyJet: based on *Financial Times*, 1, 9 and 16 November 2000 and 25 October 2000; Richard Branson, etc.: based on *Financial Times*, 1 November 1995 and 17 May 2000; Prof. Young: based on *Financial Times*, 14 June 2001.

Introduction

There are many ways of raising money by selling shares. This chapter looks at the most important. It considers the processes that a firm would have to go through to gain a quotation on the Official List (OL) and raise fresh equity finance. We will examine the tasks and responsibilities of the various advisers and other professionals who assist a company like easyJet to present itself to investors in a suitable fashion.

A firm wishing to become quoted may, in preference to the OL, choose to raise finance on the Alternative Investment Market (AIM), also run by the London Stock Exchange, where the regulations and the costs are lower.

In addition to, or as an alternative to, a 'new issue' on a stock market (also called an initial public offering, IPO), which usually involves raising finance by selling shares to a new group of shareholders, a company may make a rights issue, in which existing shareholders are invited to pay for new shares in proportion to their present holdings. This chapter explains the mechanics and technicalities of rights issues as well as some other methods, such as placings and open offers.

It is necessary to broaden our perspective beyond stock markets, to consider the equity finance-raising possibilities for firms that are not quoted on an exchange. There are over one million limited liability companies in the UK and only 0.2 percent of them have shares traded on the recognized exchanges. For decades there has been a perceived financing gap for small and medium-sized firms which has to a large extent been filled by the rapidly growing venture capital/private equity capital industry. Venture capital firms have supplied share and debt capital to thousands of companies on fast-growth trajectories, such as the company established by Professor Young.

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Many, if not most, companies are content to grow without the aid of either stock markets or venture capital. For example JC Bamford (JCB), which manufactures earth-moving machines, has built a large, export award winning company, without needing to bring in outside shareholders. This contentedness and absence of a burning desire to be quoted is reinforced by the stories that have emerged of companies which became disillusioned with being quoted. The pressures and strains of being quoted are considered by some (for example, Philip Green, owner of Arcadia and BHS) to be an excessively high price to pay for access to equity finance. So to round off this chapter we examine some of the arguments advanced against gaining a quotation and contrast these with the arguments a growing company might make for joining a market.

What is equity capital?

Ordinary shares

Ordinary shares represent the equity share capital of the firm. The holders of these securities share in the rising prosperity of a company. These investors, as owners of the firm, have the right to exercise control over the company. They can vote at shareholder meetings to determine such crucial matters as the composition of the team of directors. They can also approve or disapprove of major strategic and policy issues such as the type of activities that the firm might engage in, or the decision to merge with another firm. These ordinary shareholders have a right to receive a share of dividends distributed as well as, if the worst came to the worst, a right to share in the proceeds of a liquidation sale of the firm's assets. To exercise effective control over the firm the shareholders will need information; and while management are reluctant to put large amounts of commercially sensitive information which might be useful to competitors into the public domain, they are required to make available to each shareholder a copy of the annual report.

Ordinary shares represent the equity share capital of the firm.

There is no agreement between ordinary shareholders and the company that the investor will receive back the original capital invested. What ordinary shareholders receive depends on how well the company is managed. To regain invested funds an equity investor must either sell the shares to another investor (if the company is doing a share buy-back program, it might be possible to sell shares to it, but this is rare) or force the company into liquidation, in which case all assets are sold and the proceeds distributed. Both courses of action may leave the investor with less than originally invested. There is a high degree of discretion left to the directors in proposing an annual or semi-annual dividend, and individual shareholders are often effectively powerless to influence the income from a share – not only because of the risk attached to the trading profits which generate the resources for a dividend, but also because of the relative power of directors in a firm with a disparate or divided shareholder body.

Ordinary shareholders are the last in the queue to have their claims met. When the income for the year is being distributed others, such as debenture holders and preference shareholders, get paid first. If there is a surplus after that, then ordinary shareholders may receive a dividend. Also when a company is wound up, employees, tax authorities, trade creditors and lenders all come before ordinary shareholders. Given these disadvantages there must be a very attractive feature to ordinary shares to induce individuals to purchase and keep them. The attraction is that if the company does well there are no limits to the size of the claim equity shareholders have on profit. There have been numerous instances of investors placing modest sums into the shares of young firms who find themselves millionaires. For example, if you had bought £1,000 shares in Racal in 1961, by 1999 your holding would have been worth millions (Vodafone was one of Racal's creations).

From the company's point of view the issue of more shares has advantages, as discussed in Chapter 16, the most significant of which is their shock absorbing role. However, there are disadvantages compared with raising money by borrowing:

- *High cost* The cost of issuing shares is usually higher than the cost of raising the same amount of money by obtaining additional loans. There are two types of cost. First, there are the direct costs of issue such as the costs of advice from a merchant bank and/or broker, and the legal, accounting and prospectus costs, etc. These costs can absorb up to 10 percent of the amount of money raised. Second, and by far the most important, there is the cost represented by the return required to satisfy shareholders, which is greater than that on safer securities such as bonds issued by the firm (see Chapter 10).
- *Loss of control* Entrepreneurs sometimes have a difficult choice to make – they need additional equity finance for the business but dislike the notion of inviting external equity investors to buy shares. The choice is sometimes between slow/no growth or dilution of the entrepreneurs' control. External equity providers may impose conditions such as veto rights over important business decisions and the right to appoint a number of directors. In many instances, founders take the decision to forgo expansion in order to retain control.
- *Dividends cannot be used to reduce taxable profit* Dividends are paid out of after-tax earnings, whereas interest payments on loans are tax deductible. This affects the relative costs to the company of financing by issuing interest-based securities and financing through ordinary shares.

Entrepreneurs dislike the notion of inviting external equity investors to buy shares.

Authorized, issued and par values

When a firm is created the original shareholders will decide the number of shares to be *authorized* (the *authorized capital*). This is the maximum amount of share capital that the company can issue (unless shareholders vote to change the limit). In many cases firms do not issue up to the amount specified. For example, Green plc has authorized capital of £5m, split between £1m of preference shares and £4m of ordinary shares. The company has issued all of the preference shares (at par) but the issued ordinary share capital is only £2.5m, leaving £1.5m as *authorized but unissued ordinary share capital*. This allows the directors to issue the remaining £1.5m of capital without the requirement of asking shareholders for further permission.

Authorized capital is the maximum amount of share capital that the company can issue.

Shares have a stated par value, say 25p or 5p. This nominal value usually bears no relation to the price at which the shares could be sold or their subsequent value on the stock market. So let us assume Green has ten million ordinary shares

issued, each with a par value of 25p (£2.5m total nominal value divided by the nominal price per share, 25p = 10m shares); these were originally sold for £2 each, raising £20m, and the present market value is £3.80 per share.

The par value has no real significance¹ and for the most part can be ignored. However, a point of confusion can arise when one examines company accounts

Share premium account represents the difference between the price received by the company for the shares and the par value of those shares.

because issued share capital appears on the balance sheet at par value and so often seems pathetically small. This item has to be read in conjunction with the *share premium account*, which represents the difference between the price received by the company for the shares and the par value of those shares.

Thus, in the case of Green the premium on each share was $200p - 25p = 175p$. The total share premium in the balance sheet will be £17.5m.

Limited companies, plcs and listed companies

Limited liability means that the ordinary shareholders are only liable up to the amount they have invested or have promised to invest in purchasing shares. Lenders and other creditors are not able to turn to the ordinary shareholder should they find on a liquidation that the company, as a separate legal 'person', has insufficient assets to repay them in full. This contrasts with the position for a partner in a partnership who will be liable for all the debts of the business to the point where personal assets such as houses and cars can be seized to be sold to pay creditors.

Private companies, with the suffix 'Limited' or 'Ltd', are the most common form of company (over 95 percent of all companies). The less numerous, but more influential, form of company is a public limited company (or just public companies). These firms must display the suffix 'plc'. The private company has no minimum amount of share capital and there are restrictions on the type of purchaser who can be offered shares in the enterprise, whereas the plc has to have a minimum share capital of £50,000 but is able to offer shares to a wide range of potential investors. Not all public companies are quoted on a stock market. This can be particularly confusing when the press talks about a firm 'going public' – it may have been a public limited company for years and has merely decided to 'come to the market' to obtain a quotation. Strictly speaking, the term 'listed' should only be applied to those firms on the Official List but the term is used rather loosely and shares on the Alternative Investment Market are often referred to as being quoted or listed.

Preference shares

Preference shares usually offer their owners a fixed rate of dividend each year, unlike ordinary shares which offer no regular dividend. However if the firm has

insufficient profits the amount paid would be reduced, sometimes to zero. Thus, there is no guarantee that an annual income will be received, unlike with debt capital. The dividend on preference shares is paid before anything is paid out to ordinary shareholders – indeed, after the preference dividend obligation has been met there may be nothing left for ordinary shareholders. Preference shares are attractive to some investors because they offer a regular income at a higher rate of return than that available on fixed interest securities, e.g. bonds. However this higher return also comes with higher risk, as the preference dividend ranks after bond interest, and upon liquidation preference holders are further back in the queue as recipients of the proceeds of asset sell-offs.

Preference shares are part of shareholders' funds but are not equity share capital. The holders are not usually able to benefit from any extraordinarily good performance of the firm – any profits above expectations go to the ordinary shareholders. Also preference shares usually carry no voting rights, except if the dividend is in arrears or in the case of liquidation.

Figure 17.1 shows the basic division of shareholder funds.

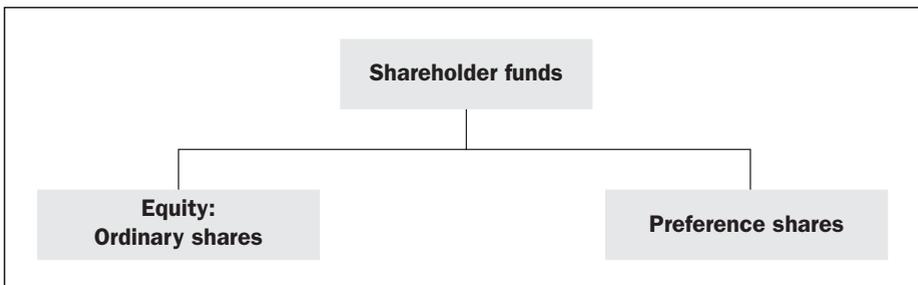
Advantages to the firm of preference share capital

Preference share capital has the following advantages:

- *Dividend 'optional'* Preference dividends can be omitted for one or more years. This can give the directors more flexibility and a greater chance of surviving a downturn in trading. Although there may be no legal obligation to pay a dividend every year the financial community is likely to take a dim view of a firm that missed a dividend – this may have a deleterious effect on the ordinary share price as investors become nervous and sell.
- *Influence over management* Preference shares are an additional source of capital which, because they do not (usually) confer voting rights, do not dilute the influence of the ordinary shareholders on the firm's direction.
- *Extraordinary profits* The limits placed on the return to preference shareholders means that the ordinary shareholders receive all the extraordinary profits when the firm is doing well.

FIGURE 17.1

Shareholder funds



- *Financial gearing considerations* There are limits to safe levels of borrowing. Preference shares are an alternative, if less effective, shock absorber to ordinary shares because of the possibility of avoiding the annual cash outflow due on dividends. In some circumstances a firm may be prevented from raising finance by borrowing as this increases the risk of financial distress, and the shareholders may be unwilling to provide more equity risk capital. If this firm is determined to grow by raising external finance, preference shares are one option.

Disadvantages to the firm of preference share capital

Preference share capital also has disadvantages:

- *High cost of capital* The higher risk attached to the annual returns and capital cause preference shareholders to demand a higher level of return than debt holders.
- *Dividends are not tax deductible* Because preference shares are regarded as part of shareholders' funds the dividend is regarded as an appropriation of profits. Tax is payable on the firm's profit before the deduction of the preference dividend. In contrast, lenders are not regarded as having any ownership rights and interest has to be paid whether or not a profit is made. This cost is regarded as a legitimate expense reducing taxable profit. In recent years preference shares have become a relatively unpopular method of raising finance because bonds and bank loans, rival types of long-term finance, have this tax advantage. This is illustrated by the example of companies A and B. Both firms have raised £1m, but Company A sold bonds yielding 8 percent, Company B sold preference shares offering a dividend yield of 8 percent. (Here we assume the returns are identical for illustration purposes – in reality the return on preference shares might be a few percentage points higher than that on bonds.) See Figure 17.2.

FIGURE 17.2
Preference shares versus bonds

	Company A	Company B
Profits before tax, dividends and interest	200,000	200,000
Interest payable on bonds	80,000	0
Taxable profit	120,000	200,000
Tax payable @ 30% of taxable profit	36,000	60,000
	84,000	140,000
Preference dividend	0	80,000
Available for ordinary shareholders	84,000	60,000

Company A has a lower tax bill because its bond interest is used to reduce taxable profit, resulting in an extra £24,000 (£84,000 – £60,000) being available for the ordinary shareholders.

Types of preference shares

There are a number of variations on the theme of preference share. Here are some features which can be added:

- *Cumulative* If dividends are missed in any year the right to eventually receive a dividend is carried forward. These prior-year dividends have to be paid before any payout to ordinary shareholders.
- *Participating* As well as the fixed payment, the dividend may be increased if the company has high profits.
- *Redeemable* These have a finite life, at the end of which the initial capital investment will be repaid. Irredeemables have no fixed redemption date.
- *Convertibles* These can be converted into ordinary shares at specific dates and on pre-set terms (for example, one ordinary share for every two preference shares). These shares often carry a lower yield since there is the attraction of a potentially large capital gain.
- *Variable rate* A variable dividend is paid. The rate may be linked to general interest rates, e.g. LIBOR or to some other variable factor.

Floating on the Official List

To ‘go public’ and become a listed company is a major step for a firm. The substantial sums of money involved can lead to a new, accelerated phase of business growth. Obtaining a quotation is not a step to be taken lightly; it is a major legal undertaking. The United Kingdom Listing Authority, UKLA (part of the Financial Services Authority)² rigorously enforces a set of demanding rules and the directors will be put under the strain of new and greater responsibilities both at the time of flotation and in subsequent years. As the example of Wolfson Microelectronics shows (*see* Exhibit 17.1), new issues can produce a greater availability of equity finance to fund expansion and development programs. It may also allow existing shareholders to realize a proportion of their investment. Shareholders benefit from the availability of a speedy, cheap secondary market if they want to sell. Not only do shareholders like to know that they can sell when they want to, they may simply want to know the value of their holdings even if they have no intention of selling at present. By contrast, an unquoted firm’s shareholders often find it difficult to assess the value of their holding. In addition it can raise the profile of a

Obtaining a quotation is not a step to be taken lightly; it is a major legal undertaking.

company both in the financial world and in its product markets, which may give it a competitive edge. A float may also make mergers easier. This is especially true if the payment for the target shares is shares in the acquirer; a quoted share has a value defined by the market, whereas shares in unquoted companies are less attractive because of the greater doubt about the value.

IPO to make millionaires of two academics

Chris Nuttall

Two Scottish academics are poised to become paper multi-millionaires when the technology company they founded is floated on the main London market next month.

Edinburgh-based Wolfson Microelectronics expects to raise £50m to £100m, in what would be the biggest initial public offering by a UK technology company in two and a half years.

The size of the stake to be sold has not yet been determined but could be as much as 25 per cent, giving the group a market capitalisation of at least £200m. ...

Wolfson makes chips for the computer and consumer electronics industries. Its products feature in Microsoft's Xbox games console, Apple's iPod music player and digital cameras, and DVD players and digital TVs. Its biggest customer, Hewlett-Packard, uses its chips in printers.

David Milne, chief executive, co-founded the company in 1984 when he was director of the Wolfson Microelec-

tronics Institute at Edinburgh University. Jim Reid, chief technical officer and the other co-founder, was also at the Wolfson and is visiting professor of engineering design at Glasgow university.

The pair own 6 per cent of the company but say they have no intention of cashing in on the IPO.

WestLB, the German bank, the Scottish Braveheart Ventures investment syndicate and Sanyo, Japanese electronics group, may sell part of their stakes in Wolfson. The group's 120 employees also have options that give them 20 per cent of the company.

Citigroup has been appointed sole bookrunner, with new and existing shares being offered to UK and overseas institutional investors. Citigroup and Cazenove will be lead managers and joint brokers.

Mr Milne said the flotation was aimed at improving Wolfson's balance sheet and expanding its product range.

EXHIBIT 17.1 IPO to make millionaires of two academics

Source: *Financial Times* 9 September 2003

What managers need to consider

Prospectus

To create a stable market and encourage investors to place their money with companies the UKLA tries to minimize the risk of investing by ensuring that the firms which obtain a quotation abide by high standards and conform to strict rules. For example the directors are required to prepare a detailed prospectus ('Listing particulars') to inform potential shareholders about the company. This

may contain far more information about the firm than it has previously dared to put into the public domain. Even without the stringent conditions laid down by the UKLA the firm has an interest in producing a stylish and informative prospectus. A successful flotation can depend on the prospectus acting as a marketing tool as the firm attempts to persuade investors to apply for shares.

A successful flotation can depend on the prospectus acting as a marketing tool.

The content and accuracy of this vital document is the responsibility of the directors. Contained within it must be three years of audited accounts, details of indebtedness and a statement as to the adequacy of working capital. Statements by experts are often required: valuers may be needed to confirm the current value of property, engineers may be needed to state the viability of processes or machinery and accountants may be needed to comment on the profit figures. All major contracts entered into in the past two years will have to be detailed. Any persons with a shareholding of more than 3 percent have to be named. A mass of operational data is required, ranging from an analysis of sales by geographic area and category of activity, to information on research and development and significant investments in other companies.

Conditions imposed and new responsibilities

All companies obtaining a full listing (i.e. on the Official List rather than the AIM) must ensure that at least 25 percent of their share capital is in public hands, to ensure that the shares are capable of being traded actively on the market. If a reasonably active secondary market is not established, trading may become stultified and the shares may become illiquid. 'Public' means people or organizations not associated with the directors or major shareholders.

Directors may find their room for discretion restricted when it comes to paying dividends. Stock market investors, particularly the major institutions, tend to demand regular dividends. Not only do they usually favor consistent cash flow, they also use dividend policy as a kind of barometer of corporate health (see Chapter 14). This can lead to pressure to maintain a growing dividend flow, which the unquoted firm may not experience.

There are strict rules concerning the buying and selling of the company's shares by its own directors. The Criminal Justice Act 1993 and the Model Code for Directors' Dealings have to be followed. Directors are prevented from dealing for a minimum period (normally two months) prior to an announcement of regularly recurring information such as annual results. They are also forbidden to deal before the announcement of matters of an exceptional nature involving unpublished information that is potentially price sensitive. These rules apply to any employee in possession of such information. All dealings in the company's shares by directors have to be reported to the market.

You might be rejected as unsuitable

The UKLA tries to ensure that the 'quality of the company' is sufficiently high to appeal to the investment community. The management team must have the necessary range and depth, and there must be a high degree of continuity and stability of management over recent years. Investors do not like to be over-reliant on the talents of one individual and so will expect a team of able directors, including some non-executives, and – preferably – a separation of the roles of chief executive and chairman. They also expect to see an appropriately qualified finance director.

The UKLA usually insists that a company has a track record (in the form of accounting figures) stretching back at least three years. However this requirement has been relaxed since 1993 for scientific research-based companies and companies undertaking major capital projects. In the case of scientific research-based companies there is the requirement that they have been conducting their activity for three years even if no revenue was produced. Some major project companies, for example Eurotunnel, have been allowed to join the market despite an absence of a trading activity or a profit record.

Technologically oriented companies can be admitted to the techMARK, part of the Official List, with only one year of accounts so long as they have a market capitalization of at least £50m and are selling at least £20m of new or existing shares when floating.

Another suitability factor is the timing of the flotation. Investors often desire stability, a reasonable spread of activities and evidence of potential growth in the core business. If the underlying product market served by the firm is going through a turbulent period it may be wise to delay the flotation until investors can be reassured about the long-term viability. Firms are also considered unsuitable if there is a dominant controlling shareholder as this could lead the company into a conflict of interest with its responsibilities to other shareholders.

Other suitability factors are a healthy balance sheet, sufficient working capital, good financial control mechanisms and clear accounting policies.

The issuing process

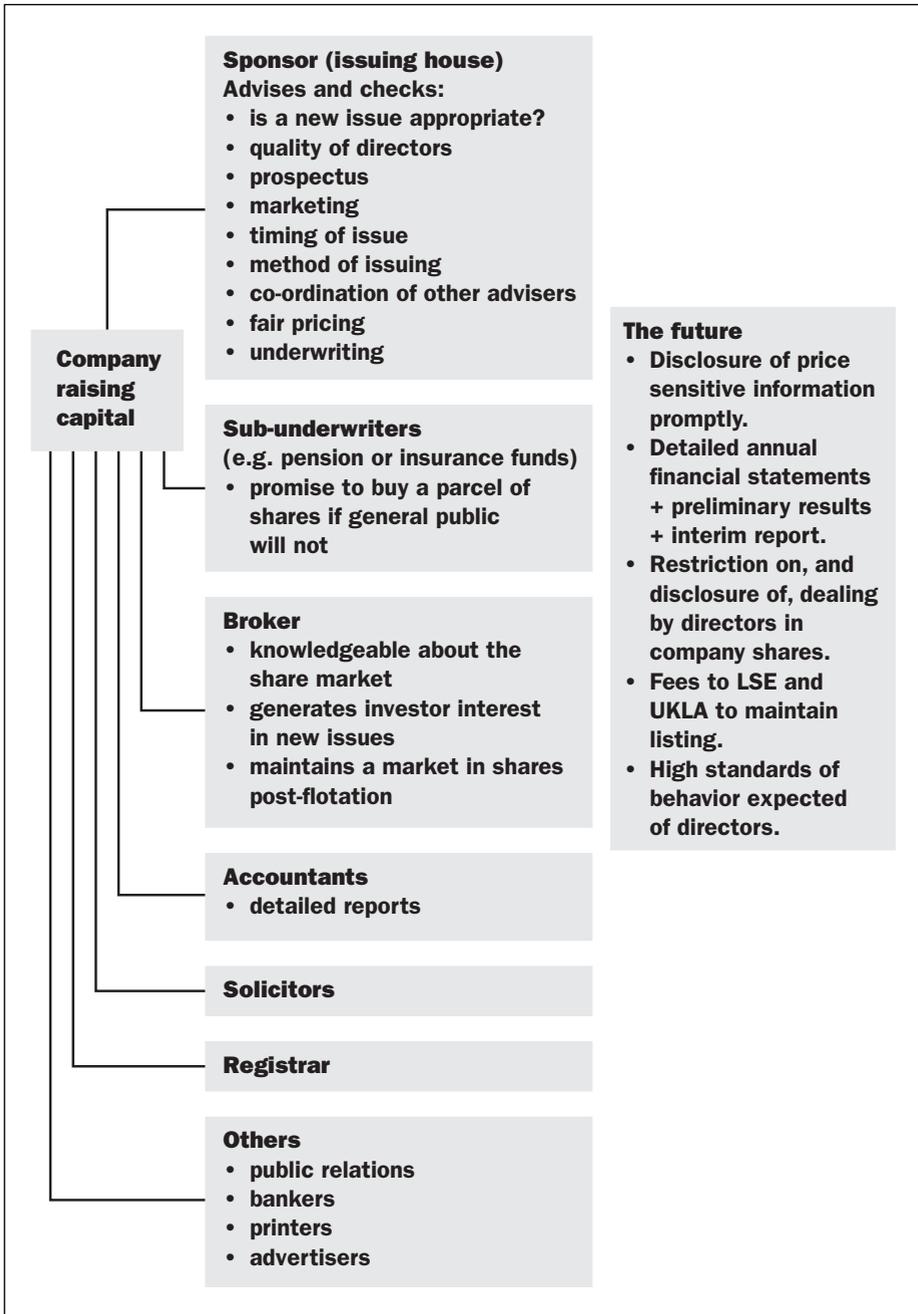
The issuing process involves a number of specialist advisers (discussed below). The process is summarized in Figure 17.3.

Hiring a sponsor

Given the vast range of matters that directors have to consider to gain a place on the Official List (the 'main market') it is clear that experts are going to be required to guide firms through the complexities. The key adviser in a flotation is the sponsor. This may be a merchant bank, stockbroker or other professional adviser. Directors, particularly of small companies, often first seek advice from their existing professional advisers, for example accountants and solicitors. These may have the necessary expertise (and approval of the UKLA) themselves

FIGURE 17.3

The issuing process for the Official List



to act for the company in the flotation or may be able to recommend a more suitable sponsor. Sponsors have to be chosen with care as the relationship is likely to be one that continues long after the flotation. For large or particularly complex issues investment banks are employed, although experienced stockbrokers have been used.

Sponsors are required by the UKLA to certify that a company has complied with all the regulatory requirements, and to ensure that all necessary documentation is filed in time. The sponsor (sometimes called the issuing house) will first examine the company to assess whether flotation is an appropriate corporate objective by taking into account its structure and capital needs. The sponsor will also comment on the composition of the board and the caliber of the directors. The sponsor may even recommend supplementation with additional directors if the existing team does not come up to the quality expected. The sponsor will draw up a timetable, which can be lengthy – sometimes the planning period for a successful flotation may extend over two years. There are various methods of floating, ranging from a placing to an offer for sale, and the sponsor will advise on the most appropriate. Another important function is to help draft the prospectus and provide input to the marketing strategy. Throughout the process of flotation there will be many other professional advisers involved and it is vital that their activities mesh into a coherent whole. It is the sponsor's responsibility to co-ordinate the activities of all the other professional advisers.

Paying underwriters

Shortly before the flotation the sponsor will have the task of advising on the best price to ask for the shares, and, at the time of flotation, the sponsor will underwrite the issue. Most new issues are underwritten, because the correct pricing of a new issue of shares is extremely difficult. If the price is set too high, demand will be less than supply and not all the shares will be bought. The company is usually keen to have certainty that it will receive money from the issue so that it can plan ahead. To make sure it sells the shares it buys a kind

The underwriter guarantees to buy the proportion of the issue not taken up by the market.

of insurance called underwriting. In return for a fee the underwriter guarantees to buy the proportion of the issue not taken up by the market. A merchant bank sponsoring the issue will usually charge a fee of 2 percent of the issue proceeds and then pays part of that fee, say 1.25 percent of the issue proceeds, to sub-underwriters (usually large financial institutions such as pension funds) who each agree to buy a certain number of shares if called on to do so. In most cases the underwriters do not have to purchase any shares because the general public are keen to take them up. However occasionally they receive a shock and have to buy large quantities.

Hiring a corporate broker

When a broker is employed as a sponsor the two roles can be combined. If the sponsor is, say, an investment bank the UKLA requires that a broker also be appointed. Brokers play a vital role in advising on share market conditions and the likely demand from investors for the company's shares. They also represent the company to investors to try to generate interest. When debating issues such as the method to be employed, the marketing strategy, the size of the issue, the timing or the pricing of the shares the company may value the market knowledge the broker has to offer. Brokers can also organize sub-underwriting and in the years following the flotation may work with the company to maintain a liquid and properly informed market in its shares.

Accountants and solicitors

The reporting accountant in a flotation has to be different from the company's existing auditors, but can be a separate team in the same firm.

The accountant will be asked by the sponsor to prepare a detailed report on the firm's financial controls, track record, financing and forecasts (the 'long form' report). Not all of this information will be included in the prospectus but it does serve to reassure the sponsor that the company is suitable for flotation. Accountants may also have a role in tax planning both from the company's viewpoint and that of its shareholders. They also investigate working capital requirements. The UKLA insists that companies show that they have enough working capital for current needs and for at least the next 12 months.

All legal requirements in the flotation preparation and in the information displayed in the prospectus must be complied with. Examples of legal issues are directors' contracts, changes to the articles of association re-registering the company as a plc, underwriting agreements and share option schemes.

Directors bear the ultimate responsibility for the truthfulness of the documents.

Solicitors also prepare the 'verification' questions that are used to confirm that every statement in the prospectus can be justified as fact. Directors bear the ultimate responsibility for the truthfulness of the documents.

Registrars

The records on the ownership of shares are maintained by registrars as shares are bought and sold. They keep the company's register and issue certificates. They are required to adjust records of ownership of company shares within two hours of a trade – electronic (rather than paper) records are now kept.

Continuing obligations after flotation

The UKLA insists on listed companies having 'continuing obligations'. The intention is to ensure that all price-sensitive information is given to the market as soon as possible and that there is 'full and accurate disclosure'. Information is

price sensitive if it might influence the share price or the trading in the shares. Investors need to be sure that they are not disadvantaged by market distortions caused by some participants having the benefit of superior information. Public announcements will be required in a number of instances, for example: the development of major new products; the signing of major contracts; details of an acquisition; a sale of large assets; a change in directors; a decision to pay a dividend. The website www.uk-wire.co.uk shows all major announcements made by companies going back many years.

Listed companies are also required to provide detailed financial statements within six months of the year-end. Firms usually choose to make preliminary profit announcements based on unaudited results for the year a few weeks before the audited results are published. Interim reports for the first half of each accounting year are also required (within four months of the end of the half year). The penalty for non-compliance is suspension from the exchange.

Other ongoing obligations include the need to inform the market about director dealings in the company's shares and the expectation that directors will conform to the standards of behavior required by the UKLA and the Exchange, some of which are contained in the Cadbury, Greenbury, Hempel and Hicks reports (now brought together in the Combined Code). While these standards of behavior are encouraged they are not required by the UKLA.

Methods of issue

The sponsor will look at the motives for wanting a quotation, at the amount of money that is to be raised, at the history and reputation of the firm and will then advise on the best method of issuing the shares. There are various methods, ranging from a full-scale offer for sale to a relatively simple introduction. The final choice often rests on the costs of the method of issue, which can vary considerably. There are five main methods.

Offer for sale

The company sponsor offers shares to the public by inviting subscriptions from institutional and individual investors. Sometimes newspapers carry a prospectus and an application form. However, most investors will need to contact the sponsor or the broker to obtain an application form. (Publications, such as *Investors Chronicle*, show the telephone numbers to call for each company floating. Details of forthcoming flotations are available at www.londonstockexchange.com/newissues, other useful websites are www.hemscot.net, www.iii.co.uk/newissues and www.issuesdirect.com).

Normally the shares are offered at a fixed price determined by the company's directors and their financial advisers. A variation of this method is an *offer for sale by tender*. Here investors are invited to state a price at which they are will-

ing to buy (above a minimum reserve price). The sponsor gathers the applications and then selects a price which will dispose of all the shares – the strike price. Investors who bid a price above this will be allocated shares at the strike price – not at the price of their bid. Those who bid below the strike price will not receive any shares. This method is useful in situations where it is very difficult to value a company, for instance, where there is no comparable company already listed or where the level of demand may be difficult to assess. Leaving the pricing to the public may result in a larger sum being raised. On the other hand it is more costly to administer and many investors will be put off by being handed the onerous task of estimating the share's value.

The sponsor selects a price which will dispose of all the shares – the strike price.

Introduction

Introductions do not raise any new money for the company. If the company's shares are already quoted on another stock exchange or there is a wide spread of shareholders, with more than 25 percent of the shares in public hands, the Exchange permits a company to be 'introduced' to the market. This method may allow companies trading on AIM to move up to the Official List or for foreign corporations to gain a London listing. This is the cheapest method of flotation since there are no underwriting costs and relatively small advertising expenditures. In 2004 ITV plc was introduced to the market. This company was created by merging Carlton with Granada, both of which had a wide spread of shareholdings and both were previously listed on the Exchange, so the company and its management were well known.

Offer for subscription

An offer for subscription is similar to an offer for sale, but it is only partially underwritten. This method is used by new companies that state at the outset that if the share issue does not raise a certain minimum the offer will be aborted. This is a particularly popular method for new investment trusts.

Placing

In a placing, shares are offered to the public but the term 'public' is narrowly defined. Instead of engaging in advertising to the population at large, the sponsor or broker handling the issue sells the shares to its own private clients – usually institutions such as pension and insurance funds. The costs of this method are considerably lower than those of an offer for sale. There are lower publicity costs and legal costs. A drawback of this method is that the spread of shareholders is going to be more limited. To alleviate this problem the Stock Exchange does insist on a large number of placees holding shares after the new issue.

In the 1980s the most frequently used method of new issue was the offer for sale. This ensured a wide spread of share ownership and thus a more liquid secondary market. It also permitted all investors to participate in new issues. Placings were only permitted for small offerings (< £15m) when the costs of an offer for sale would have been prohibitive. During the 1990s the rules were gradually relaxed so that any size of new issue could be placed. As this method is much cheaper and easier than an offer for sale, the majority of companies have naturally switched to placings.

Intermediaries offer

Another method, which is often combined with a placing, is an intermediaries offer. Here the shares are offered for sale to financial institutions such as stock-brokers. Clients of these intermediaries can then apply to buy shares from them.

The Kier Group flotation, described in Exhibit 17.2, illustrates a number of points about new issues. First, note that in a new issue not all the shares sold come from the company itself. Frequently a high proportion (if not all) the shares are sold by the existing shareholders. Note also the motives for flotation: it will permit employees to sell their holdings at a later date should they wish and will also raise £2.7m to restructure its finances by redeeming preference shares. Staff who continue to hold shares will have the satisfaction of knowing the market price should they ever wish to sell in the future. The new issue comprises two parts: one is a sale to institutional investors through a placing and the second is an offer to sell more shares to employees.

Timetable for a new offer

The various stages of a new share issue will be explained using the example of the flotation of easyJet on the Official List. This timetable is set out in Figure 17.4.

easyJet

Pre-launch publicity

For many years before the flotation easyJet raised its profile with the public with exciting news stories. It even allowed a television company to make a fly-on-the-wall documentary about the firm's operations. This was shown weekly for many weeks, almost like a soap opera.

Technicalities

UBS Warburg and Credit Suisse First Boston were co-leading sponsors, with Merrill Lynch and Schroder Salomon Smith Barney assisting as co-managers. It was decided to float by way of a placing, so having many leading City institutions

Float tag of 170p values Kier at £53.8m

Andrew Taylor

The value of employee shares in Kier Group, Britain's largest unquoted construction company, has increased tenfold since 1992, based on a flotation price, announced yesterday, which values the group at £53.8m.

The average employee investment of £4,800 is now worth £48,000 at the 170p a share price.

Kier is floating by way of a placing and employee offer.

The company was bought four years ago by its employees from Hanson, the UK conglomerate.

Kier is issuing 1.6m new ordinary shares to raise £2.7m in order to redeem preference shares held by Hill Samuel.

The balance of the preference shares is held by Electra Fleming, which is redeeming its holdings in return for ordinary shares. These, together with other

purchases, will leave Electra Fleming with a 9.8 per cent stake.

Employee shareholders representing 4.3 per cent of the enlarged capital have opted to sell their shares.

Staff, former employees and their families, however, would retain an 80.9 per cent stake in the company, said Mr Colin Busby, Kier's chairman and chief executive.

The placing price represented a multiple of about 11 times historic earnings per share of 15.5p in the 12 months to the end of June.

In that year, pre-tax profits increased 4 per cent to £7.3m (£7m). Turnover was up from £585.7m to £614.6m.

A notional dividend of 6.5p for the year represents a yield of 4.8 per cent at the placing price.

EXHIBIT 17.2 Float tag valuation

Source: *Financial Times*, 6 December 1996

managing the issue, with their extensive range of contacts with fund managers, was valuable. On 9 November a price range of 280p–340p was indicated. This was a narrowed range from that announced the previous week (250p–350p). By announcing a price range the sponsors and fund managers can gauge reaction from potential buyers before selecting the final single price.

It was decided that the company would sell 63 million shares (25.1 percent of the enlarged capital). A further 9.45 million shares were put aside for a 'green-shoe' or over-allotment issue. This means that the company reserved the right to sell these additional shares if there was sufficient demand. Doing so would raise the final free float (shares not associated with a connected person) to 27.8 percent of the enlarged capital. (These must be issued at the offer price within 30 days of the Official listing.)

During 2000 easyJet had been gathering a distinguished group of non-executive directors to supplement its board. They have the task of looking after the interests of *all* the shareholders. Tony Illsley, the former chief executive of Telewest Communications, was hired in May, Colin Day, chief financial officer of Reckitt Benckiser, was appointed in September and John Quelch, Dean of the London Business School, joined in November.

FIGURE 17.4
Timetable of an offer for sale and a placing

Time relative to Impact Day	Stage	Time	Event
1–2 years	Pre-launch publicity.		
Several weeks	Sponsor and other advisers consider details such as price and method of issue. Also obtain underwriting, etc.	A few days	Pathfinder prospectus <ul style="list-style-type: none"> • to Press; • to major investors. No price.
		IMPACT DAY	Prospectus published. Price announced in a fixed-price sale offer or placing.
		A few days	Investors apply and send payments.
		2 days to 2 weeks for offer for sale	Allotment.
		2 weeks or so for an offer for sale	Admission to the Exchange and dealing begins.
Dates for easyJet (placing)		1998 to 2000	
		Late 2000	
		31 October: price range of 250p–350p is announced.	
		15 November: a price is given: 310p.	
		22 November: first dealings.	

During the period up to Impact Day the auditors were very busy and the sponsoring banks marketed the issue forcefully.

Auditors have been working hard to get the figures into shape for the prospectus, but in the meantime analysts from easyJet's heavyweight investment banks have been intensely marketing this research to institutional investors.

(Financial Times, 25 October 2000, p. 3)

It was decided that no shares were to be sold by existing shareholders.

Pathfinder prospectus

The pathfinder prospectus is made available a few days before the sale. This contains background information on the company but does not tell potential investors the price at which the shares are to be offered. The pathfinder prospectus for easyJet this was sent out on 31 October.

Impact Day

The prospectus is launched at this stage, together with the price. For easyJet the price was set at 310p, valuing the company at £778m.

Offer closes

In an offer for sale up to two weeks is needed for investors to consider the offer price and send in payments. There is a fixed cut-off date for applications. In the case of a placing the time needed is much shorter as the share buyers have already indicated to the sponsors and managers their interest and transactions can be expedited between City institutions.

Allotment

More shares were applied for than were available and so they had to be allocated. This can be achieved in a number of different ways. A ballot means that only some investors receive shares (recipients are selected at random). In a scale down applicants generally receive some shares, but fewer than they applied for. A cut-off point might be imposed in which applicants for large quantities are excluded. Money not used to buy shares is returned to investors. easyJet's share offer was over-subscribed by almost ten times. It is not clear how the available shares were allocated.

Dealing begins

Formal dealing in the shares through the Stock Exchange started on 22 November for easyJet. The shares traded 10 percent above the placing price at 342p, giving investors an immediate profit.

Book-building

Selling new issues of shares through book-building is a popular technique in the USA. It is starting to catch on in Europe as Exhibit 17.3 demonstrates. Under this method the financial advisers to an issue contact major institutional investors to get from them bids for the shares. The investors' orders are sorted according to price, quantity and other factors such as 'firmness' of bid. This data may then be used to establish a price for the issue and the allocation of shares. easyJet's sponsors used book-building (organized by a 'bookrunner').

Booking the bids in the power sale

Conner Middelman

This morning at 8.30 precisely, a small room on the second floor of a City office building will erupt in a flurry of activity as the international sale of the government's remaining 40 per cent stake in the UK's two big power generators – National Power and PowerGen – kicks off.

The 'book-building room' – the nerve centre of the operation – resembles the bridge of the Starship Enterprise, with a wall of computer screens displaying colour graphics that chart the progress of the sale by the minute. Thick blinds shield the action from inquisitive eyes.

Share orders from institutional investors across the globe will arrive here over the next week, indicating how much money they are prepared to invest at specific prices. The book-building period for the £4bn sale, one of Europe's largest privatisations this year, ends on March 3 at 5pm. The international offer price and allocation will be agreed over the week-end, and trading in the partly-paid shares begins on March 6.

Book-building, which has been used in previous UK privatisations, allows the Treasury to compile a comprehensive picture of the strength of institutional demand for the shares over a range of prices. The aim is to ensure that the shares will be spread across a wide range of high-quality investors.

The share offer, totalling about £4bn, is structured in two parts: a UK public offer, targeted at UK retail investors, and two separate international tender offers (one for shares in National Power

and one for shares in PowerGen) aimed at institutional investors in the UK and around the world.

Roadshows for the international offer began last week, with both companies conducting separate roadshows in financial centres throughout Europe and the US.

The offers are being marketed through a syndicate of 17 investment banks with BZW and Kleinwort Benson acting as joint global co-ordinators and bookrunners.

The book-building process starts in the 'inputting room', where nine fax machines spew out forms detailing investors' orders. These show: how many shares in each company investors are willing to buy at what price, how much they would pay for a combination of shares in both at a ratio determined by the Treasury ('sector bid'), and whether the bid is firm or indicative.

The price and quality of investors' bids is crucial as it affects their final allocation. The Treasury will favour bids by investors considered to be likely buyers or holders of shares in the aftermarket; bids made at an early stage of the offer period; firm bids; bids at specific price levels (rather than market-relative or strike-price bids); and sector bids.

All the information is entered into a computer system by one of 15 input clerks and transmitted to the book-building room, where 24 screens throw up an instant graphic analysis of the data, highlighting strengths and weaknesses of distribution as the sale proceeds.

One monitor might show the build-up in demand for both companies over time. Another illustrates the value of demand at any given price. A pie chart represents the value of demand by country, and a bar chart shows it by syndicate member.

Yet another breaks down the orders into six different categories of investor quality, ranging from very serious, long-term investors to highly speculative accounts looking to play the deal over the very short term.

EXHIBIT 17.3 Booking the bids in the power sale

Source: *Financial Times*, 23 February 1995

How does an alternative investment market (AIM) flotation differ from one on the Official List?

The driving philosophy behind AIM is to offer young and developing companies access to new sources of finance, while providing investors with the opportunity to buy and sell shares in a trading environment run, regulated and marketed by the LSE. Efforts were made to keep the costs down and make the rules as simple as possible. In contrast to the OL there is no requirement for AIM companies to be a minimum size, to have traded for a minimum period or for a set proportion of their shares to be in public hands.

There is no requirement for AIM companies to be a minimum size, to have traded for a minimum period or for a set proportion of their shares to be in public hands.

Investors are reassured about the quality of companies coming to the market by the requirement that the floating firms have to appoint, and retain at all times, a nominated adviser and nominated broker. The nominated adviser ('nomad') is selected by the corporation from a Stock Exchange approved register of firms. The nominated advisers are paid a fee by the company to act as an unofficial 'sponsor' in investigating and verifying its financial health. These advisers have demonstrated to the Exchange that they have sufficient experience and qualifications to act as a 'quality controller', confirming to the LSE that the company has complied with the rules.

Nominated brokers have an important role to play in bringing buyers and sellers of shares together. Investors in the company are reassured that at least one broker is ready to trade or do its best to match up buyers and sellers. The adviser and broker are to be retained throughout the company's life in AIM. They have high reputations and it is regarded as a very bad sign if either of them abruptly refuses further association with a firm.

AIM companies are also expected to comply with strict rules regarding the publication of price-sensitive information and the quality of annual and interim reports. Upon flotation a detailed prospectus is required. This even goes so far as to state the directors' unspent convictions and all bankruptcies of companies where they were directors.

When the cost of the nominated advisers' time is added to those of the stock exchange fees, accountants, lawyers, printers and so on, the (administrative) cost of capital raising can be as much as 10–12 percent of the amount being raised. This, as a proportion, is comparable with the main market but the sums of money raised are usually much less on AIM and so the absolute cost is lower. AIM was designed so that the minimum cost of joining was in the region of £40,000–£50,000. But, as Exhibit 17.4 shows, it has now risen so that frequently more than £300,000 is paid. This sum is significantly higher than the originators of AIM

AIM was designed so that the minimum cost of joining was in the region of £40,000–£50,000. It has now risen so that frequently more than £300,000 is paid.

Property flotation highlights AIM fees

Christopher Price

Concerns among smaller companies over the costs of joining the Alternative Investment Market are likely to be heightened by news that most of the £300,000 being raised by a property company is to be spent on fees for the junior market.

Advisers to Inner City Enterprises said the cost of joining AIM would exceed £200,000; prospective institutional shareholders have been told by the company the cost is nearer the total being raised.

The average cost of joining AIM varies widely, but basic fees for the nominated adviser, nominated broker, solicitor, accountants and public relations company rarely top £100,000. Additional charges are usually associated with the raising of capital.

A survey last week from Neville Russell, the accountants, found that 20 per cent of companies joining AIM paid between £100,000 and £200,000, while a quarter paid more than £300,000. All had raised funds as part of their admission. Companies paying less than £100,000 had generally not raised any.

A third of the companies surveyed said their flotations had caused 'significant disruption'. Estimates for 'hidden' costs ranged between £50,000 and £2m.

Mr Stephen Goschalk, a corporate

financier at English Trust, Inner City's adviser, said there were extenuating circumstances explaining the high costs it was incurring.

Among these were additional documentation required for its 60 existing institutional shareholders. Also, Inner City's property portfolio has had to be assessed and individually certified. However, both the company's adviser and Teather & Greenwood, its broker, said the costs were also a reflection of the rising price of joining AIM. 'Prices are going up because of pressure from the AIM authorities to tighten up on standards,' said Mr Ken Ford of Teather & Greenwood.

Last summer, AIM was hit by a series of corporate mishaps, such as profits warnings and delistings, which unnerved the authorities and led to monitoring of some advisers' behaviour. Under AIM rules, companies must retain a broker and an adviser. The latter has responsibility for a company's credentials in joining AIM and during membership.

'There is a move to improve standards and this has led to an increase in costs,' said Mr Goschalk. He added that the increases were such that it was uneconomical for a company with a market capitalisation of 'less than £7m' to come to the market.

EXHIBIT 17.4 Property flotation highlights AIM fees

Source: *Financial Times* 3 February 1997

planned. Most of the additional cost arises on raising funds rather than simply joining AIM, which is around £100,000–£150,000. The nominated advisers argue that they are forced to charge firms higher fees because they incur more investigatory costs due to the emphasis put on their policing role by the Stock Exchange.

The prospectus (or AIM document) is less detailed than the prospectus for an OL quotation and therefore cheaper. The real cost savings come in the continuing annual expense of managing the quotation. For example AIM companies do not have to disclose as much information as companies on the Official List. Price-sensitive information has to be published but normally this will require only an electronic message from the adviser to the Exchange rather than a circular to shareholders.

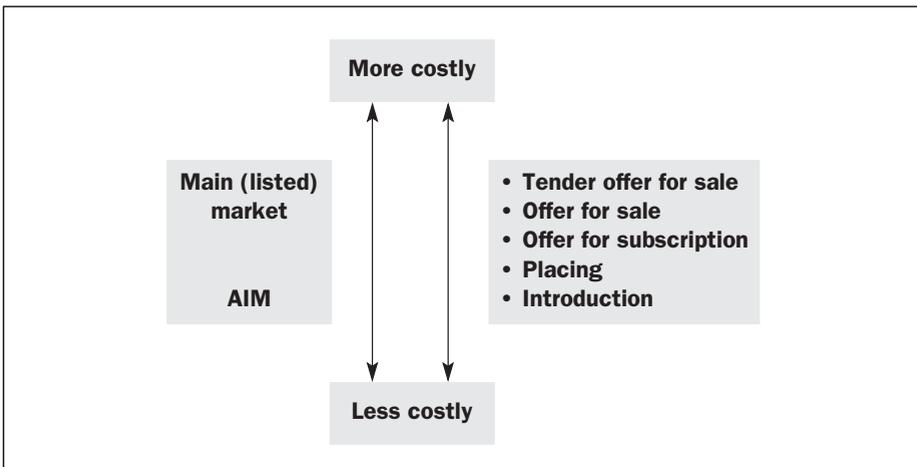
The costs of new issues

There are three types of cost involved when a firm makes an issue of equity capital:

- administrative/transaction costs
- the equity cost of capital
- market pricing costs.

The first of these has already been discussed earlier in this chapter. For both the Official List and AIM the costs as a proportion of the amount raised can be anywhere between 5 and 12 percent depending on the size of issue, and the method used (*see* Figure 17.5).

FIGURE 17.5
Costs of new issues



The second cost was discussed in more detail in Chapter 10. This relates to the investor's opportunity cost. By holding shares in one company shareholders give up the use of that money elsewhere. The firm therefore needs to produce a rate of return for those shareholders at least equal to the return they could obtain by investing in other shares of a similar risk class. Because ordinary shareholders face higher risks than debt or preference shareholders the rate of return demanded is higher. If the firm does not produce this return then shares will be sold and the firm will find raising capital difficult.

The market pricing cost is to do with the possibility of under-pricing new issues. It is a problem that particularly affects offers for sale at a fixed price and placings. The firm is usually keen to have the offer fully taken up by public investors. To have shares left with the underwriters gives the firm a bad image because it is perceived to have had an issue which 'flopped'. Furthermore, the

The sponsoring organizations consist of people who are professional analysts and dealmakers and an issue which flops can be very bad for their image.

underwriters, over the forthcoming months, will try to offload their shares and this action has the potential to depress the price for a long time. The sponsor also has an incentive to avoid leaving the underwriters with large blocks of shares. The sponsoring organizations consist of people who are professional analysts and dealmakers and an issue which flops can be very bad for their image. It might indicate that

they are not reading the market signals correctly and that they have overestimated demand. They might have done a poor job in assessing the firm's riskiness or failed to communicate its virtues to investors. These bad images can stick, so both the firm and the sponsor have an incentive to err on the side of caution and price a little lower to make sure that the issue will be fully subscribed. A major problem in establishing this discount is that in an offer for sale the firm has to decide the price one or two weeks before the close of the offer. In the period between Impact Day and first trading the market may decline dramatically. This makes potential investors nervous about committing themselves to a fixed price. To overcome this additional risk factor the issue price may have to be significantly less than the expected first day's trading price. Giving this discount to new shares deprives the firm of money which it might have received in the absence of these uncertainties, and can therefore be regarded as a cost. In the case of easyJet the shares moved to a first-day premium of 10 percent. It could be argued that the existing shareholders sold a piece of the business too cheaply at the issue price.

In addition to the issue costs there are also high costs of maintaining a listing – see Exhibit 17.5.

Professional expenses prove a deterrent to maintaining stock market exposure

Bertrand Benoit

But costs of public-to-private deals can also be considerable

Ask Richard Johnson, chief executive of Wyko, what the industrial distribution and maintenance group gained in 10 years on the stock market and the answer is likely to be short.

Launched with a market value of about £50m in 1989, the group was performing honorably until investors began to pull out from the small company sector last year.

In less than six months, its shares fell from 190p to 64p. 'This happened as we were considering a £60m acquisition,' Mr Johnson says. 'But with a p/e of 5, we had suddenly become vulnerable to a takeover.'

Unable to expand in a market where size increasingly mattered, Wyko put an end to its turbulent relationship with the Stock Exchange last week by going private in a management buy-out valuing it at £92.2m, a 30 per cent discount to its peak price.

This is not an isolated case. So far this year, nearly 40 companies have pulled out of the exchange, against 25 last year and a mere seven in 1997.

Some deals might have been sparked by the 10.5 per cent fall in the small cap index in 1998, against a 10.9 per cent gain in the FTSE All-Share. But the fact that small companies have outperformed bigger ones this year suggests some are no longer prepared to bear the cost and bother maintaining a listing.

Although linked to the size of the company, the expense typically amounts to £250,000 a year. Businesses meeting the minimum requirements imposed by the exchange pay a lot less. However, Roy Hill, chief executive of Liberfabrica, the book manufacturer bought by a trade buyer this month, claims his com-

pany will save up to £400,000 a year in City-associated costs.

These include fees paid to stockbroker, registrars, lawyers, merchant banker and financial PR company, as well as the exchange fee and the auditing, printing and distribution of accounts.

Another problem has been the low rating experienced by some of the smaller companies that have virtually disappeared from investors' radar screens. As institutions have grown increasingly reluctant to invest in small caps, brokers have stopped following many of them, thus hastening share price declines.

'Some institutions have stopped investing in companies with a market capitalisation below £100m,' says Penny Freer, head of smaller companies research at Crédit Lyonnais in London. 'Some smaller companies that deliver good results may end up with a single digit p/e.'

For Tony Fry, partner at KPMG Transaction Services, 'being on the stock market is all about getting access to funding, if you are barred from such access, then the attraction disappears'.

In addition to the venture capital funding that can facilitate acquisitions, managers have been lured into public-to-private deals by the chance of raising their stake in the business. In a typical MBO backed by a private equity house, managers can end up owning up to 20 per cent of the bidding vehicle. One banker calculates that the value of such a stake can grow 10 times if the company is later sold for twice the price of the buy-out.

But because MBOs are highly geared operations, the risks involved are equally considerable. The same managers could lose all their investment if

the company were sold below the original offer price.

Nor are the financial costs associated with a public-to-private transaction negligible. According to Richard Grainger, managing director at Close Brothers, the advisory firm, fees paid to bankers, registrars, venture capital funds and PR firms, can amount to 4 or 5 per cent of the purchase price.

The time spent in putting transactions together can also be consuming.

'The negotiations are so absorbing and involve so many parties that it can be very easy for management to take their eyes off the ball, especially if they do not have first class advisers,' says Mr Johnson, whose MBO of Wyko was concluded after seven months of talks.

In some instances, these efforts prove fruitless, as at Liberfabrica, whose management team was outbid by a trade buyer. Mr Hill reckons that £500,000 in fees was wasted in the exercise.

The cost of listing

Estimated annual cost of listing for a company with a market capitalization of around £100m

Stockbroker	£20,000 to £25,000
Financial PR	£20,000 to £25,000
Financial reports and accounts	Around £30,000
Registrars	£5,000 to £25,000
High profile merchant bank	Around £50,000
Solicitors	Around £50,000
Other costs	Around £50,000
Total (per year)	£250,000 to £350,000

Estimated cost of going private for a company with a purchase price of around £100m

Advisers to the bidders	Around 1% of purchase price
Lawyers to the bidders	£100,000 to £200,000
Due diligence accountants	£100,000 to £400,000
Market report due diligence	£30,000 to £50,000
Stamp duty	Around 0.5% of purchase price
Printers	£15,000 to £20,000
Receiving banks	£10,000 to £15,000
Takeover panel fee	Around £25,000
Funders fee	2 to 3% of purchase price
Total	£3,780,000 to £5,210,000

Source: Industry estimates

EXHIBIT 17.5 Professional expenses prove a deterrent

Source: *Financial Times* 31 August 1999

Rights issues

A rights issue is an invitation to existing shareholders to purchase additional shares in the company. This is a very popular method of raising new funds. It is easy and relatively cheap (compared with new issues). Directors are not required to seek the prior consent of shareholders, and the London Stock Exchange will only intervene in larger issues (to adjust the timing so that the market does not suffer from too many issues in one period). The UK has particularly strong traditions and laws concerning *pre-emption rights*. These require that a company raising new equity capital by selling shares first offers those shares to the existing shareholders. The owners of the company are entitled to subscribe for the new shares in proportion to their existing holding. This will enable them to maintain the existing percentage ownership of the company – the only difference is that each slice of the company cake is bigger because it has more financial resources under its control.

The shares are usually offered at a significantly discounted price from the trading price of the company's current shares – typically 10–20 percent. This gives the illusion that shareholders are getting a bargain. But, as we shall see, the benefit from the discount given is taken away by a decline in value of the old shares.

Shareholders can either buy these shares themselves or sell the 'right' to buy to another investor. For further reassurance that the firm will raise the anticipated finance, rights issues are usually underwritten by institutions.

An example

Take the case of the imaginary listed company Swell plc with 100 million shares in issue. It wants to raise £25m for expansion but does not want to borrow it. Given that its existing shares are quoted on the stock market at 120p, the new rights shares will have to be issued at a lower price to appeal to shareholders because there is a risk of the market share price falling in the period between the announcement and the purchasing of new shares. (The offer must remain open for at least three weeks.) Swell has decided that the £25m will be obtained by issuing 25 million shares at 100p each. Thus the ratio of new shares to old is 25:100. In other words, this issue is a 'one-for-four' rights issue. Each shareholder will be offered one new share for every four already held.

If the market price before the rights issue is 120p valuing the entire company at £120m and another £25m is pumped into the company by selling 25 million shares at £1, it logically follows that the market price after the rights issue can not remain at 120p (assuming all else equal). A company that was previously valued at £120m which then adds £25m of value to itself (in form of cash) should be worth £145m. This company now has 125 million shares therefore each share is worth £1.16 (i.e. £145m divided by 125 million shares).

$$\frac{\text{Total market capitalization}}{\text{Total shares available}} = \frac{\text{£145m}}{125\text{m}} = \text{£1.16}$$

An alternative way of calculating the ex-rights price is as follows:

Four existing shares at a price of 120p	480p
One new share for cash at 100p	<u>100p</u>
Value of five shares	580p
Value of one share ex-rights $580p/5$	116p

The shareholders have experienced a decline in the price of their old shares from 120p to 116p. A fall of this magnitude necessarily follows from the introduction of new shares at a discounted price. However the loss is exactly offset by the gain in share value on the new rights issue shares. They cost 100p but have a market price of 116p. This can be illustrated through the example of Sid, who owned 100 shares worth £120 prior to the rights announcement. Sid loses £4 on the old shares – their value is now £116. However he makes a gain of £4 on the new shares.

Cost of rights shares ($25 \times \pounds 1$)	£25
Ex-rights value ($25 \times \pounds 1$)	<u>£29</u>
Gain	<u>£4</u>

When the press talks glibly of a rights offer being ‘very attractively priced for shareholders’ they are generally talking nonsense. Whatever the size of the discount the same value will be removed from the old shares to leave the shareholder no worse or better off. Logically value cannot be handed over to the shareholders from the size of the discount decision. Shareholders own all the company’s shares before and after the rights issue – they cannot hand value to themselves without also taking value from themselves. Of course, if the prospects for the company’s profits rise because it can now make brilliant capital expenditures, which lead to dominant market positions, then the value of shares will rise – for both the old and the new shares. But this is value creation that has nothing to do with the level of the discount.

What if a shareholder does not want to take up the rights?

As owners of the firm all shareholders must be treated in the same way. To make sure that some shareholders do not lose out because they are unwilling or unable to buy more shares the law requires that shareholders have a third choice, other than to buy or not buy the new shares. This is to sell the rights on to someone else on the stock market (selling the rights nil paid). Take the case of impoverished Sid, who is unable to find the necessary £25. He could sell the rights to subscribe for the shares to another investor and not have to go through the process of taking up any of the shares himself. Indeed, so deeply enshrined are pre-emption rights that even if the shareholder does nothing the company will sell his rights to the new shares on his behalf and send the proceeds to him.

Thus, Sid would benefit to the extent of 16p per share or a total of £4 (if the market price stays constant) which adequately compensates for the loss on the 100 shares he holds. But the extent of his control over the company has been reduced – his percentage share of the votes has decreased.

The value of a right on one new share is:

$$\begin{aligned} \text{Theoretical market value of share ex-rights} - \text{Subscription price} \\ = 116\text{p} - 100\text{p} = 16\text{p} \end{aligned}$$

The value of a right on one old share in Swell is:

$$\begin{aligned} \frac{\text{Theoretical market value of share ex-rights} - \text{Subscription price}}{\text{No. of old shares required to purchase one new share}} \\ = \frac{116 - 100}{4} = 4\text{p} \end{aligned}$$

Ex-rights and cum-rights

Shares bought in the stock market designated cum-rights carry with them to the new owner the right to subscribe for the new shares in the rights issue. After a cut-off date the shares go ex-rights, which means that any purchaser of old shares will not have the right to purchase the new shares.

The price discount decision

It does not matter greatly whether Swell raises £25m on a one-for-four basis at 100p or on a one-for-three basis at 75p per share, or on some other basis (*see* Table 17.3).

TABLE 17.3
Comparison of different rights bases

Rights basis	Number of new shares (m)	Price of new shares (p)	Total raised (£m)
1 for 4	25	100	25
1 for 3	33.3	75	25
1 for 2	50	50	25
1 for 1	100	25	25

As Table 17.3 shows, whatever the basis of the rights issue, the company will receive £25m and the shareholders will see the price of their old shares decrease, but this will be exactly offset by the value of the rights on the new shares. However, the ex-rights price will change. For a one-for-three basis it will be £108.75:

Three shares at 120p	360p
One share at 75p	75p
Value of four shares	<u>435p</u>
Value of one share (435/4)	108.75p

If Swell chose the one-for-one basis this would be regarded as a *deep-discounted rights issue*. With an issue of this sort there is only a minute probability that the market price will fall below the rights offer price and therefore there is almost complete certainty that the offer will be taken up. It seems reasonable to suggest that the underwriting service provided by the institutions is largely redundant here and that the firm can make a significant saving. Yet 95 percent of all rights issues are underwritten, usually involving between 100 and 400 sub-underwriters. The underwriting fees used to be a flat 2 percent of the offer. Of this the issuing house received 0.5 per cent, the broker received 0.25 percent and the sub-underwriter 1.25 percent (the same distribution as in a new issue). However, fees have fallen recently and can be as little as 0.75 per cent for low risk deep discounted issue.

Other equity issues

Some companies argue that the lengthy procedures and expense associated with rights issues (for example, a minimum three-week offer period) frustrate directors' efforts to take advantage of opportunities in a timely fashion. Firms in the USA have much more freedom to bypass pre-emption rights. They are able to sell blocks of shares to securities houses for distribution elsewhere in the market. This is fast and has low transaction costs. The worry for existing shareholders is that they could experience a dilution of their voting power and/or the share could be sold at such a low price that a portion of the firm is handed over to new shareholders too cheaply.

The UK authorities have produced a compromise. Here firms must obtain shareholders' approval through a special resolution (a majority of 75 percent of those voting) at the company's annual general meeting or at an extraordinary general meeting to waive the pre-emption right. Even then the shares must not be sold to outside investors at more than a 5 percent discount to the share price. This is an important condition. It does not make any difference to existing

The shares must not be sold to outside investors at more than a 5 percent discount to the share price.

shareholders if new shares are offered at a deep discount to the market price as long as they are offered to them. If external investors get a discount there is a transfer of value from the current shareholders to the new.

Placings and open offers

In placings, new shares are sold directly to a narrow group of external investors. The institutions, wearing their hat of existing shareholders, have produced guidelines to prevent abuse, which normally only allow a placing of a small proportion of the company's capital (a maximum of 5 percent in a single year and no more than 7.5 percent is to be added to the company's equity capital over a rolling three-year period) in the absence of a *claw back*.

With a claw back the issue becomes an 'open offer'.

Under claw back existing shareholders have the right to reclaim the shares as though they were entitled to them under a rights issue. They can buy them at the price they were offered to the external investors. With a claw back the issue becomes an 'open offer'. The major difference compared with a rights issue is that if they do not exercise this claw back right they receive no compensation for a reduction in the price of their existing shares – there are no nil-paid rights to sell.

Acquisition for shares

Shares are often issued to purchase businesses or assets. This is usually subject to shareholder approval.

Vendor placing

If a company wishes to pay for an asset such as a subsidiary of another firm or an entire company with newly issued shares, but the vendor(s) does not want to hold the shares, the purchaser could arrange for the new shares to be bought by institutional investors for cash. In this way the buyer gets the asset, the vendors (for example shareholders in the target company in a merger or takeover) receive cash and the institutional investor makes an investment. There is usually a claw back arrangement for a vendor placing (if the issue is more than 10 percent of market capitalization of the acquirer). Again the price discount can be no more than 5 percent of the current share price.

Bought deal

Instead of selling shares to investors companies are sometimes able to make an arrangement with a securities house whereby it buys all the shares being offered for cash. The securities house then sells the shares on to investors included in its distribution network, hoping to make a profit on the deal. Securities houses often compete to buy a package of shares from the company, with the highest bidder winning. The securities house takes the risk of being unable to sell the shares for at least the amount that they paid. Given that some of these bought deals are for over £100m, these securities houses need substantial capital backing. Bought deals are limited by the 5 percent pre-emption rules.

Scrip issues

Scrip issues do not raise new money: a company simply gives shareholders more shares in proportion to their existing holdings. The value of each shareholding does not change, because the share price drops in proportion to the additional shares. They are also known as capitalization issues or bonus issues. The purpose is to make shares more attractive by bringing

British investors are thought to consider a share price of £10 and above as less marketable than one in single figures.

down the price. British investors are thought to consider a share price of £10 and above as less marketable than one in single figures. So a company with shares trading at £15 on the Exchange might distribute two 'free' shares for every one held – a two-

for-one scrip issue. Since the amount of money in the firm and its economic potential is constant the share price will theoretically fall to £5.

A number of companies have an annual scrip issue while maintaining a constant dividend per share, effectively raising the level of profit distribution. For example,

Scrip issues are often regarded as indicating confidence in future earnings increases.

if a company pays a regular dividend of 20p per share but also has a one-for-ten scrip, the annual income will go up by 10 percent. (A holder of ten shares who previously received 200p now receives 220p on a holding of 11 shares.) Scrip issues are often regarded as indicat-

ing confidence in future earnings increases. If this new optimism is expressed in the share price it may not fall as much as theory would suggest.

Scrip dividends are slightly different: shareholders are offered a choice between receiving a cash dividend or receiving additional shares. This is more like a rights issue because the shareholders are making a cash sacrifice if they accept the scrip shares.

A *share split* (stock split) means that the nominal value of each share is reduced in proportion to the increase in the number of shares, so the total book value of shares remains the same. So, for example, a company may have one million shares in issue with a nominal value of 50p each. It issues a further one million shares to existing shareholders with the nominal value of each share reducing to 25p, but total nominal value remains at £500,000. Of course, the share price will halve – assuming all else is constant.

Warrants

Warrants give the holder the right to subscribe for a specified number of shares at a fixed price at some time in the future. If a company has shares currently trading at £3 it might choose to sell warrants, each of which grants the holder the right to buy a share at, say, £4 in five years. If by the fifth year the share price has risen to £6 the warrant holders could exercise their rights and then sell the shares immediately, realizing £2 per share, which is likely to be a consid-

erable return on the original warrant price of a few pence. Warrants are frequently attached to bonds, and make the bond more attractive because the investor benefits from a relatively safe (but low) income on the bond if the firm performs in a mediocre fashion, but if the firm does very well and the share price rises significantly the investor will participate in some of the extra returns through the ‘sweetener’ or ‘equity kicker’ provided by the warrant.

Equity finance for unquoted firms

We have looked at some of the details of raising money on the Stock Exchange. In the commercial world there are thousands of companies that do not have access to the Exchange. We now consider a few of the ways that unquoted firms can raise equity capital.

Business angels (informal venture capitalists)

Business angels are wealthy individuals, generally with substantial business and entrepreneurial experience, who usually invest between £10,000 and £250,000 primarily in start-up, early stage or expanding firms. These companies will be years away from obtaining a market quotation for their shares and so, in becoming a business angel the investor accepts that it may be difficult to dispose of their shares even if the company is progressing nicely. They also accept a relatively high degree of risk of complete failure. But the upside, if all goes well, can be tremendous. Investors putting just a few thousand pounds in a small company have become very wealthy following the firm’s flotation, or when it is sold to another company. For example, Body Shop investor Mr Ian McGlenn was a garage owner who put £4,000 into Body Shop in 1976. He owned over one-quarter of the company’s shares which are now worth millions.

Business angels are wealthy individuals, generally with substantial business and entrepreneurial experience.

About three-quarters of business angel investments are for sums of less than £100,000 with the average investment around £25,000–£30,000. The majority of investments are in the form of equity finance but angels do purchase debt instruments and preference shares. They usually do not have a controlling shareholding and they are willing to invest at an earlier stage than most formal venture capitalists. (They often dislike the term business angel, preferring the title informal venture capitalist).

Business angels prefer the title informal venture capitalist.

They are generally looking for entrepreneurial companies with high aspirations and potential for growth. A typical business angel makes one or two investments in a three-year period, often in an investment syndicate (with an ‘archangel’ leading the group). They generally invest in companies within a reasonable traveling distance from their homes because most like to be ‘hands-on’ investors, playing a significant role in strategy and management – on average

angels allocate ten hours a week to their investments. Most angels take a seat on the board.³ Business angels are patient investors willing to hold their investment for at least a five-year period.

The main way in which firms and angels find each other is through friends and business associates, although there are a number of formal networks. See British Venture Capital Association at www.bvca.co.uk for a list of networks. Other useful contacts: National Business Angels Network (NBAN) www.best-match.co.uk or www.nban.com. Angel Bourse, www.angelbourse.com; Wave2, www.wave2.org; Venture Capital Report, www.vcr1978.com; Katalyst Ventures, www.katalystventures.com; Hotbed, www.hotbed.uk.com; Beer & Partners www.beerandpartners.com; Entrust, www.entrust.co.uk; Department of Trade and Industry, www.dti.gov.uk.

There are hundreds of groups of business angels throughout Europe. Exhibit 17.6 highlights some of the activity around Cambridge.

Chance to save the most deserving

Phil Davis

A well-established group in Cambridge helps link investors and start-up companies in an unusual reversal of the usual process – by presenting young companies directly to investors through a kind of beauty contest.

The Great Eastern Investment Forum (GEIF), set up eight years ago by NW Brown, a Cambridge financial services firm, has a team of managers who sift through hundreds of business plans every year from start-ups seeking capital.

The best ones win the right to present their business to GEIF's 314-strong community, which comprises wealthy individuals, venture capitalists, corporate investors and professional advisers. The rapid-fire presentations, held four times a year, last 10 minutes, after which investors can talk at length with any company that has impressed them.

The process appeals to investors because of its transparency, but becoming a 'business angel' is only for the experienced, warns Nigel Brown, chairman of GEIF. 'The high-tech bubble made people think of quick, massive returns and that mentality remains.' ...

Derek Harris, a GEIF member with eight big investments to his name in a 20-year career as a business angel, takes his 'angel' responsibilities seriously ...

Harris likes to be fully involved as a director or chairman of companies he invests in, and is chairman of Coffee Nation, a vending machine company that has raised £240,000 since it first made a presentation at the GEIF. His motivation is the buzz of seeing a business grow, rather than his 'very modest' salary as chairman.

'It is good fun working with youngsters and providing a steady hand on the wheel,' Harris says. 'I hated office politics and big organisations that don't focus on markets and customers, so I would never go back to being a salaried employee.'

Companies approaching the GEIF for funding range from biotechnology and IT to engineering projects and restaurant groups.

The Great Eastern Investment Forum at: www.geif.co.uk

EXHIBIT 17.6 Chance to save the most deserving

Source: *Financial Times* 13/14 September 2003

Angel network events are organized where entrepreneurs can make a pitch to potential investors, who, if they like what they hear in response to their questions, may put in tens of thousands of pounds. Prior to the event the network organizers (or a member) generally screen the business opportunities to avoid time wasting by the no-hopers. To be a member of a network investors are expected to either earn at least £100,000 per year or have a net worth of at least £250,000 (excluding main residence). If you have a specialist skill to offer, for example you are an experienced company director or chartered accountant, you may be permitted membership despite a lower income or net worth.

Many business angel deals are structured to take advantage of tax breaks such as those through enterprise investment schemes, EIS, which offer tax relief – see later in this chapter.

Venture capital

There has been the rapid development of the venture capital industry over the past 20 years. Today over £6bn per year⁴ is supplied by formal venture capital suppliers to unquoted UK firms compared with just a few million in the 1970s. The tremendous growth of venture capital has to a large extent plugged the ‘financing gap’, which so vexed politicians and business people alike in the 1970s and early 1980s. (The financing gap is the difficulty of finding finance for companies too big for the founders or banks to support growth and not ready for stock flotation.)

Venture capital funds provide finance for high-growth-potential unquoted firms. Venture capital is a medium- to long-term investment and can consist of a package of debt and equity finance. Venture capitalists take high risks by investing in the equity of young companies often with a limited (or no) track record. Many of their investments are into little more than a management team with a good idea – which may not have started selling a product or even developed a prototype. It is believed, as a rule of thumb in the venture capital industry, that out of ten investments two will fail completely, two will perform excellently and the remaining six will range from poor to very good.

Out of ten investments two will fail completely, two will perform excellently.

High risk goes with high return. Venture capitalists expect to get a return of between five and ten times their initial equity investment in about five to seven years. This means that the firms receiving the equity finance are expected to produce annual returns for investors of at least 29 percent. Alongside the usual drawbacks of equity capital from the investors’ viewpoint (last in the queue for income and on liquidation, etc.), investors in small unquoted companies also suffer from a lack of liquidity because the shares are not quoted on a public exchange. There are a number of different types of venture capital (the last three are sometimes classified separately – see private equity section later in this chapter):

- *Seedcorn* This is financing to allow the development of a business concept. Development may also involve expenditure on the production of prototypes and additional research.
- *Start-up* A product or idea is further developed, and/or initial marketing is carried out. Companies are very young and have not yet sold their product commercially.
- *Other early-stage* Funds for initial commercial manufacturing and sales. Many companies at this stage will remain unprofitable.
- *Expansion (Development)* Companies at this stage are on to a fast-growth track and need capital to fund increased production capacity, working capital and for the further development of the product or market. Professor Steve Young's company Entropic (see Case study 17.1 at the beginning of the chapter) provides an example of this.
- *Management buyouts (MBO)* Here a team of managers make an offer to their employers to buy a whole business, a subsidiary or a section so that they own and run it for themselves. Large companies are often willing to sell to these teams, particularly if the business is under-performing and does not fit with the strategic core business. Usually the management team have limited funds of their own and so call on venture capitalists to provide the bulk of the finance.
- *Management buy-ins (MBI)* A new team of managers from outside an existing business buy a stake, usually backed by a venture capital fund. A combination of an MBO and MBI is called a BIMBO – buy-in management buyout – where a new group of managers join forces with an existing team to acquire a business.
- *Public-to-private* The management of a company currently quoted on a stock exchange may return it to unquoted status with the assistance of venture capital finance being used to buy the shares.

A combination of an MBO and MBI is called a BIMBO – buy-in management buy-out.

Venture capital firms are less keen on financing seedcorn, start-ups and other early-stage companies than expansions, MBOs and MBIs. This is largely due to the very high risk associated with early-stage ventures and the disproportionate time and costs of financing smaller deals. To make it worthwhile for a VC organization to consider a company the investment must be at least £250,000 – the average investment is about £5m.

Because of the greater risks associated with the youngest companies, the VC funds may require returns of the order of 50–80 percent per annum. For well-established companies with a proven product and battle-hardened and respected management the returns required may drop to the high 20s. These returns may seem exorbitant, especially to the managers set the task of achieving them, but they have to be viewed in the light of the fact that many VC investments will turn out to be failures and so the overall performance of the VC

funds is significantly less than these figures suggest. In fact the British Venture Capital Association reports that returns on funds are not excessively high. Taken as a whole, the return to investors net of costs and fees was 14.6 percent per annum to the end of 2002 for funds raised between 1980 and 1998. This compares well with average annual returns of around 8.8 percent on UK quoted shares in the period 1980 to 2002.

Exhibit 17.7 shows the thrills and spills of VC investing. In 11 months 3i turned £83.5m into £231m by investing in Go: *thrill*. It also reported massive losses on technology investments: *spill*.

3i and funds gain £231m on Go stake

Katharine Campbell

3i and its associated funds realised £231m on their stake in Go in less than a year, making it one of the best buy-out investments in the private equity group's history.

easyJet is paying £374m for the discount airline 11 months after British Airways sold it for £110m.

3i's shares rallied 40p to close at 762p yesterday, despite the group unveiling losses of £960m for the year to March 31, alongside the deal. The losses came largely as a result of 3i's misadventures in technology. ...

3i's investment in Go from its own balance sheet, third party funds it manages and syndicate partners totalled £83.5m. The £231m proceeds from the

sale represent a cash-to-cash multiple of about 2.7 times on the investment. ...

Losses on technology investments amounted to £937m, with another £73m in goodwill write-offs for technology investments – acquired during the dotcom bubble.

Buy-out and growth capital investments produced a small positive return of £50m.

3i saw 65 technology companies fail from its portfolio of 809, up from 25 last year. Another 80 non-technology businesses failed, the same number as 2001. ...

New investment levels for the year had halved to just over £1bn from £1.97bn.

EXHIBIT 17.7 3i and funds gain £231m

Source: *Financial Times* 17 May 2002

There are a number of different types of VC providers, although the boundaries are increasingly blurred as a number of funds now raise money from a variety of sources. The *independents* can be firms, funds or investment trusts, either quoted or private, which have raised their capital from more than one source. The main sources are pension and insurance funds, but banks, corporate investors and private individuals also put money into these VC funds. *Captives* are funds managed on behalf of a parent institution (banks, pension funds, etc.). *Semi-captives* invest funds on behalf of parent and also manage independently raised funds.

For the larger investments, particularly MBOs and MBIs, the venture capitalist may provide only a fraction of the total funds required. Thus, in a £50m buyout the venture capitalist might supply (individually or in a syndicate with other VC funds), say, £15m in the form of share capital (ordinary and preference shares). Another £20m may come from a group of banks in the form of debt finance. The remainder may be supplied as mezzanine debt – high-return and high-risk debt which usually has some rights to share in the spoils should the company perform exceptionally well (see Chapter 16). In the case of UniPoly (see Exhibit 17.8), of the £620m that was needed to buy this company and provide it with capital for expansion, 28 percent was equity, 64 percent bank debt (28 banks) and 8 percent mezzanine finance (eight lenders).

Banks replace management at UniPoly

Maggie Urry

The banks that backed the £620m management buy-out of UniPoly in 1997 have brought in a new management to improve the performance of the engineering business . . .

The 28 banks and eight mezzanine lenders in the syndicate have promised to support the business after 'a recent period of uncertainty', said Mr Teacher . . .

Unipoly makes industrial belting, fluid handling equipment and owns Schlegel, the US-based shielding equipment maker. It was sold by BTR, since renamed Invensys, in December 1997.

At the time, UniPoly's diverse product range included water beds for cows and Wellington boots.

The original plan was that the business would be floated, or broken up and sold, within three to five years . . .

BTR received £515m for the company, which also raised a further £105m of capital for expansion.

Legal and General Ventures led the investors who put in £175m of equity and £50m of mezzanine finance, while Fuji Bank led the £395m debt finance.

EXHIBIT 17.8 Banks replace management at UniPoly

Source: *Financial Times* 12 June 2001

Venture capitalists generally like to have a clear target set as the eventual 'exit' (or 'take-out') date. This is the point at which the VC can recoup some or all of the investment. The majority of exits are achieved by a sale of the company to another firm, but a popular method is a flotation on a stock market. Alternative exit routes are for the company to repurchase its shares or for the venture capitalist to sell the holding to an institution such as an investment trust.

Venture capital funds are rarely looking for a controlling shareholding in a company and are often content with a 20 or 30 percent share. They may also supply funds through the purchase of convertible preference or preferred shares which give them rights to convert to ordinary shares – which will boost their equity holding and increase the return if the firm performs well. They may also

insist, in an initial investment agreement, on some widespread powers. For instance, the company may need to gain the venture capitalist's approval for the issue of further securities, and they may hold a veto over acquisition of other companies. Even though their equity holding is generally less than 50 percent, the VC funds frequently have special rights to appoint a number of directors. If specific negative events happen, such as a poor performance, they may have the right to appoint most of the board of directors and therefore take effective control. More than once the founding entrepreneur has been aggrieved to find himself/herself removed from power. (Despite the loss of power, they often have a large shareholding in what has grown to be a multi-million pound company.) They are often sufficiently upset to refer to the fund which separated them from their creation as 'vulture capitalist'. But this is to focus on the dark side. When everything goes well, we have, as they say in the business jargon, 'a win-win-win situation': the company receives vital capital to grow fast, the venture capitalist receives a high return and society gains new products and economic progress.

VC funds frequently have special rights to appoint a number of directors.

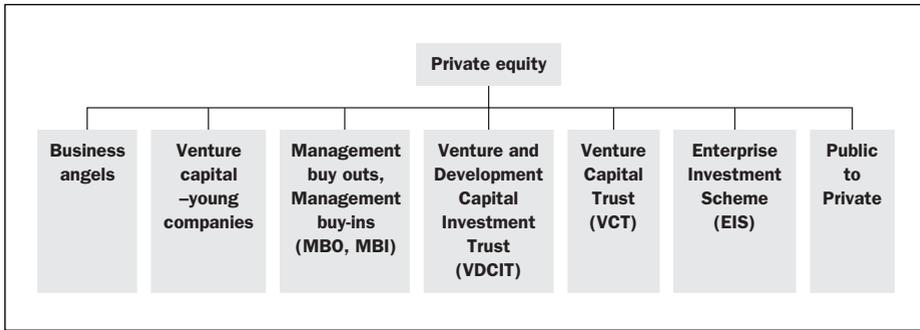
The venture capitalist can help a company with more than money. Venture capitalists usually have a wealth of experience and talented people able to assist the budding entrepreneur. Many of the UK's most noteworthy companies were helped by the VC industry, for example Waterstones bookshops, Derwent Valley Foods (Phileas Fogg Crisps), Oxford Instruments (and in America: Apple computers, Sun Microsystems, Netscape, Lotus and Compaq).

Private equity

With the growth of share investment outside of stock markets it has become more differentiated. The main categories are shown in Figure 17.6. The title overarching all these activities is private equity. Private equity is defined as medium- to long-term finance provided in return for an equity stake in potentially high growth unquoted companies. In this more differentiated setting the term venture capital is generally confined to describing the building of companies from the ground floor, or at least from a very low base. Management buyouts and buy-ins of established businesses (already off the ground floor) have become specialist tasks, with a number of dedicated funds.

Many of these funds have been formed as private partnerships by wealthy individuals, a high proportion of which are American owned. However, funds such as 3i still conduct traditional VC business and MBOs and MBIs. They are frequently classified as venture and development capital investment trusts (VDCITs), which means they are stock market quoted companies with the objective of investing their shareholders' money in unquoted developing companies. The disadvantage of VDCITs is the absence of tax benefits. This is where the Venture Capital Trusts (VCTs) and the Enterprise Investment Scheme (EIS) come in. They both offer

The disadvantage of VDCITs is the absence of tax benefits.

FIGURE 17.6**Private equity and its component parts**

significant tax breaks to investors in small unquoted companies. Some funds have specialized in providing financial and professional support to quoted companies that wish to leave the stock market – public-to-private deals.

Venture capital trusts (VCTs)

It is important to distinguish between venture capital trusts, investment vehicles designed to encourage investment in small and fast-growing companies which have important tax breaks, and two other types of venture capital organizations: venture and development capital investment trusts, (VDCITs) which are standard investment trusts with a focus on more risky developing companies, and venture capital funds (described above).

There are tax breaks for investors putting money into VCTs. There is an immediate relief on their current year's income at 40 percent (by putting £10,000 into a VCT an investor will pay £4,000 less tax, so the effective cost is only £6,000). The returns (income and capital gains) on a VCT are free of tax for investments. Investors can place up to £200,000 each per year in VCTs. These benefits are only available to investors buying new VCT shares who hold the investment for three years. The VCT managers can only invest in companies worth less than £15m and the maximum amount a VCT is allowed to put into each unquoted company's shares is limited to £1m per year. ('Unquoted' for VCT is used rather loosely and includes AIM companies.) A maximum of 15 percent of the VCT fund can be invested in any one company. Up to half of the fund's investment in qualifying companies can be in the form of loans. VCTs are quoted on the London Stock Exchange.

Enterprise Investment Scheme (EIS)

Another government initiative to encourage the flow of risk capital to smaller companies is the Enterprise Investment Scheme. Income tax relief is available for investments of up to £200,000 made directly into qualifying company shares.

Capital gains tax relief is available as well. ‘Direct investment’ means investing when the company issues shares. It does not mean buying in the secondary market from other investors. The tax benefits are lost if the investments are held for less than three years. To raise money from this source the firm must have been carrying out a ‘qualifying activity’ for three years – this generally excludes financial investment and property companies. The company must not be quoted on the Official List and the most it can raise under the EIS in any one year is usually £1m. The company must not have gross assets worth more than £15m. Funds which invest in a range of EIS companies are springing up to help investors spread risk.

‘Direct investment’ means investing when the company issues shares.

Corporate venturing and incubators

Larger companies sometimes foster the development of smaller enterprises. This can take numerous forms, from joint product development work to an injection of equity finance. The small firm can retain its independence and yet contribute to the large firm: perhaps its greater freedom to innovate will generate new products which the larger firm can exploit to the benefit of both. Intel uses corporate venturing to increase demand for its technology by, for example, investing in start-up companies in China. Nokia Venture Partners invests in start-up companies in the wireless internet industry. BT set up Brightstar to harvest value from its 14,000 patents and 2,500 unique inventions in its laboratories.

The small firm can retain its independence and yet contribute to the large firm.

Incubators are places where a start-up company not only will gain access to finance, but will be able to receive support in many forms. This may include all humdrum operational managerial tasks being taken care of (e.g. accounting, legal, human resources), business planning, the supply of managers for various stages of the company’s development, property management, etc. As a result the entrepreneurial team can concentrate on innovation and grow the business, even if they have no prior managerial experience.

Government sources

Some local authorities have set up VC-type funds to attract and encourage industry. Large organizations with similar aims include the Scottish Development Agency and the Welsh Development Agency. Equity, debt and grant finance may be available from these sources.

Disillusionment and dissatisfaction with quotation

Appendix 17.1 contains a number of newspaper articles about companies which either are dissatisfied with being quoted on a Stock Exchange or have never been

quoted and feel no need to join. A reading of these will provide a wider understanding of the place of stock markets, their importance to some firms and how many companies are able to expand and produce wealth without them. Some of the main points are summarized in Table 17.4. The arguments are taken directly from the articles and do not necessarily represent reasoned scientific argument.

Conclusion

There are a number of alternative ways of raising finance by selling shares. The advantages and problems associated with each method and type mean that careful thought has to be given to establishing the wisest course of action for a firm, given its specific circumstances. Failure here could mean an unnecessary loss of control, an unbalanced capital structure, an excessive cost of raising funds or some other destructive outcome. Joining a stock market is merely one option; it has considerable drawbacks and so is not appropriate for many firms. Many of the UK's most well known entrepreneurs prefer to expand their businesses outside of the stock exchange with a mixture of bank finance, venture capital and plowed-back profits.

Websites

www.bvca.co.uk British Venture Capital Association
www.businesslinks.co.uk BusinessLinks
www.enterprisezone.org.uk Enterprise zone
www.evca.com European Private Equity and Venture Capital Associations
www.fsa.gov.uk Financial Services Authority
www.londonstockexchange.co.uk London Stock Exchange
www.fsa.gov.uk/ukla United Kingdom Listing Authority
www.uk-wire.co.uk UK-Wire Financial News, Regulatory News Services Stock Exchange announcements
www.hemscot.net Hemscott
www.iii.co.uk/newissues Ample
www.issuesdirect.com Issues Direct
www.bvca.co.uk British Venture Capital Association
www.bestmatch.co.uk or www.nban.com National Business Angels Network (NBAN)
www.angelbourse.com Angel Bourse
www.wave2.org Wave2
www.vcr1978.com Venture Capital Report
www.katalystventures.com Katalyst Ventures
www.hotbed.uk.com Hotbed
www.beerandpartners.com Beer & Partners
www.entrust.co.uk Entrust
www.dti.gov.uk Department of Trade and Industry

TABLE 17.4
Arguments for and against joining a stock exchange

For	Against
<ul style="list-style-type: none"> ■ Access to new capital for growth. ■ Liquidity for existing shareholders. ■ Discipline on management to perform. ■ Able to use equity to buy businesses. ■ Allows founders to diversify. ■ Borrow more easily or cheaply. ■ Can attract better management. ■ Forces managers to articulate strategy clearly and persuasively. ■ Succession planning may be made easier – professional managers rather than family. ■ Increased customer recognition. ■ Allow local people to buy shares. 	<ul style="list-style-type: none"> ■ Dealing with ‘City’ folk is time consuming and/or boring. ■ City is short-termist. ■ City does not understand entrepreneurs. ■ Stifles creativity. ■ Focus excessively on return on capital. ■ Empire building through acquisitions on a stock exchange – growth for its own sake (or for directors) can be the result of a quote. ■ The stock market undervalues entrepreneur’s shares in the entrepreneur’s eyes. ■ Loss of control for founding shareholders. ■ Strong family-held companies in Germany, Italy and Asia where stock markets are used less. ■ Examples of good strong unquoted companies in UK: Bamford, Rothschilds. ■ Press scrutiny is irritating. ■ Market share building (and short-term low profit margins) are more possible off exchange. ■ The temptation of over-rapid expansion is avoided off exchange. ■ By remaining unquoted, the owners, if they do not wish to put shareholder wealth at the center of the firm’s purpose, don’t have to (environment or ethical issues may dominate). ■ Costs of maintaining a quote, e.g. SE fees, extra disclosure costs, management time.

Appendix 17.1 Arguments for and against floating

JCB's reasons to be private

To float or not to float? Sir Anthony Bamford has no hesitation in answering, writes *Paul Betts*.

'Yes, we have looked at it but for a company like JCB with only a few family shareholders it is not a satisfactory option. We either stay private or sell 100 per cent; and I have no intention of doing that.'

He admits this makes his company somewhat singular: a privately owned, successful British-based manufacturer that is a global brand.

Started in the Midlands in 1945, JCB is now the UK's biggest privately owned manufacturer and the world's fourth largest maker of construction machinery, exporting nearly 75 per cent of its products to 140 countries.

Sir Anthony says the company has remained focused on its business, growing organically in its niche construction, indus-

trial and agricultural equipment markets, relying on its own cash rather than borrowing and adopting a 'simple long-term strategy led by product and innovation'.

Floating the company would have spoilt this. 'If we were a public company we would probably have had to diversify because analysts and stockbrokers would have said we were in a very cyclical industry. They would have ... pushed us into doing things we shouldn't.'

Companies float for several reasons, he says. 'They have lots of shareholders who want to cash in. But we don't. Or they need more capital and, again, we don't. Or they want to have paper to buy other businesses – but we have stuck to organic growth.'

EXHIBIT 17.9 JCB's reasons to be private

Source: *Financial Times* 4 February 2003

Ferrari chief keen for IPO to drive growth

By *Paul Betts* in Maranello

Luca di Montezemolo, Ferrari's chairman, is keen to see the sports car and racing company launch a public offering on the stock market.

He told the *Financial Times* this would help fund Ferrari's expansion into entertainment, including the development of Ferrari theme parks. It also wants to step up its retailing activities and further develop its Maserati car business.

To launch an initial public offer, Mr Montezemolo needs the approval of Ferrari's main shareholder, the Italian Fiat automotive group with 90 per cent of the company. The other 10 per cent is held by Piero Lardi-Ferrari, son of the company's founder.

In a leaked document following a recent board meeting, Fiat said it was contemplating a possible Ferrari IPO within the framework of a programme to cut its €6bn debt. However, a person close to Fiat suggested yesterday that a Ferrari IPO was unlikely before next year. One key issue would be how the proceeds would be split between Fiat and Ferrari.

Ferrari had always relied on its own financial resources and would continue to do so. But at some later stage, an IPO would help raise fresh resources for new developments, he explained.

An IPO would also help develop Maserati. Ferrari relaunched Maserati four years ago and Mr Montezemolo said he now wanted to develop its racing activities.

EXHIBIT 17.10 Ferrari chief keen for IPO to drive growth

Source: *Financial Times* 18 March 2002

Mature, experienced Virgin seeks out bright City lights

Patrick Jenkins

It has taken 14 years, but Sir Richard Branson has finally admitted it. If he is to continue to expand his Virgin empire, he needs the support of the stock market.

Last week, the man famous for unorthodox stunts – he dressed up as a bride to launch his wedding services business and as a can of cola to promote Virgin Drinks – told the Financial Times of his plans to court the City's suits again.

He will float eight companies over the next eight years, generating an estimated £2bn in the process to fund new ventures.

It is an ambitious about-turn. In 1998, after a disappointing 23 months on the stock market, an embarrassed Richard Branson took Virgin Group private again.

He was furious that the stock market could punish such an apparently successful business, and railed against the short-termism of institutional investors. The shares fell 40 per cent over a year and a half before he offered to buy them back at the float price.

When it came to Virgin's shares, it seemed, his thriving consumer brand counted for little.

So why the change of heart? Sir Richard, now 51, says time has healed his wounds. 'We've matured. I have personally and so has the group.'

That may be so, but the truth is there is no other avenue left open to him. Even his biggest and most established ventures – Virgin Atlantic and Virgin Rail – cannot be relied upon to generate profits in the short-term.

Atlantic operates in the notoriously tight-margin airline business and was thrown deep into loss last year – how deeply has not yet emerged – by the evaporation of demand for transatlantic flights in the wake of September 11. Virgin Rail, though likely to turn a profit for last year, faces ever stiffer conditions.

If Sir Richard is to make money from businesses such as these – let alone the myriad smaller companies that have never made a profit – it will have to be through releasing equity.

He has begun the process, in recent years, by selling stakes to private partners. All his biggest businesses are now half-owned by others. Singapore Airlines has bought 49 per cent of Virgin Atlantic. Stagecoach, the transport company, took 49 per cent of Virgin Rail. T-Mobile owns 50 per cent of Virgin Mobile (UK). AMP took half of Virgin Money.

That strategy replaced an earlier model of selling businesses outright – Virgin Records to EMI and Virgin Radio to Scottish Media Group.

Sir Richard is now determined never to cede control like that again. 'Going below a 30 or 35 per cent shareholding is unwise. You lose control of the brand. It hasn't damaged us yet, fortunately. But our future strategy will be to keep reasonable ownership of branded Virgin companies.'

But with the name counting for so much, Sir Richard wants to pre-empt that risk. Floating businesses, while retaining substantial shareholdings, is his new model.

The first company to float, early next year, will be Virgin Blue, the Australian airline that is 50 per cent owned by Patrick Corp.

By 2010, Virgin believes it could be joined by Virgin Mobile (UK); Virgin Entertainment, the retail and cinema business; Virgin Atlantic; Trainline.com, the rail booking operation; Virgin Active healthclubs; Virgin Rail; and Virgin Money, the personal finance operation.

Could the sceptics be right about the black holes in the business? Sir Richard, they say, needs regular billion-pound injections just to stem the haemorrhaging of cash.

The group no longer has a cash cow, with Virgin Atlantic in deficit and Virgin Records sold a decade ago. The majority of businesses lose money. And for a man with a reputation for merciless treatment of competitors, Sir Richard is surprisingly sentimental about his own businesses.

He plans to devote an extra \$500m (£342.4m) to US expansion in addition to the \$162m he recently committed to the mobile phone joint venture with Sprint, the US operator. Much of the money will go towards building a

domestic US airline, providing 'open skies' regulations are amended.

Australia's mobile business is also absorbing investment fast, as is retail expansion in Japan.

The 40 per cent decline in Virgin Group shares in the mid-1980s was an ominous start. Two more disappointments followed. Victory Corp – the clothing and cosmetics business that is 83 per cent owned by Virgin – has slumped 92 per cent since its 1996 float. And Virgin Express, the Brussels-listed airline, is 89 per cent down on its 1997 float price.

EXHIBIT 17.11 Experienced Virgin seeks out city lights

Source: *Financial Times* 7 May 2002

A solo artist celebrates his empire

Susanna Voyle

Green's pride at securing his prize – Arcadia and his current BHS business combined will give him some £2.75bn of sales and make him the second largest clothing presence on the high street after Marks and Spencer at £3.6bn.

'I have created Britain's biggest private retail company,' he said. 'Look back in history at all the great entrepreneurs.

People talk about those like Hanson as great empire builders. But that was all done through the stock market money. I have done this as a solo artist.'

'I think private is better than public,' he said. 'Partly because you can spend all your time and attention on the business and not be distracted worrying about reporting and everybody sitting on your head.'

EXHIBIT 17.12 A solo artist celebrates his empire

Source: *Financial Times* 7/8 September 2002

Stock market receives a kick in the privates

Norma Cohen

When stock market pundits look back at 2003, the year will show one outstanding characteristic; it was the year in which twice as much equity was withdrawn from the public market in the form of public-to-private deals than was put in through initial public offerings.

Moreover, the attractiveness of private – as opposed to public shareholding – ownership of companies was evident on the Continent as well. According to data from Dealogic, a record of 96 companies were taken private, up from the previous peak in 1999 of 83 transactions.

Indeed, both the absolute number of transactions, and the size of some of the largest deals, has caused investors – those investing in both public and privately-owned equity – to ask the central question: why be a public company anyway?

What business advantages do public companies have over private ones and in any event, are these advantages really so great that they outweigh the costs and penalties privately-held companies manage to avoid?

Investment bankers, whose fortunes are most closely tied to the existence of publicly-owned companies, say the advantages are very clear.

‘The key thing [about a public listing] is that it creates a market in the shares of companies,’ says Paul Baker, co-head of corporate broking at Merrill Lynch. ‘It allows existing shareholders to sell and it creates a relatively easy way of raising new money.’

Moreover, the existence of public stock markets is the bulwark of a capitalist economy. ‘If you believe in capitalism, then you believe in the [stock] market,’ he says.

Also, some bankers say, being public is sometimes the only thing that keeps companies from going to the wall in tough times.

The so-called rescue rights offering – usually loathed by shareholders for the

call it makes on capital – has allowed near-bankrupt companies to get their respective houses in order.

Shareholders say they go along with such transactions in order to avoid losing the money they have already invested, but point out that they frequently demand concessions such as a change in top management.

Marcus Agius, chairman of Lazard, the investment bank, cautions that much of what went on in 2003 reflects an unusual confluence of events, rather than some fundamental reassessment of the merits of public ownership.

‘As share prices collapsed, managements were demoralised,’ he says. ‘Shareholders were saying to boards “Don’t do anything foolish. Fix your company. Get your house in order”’.

In effect, he says, private equity investors who had been sidelined as soaring share prices locked them out of the market saw their opportunity.

Moreover, some bankers say, stunned and disillusioned equity investors, watching markets plumb depths not seen in years, were – despite the modest recovery in stock markets since late spring – prepared to sell out at almost any price, provided it was a premium to wherever share prices were at any particular moment.

However, other investors say that what has gone on over the past year reflects much more than canny buyers seizing the moment. In effect, three previous years of falling stock markets have caused widespread reappraisal of who should, or should not, seek a public listing.

Too many companies, investors say, came to market via aggressive marketing from investment bankers who targeted gullible investors who did not ask enough hard questions.

Privately, investors point to what one terms ‘the ego value’ of running a public company, saying that entrepreneurs who

had built large fortunes see flotation as a means of trumpeting their achievements rather than a means of delivering long-term value to investors. Others, they say, see a float as the best way to get a high price for a company that they have built from scratch but in which they have little interest in its long-term health.

Some also argue that being public requires managements to constantly tell a 'growth story' to investors, a requirement that sometimes drives businesses into activities for which they are not well-suited.

Investors cite the ill-fated overseas expansion drives of some retailers such as Marks and Spencer and WH Smith as activities that might not have been undertaken by privately-held companies.

Also, the need to manage and meet the shareholder expectations in the form

of 'earnings guidance' may have encouraged companies to engage in some of the worst accounting excesses exposed by the meltdown in stock markets.

However, Richard Hughes, fund manager at M&G, an arm of Prudential, argues that the existence of public stock markets promotes popular capitalism, spreads wealth and encourages social cohesion.

'From the UK saver's point of view, a UK Plc dividend stream has been very satisfactory,' he says. When wealth is concentrated in very few hands, it has been by the buy-out of companies such as Arcadia and Selfridges, it concentrates risk and sets limits on democratic wealth creation, he adds.

'It is much better to have lots of little stakes in lots of companies,' he says.

EXHIBIT 17.13 Stock market receives a kick in the privates

Source: *Financial Times* 31 December 2003

Fast work if you are out of the spotlight

Peter Smith

John Kelly dismisses the suggestion that private equity groups are akin to dodgy antique dealers when one decides to sell a business to another.

The chief executive of Gala, the bingo and casinos group, has worked with three sets of private equity backers in his seven years at the top and says he can point to the creation of a lot of value over that time.

When Candover and Cinven took control of Gala this year, it was valued at £1.24bn. But in 1997, PPMV and Royal Bank Development Capital paid £236m for what was then Bass's bingo chain. Some of the difference can be explained by Gala's £380m acquisition spree, but not all of it.

As part of the original management buy-in team, Mr Kelly has clear views about running a private equity-backed business.

'Private equity is in the business of exiting and management teams must recognise that, it may be two years or it may be seven. Provided you recognise that from the outset, there is a core of commonality,' he said.

'But if the private equity house has a covert agenda then you have a problem. You will be dancing around the daffodils and there will be a defining event that will cause a problem.'

And Mr Kelly admits to the occasional bust-ups, both strategic and personal.

As part of a reshuffle at CSFB, which acquired a large stake from PPMV, Gala suddenly lost two board directors who were replaced.

'The two original CSFB guys had emotionally done the due diligence on the business and you get to know them better than your wife. There is a bonding process and suddenly these guys go.'

Mr Kelly said both parties had to work to 'rebuild chemistry' to make sure the business wasn't damaged.

He also points to disagreement over a deal which management wanted to undertake but one of the private equity groups did not.

'One [of the backers] felt it was not appropriate and that is life.'

However, the issue led to upheaval, prompting a refinancing of Gala to allow the private equity group to sell.

'There was a parting of the ways. It was difficult and in my view, and if we had 20/20 vision in hindsight, it was avoidable.'

But being close to the owners of the business provides advantages not always available to public companies.

In March 2000, Gala completed a \$400m refinancing and three days later completed the acquisition of Riva, a rival bingo operator, for £90m. And within three months, the group was negotiating with Ladbroke to buy its casino business, which it bought later that year for £235m.

'Doing these three things so close together would not happen in the public company arena. Both the deals have been enormously shareholder value enhancing,' Mr Kelly said.

'We didn't have to do a roadshow to institutions, speak to brokers and analysts but we had to convince one party and that was CSFB. And then the process can be very quick and very clear.'

In a recent US survey, 80 per cent of those polled said they would rather be a chief executive of a private company than a public one.

Tom Wamberg, executive chairman of Clark Consulting, the pay consultancy which carried out the survey, said many executives do not want to operate under the spotlight of the markets.

'Many think that being public is a hassle today, rather than a privilege,' he said.

Mr Kelly may find himself going in the other direction. Although he claims that from 'a personal perspective. I have no aspiration to be a CEO of a large listed company', the next big move for Gala is likely to be a flotation.

'It makes a lot of sense,' Mr Kelly said. 'We went all the way to the wire [earlier this year],' adding that it did not go ahead because of issues concerning valuation.

'But with the IPO market shut, where would a lot of companies have been in the last two years if it wasn't for private equity.'

EXHIBIT 17.14 Fast work if you are out of the spotlight

Source: *Financial Times* 10 September 2003

Climbing aboard the flight from flotation

Phillip Coggan

Farewell to the stock market. Hardly a week goes by without some smaller company announcing that it is in talks about a bid from its founding shareholders or from venture capital groups. By contrast, the new issues calendar looks fairly moribund.

The appeal of a stock market listing seems to be wearing thin. In large part, of course, this is because of three years of falling share prices. There was no shortage of listing applicants four years ago when you could float a brick on the world's stock markets.

Nowadays, however, entrepreneurs fret that the market does not give their shares an appropriate rating. They tire of being cross-questioned by impertinent shareholders about the details of their strategy and the minutiae of their accounts. Life will be better, they feel, outside the public gaze.

They may find that this is an illusion. Venture capital groups can be hard taskmasters. After all, they have large and illiquid stakes and tightly defined return targets. They will be even more attentive to detail than the likes of Fidelity and State Street.

Nevertheless, this flight from quotation does raise some important issues about the future of the stock market. There are more than 2,000 quoted companies in the UK. But the largest 100 companies in the FTSE 100 index comprise more than 80 per cent of the value of the market; while the Hoare Govett Smaller Company index, which covers the smallest 10 per cent of the main market by value, contains 1,284 constituents.

In other words, the vast bulk of investor attention focuses on a very small proportion of the market by number. The minnows of the market are often too tiny to be noticed by the big institutional investors; many would not look at a business valued at less than £100m. By the same token, they would be unlikely to

attract the attention of investment bank analysts; it would not be worth the analysts' time, given the small amount of business such a company would be likely to generate. The same difficulties arise in other markets. Indeed, in the US, the threshold for attracting serious investor interest is probably significantly higher than in the UK.

What then is the point of such small companies being on the market? The theory of stock markets is that they add value by allowing companies to raise new capital, so they can expand. But many quoted companies joined the market, and had their best chance to raise capital, years ago. A lack of serious institutional or analytical interest means that it would be very hard for them to raise new equity capital in current markets.

A few small companies will always be able to exploit their listings. But these are likely to be businesses in fast-growing industries, at least, businesses that are able to *convince* investors they are fast-growing. If they are engineering companies from the UK Midlands or the US Midwest, they have no hope.

In the 1990s, a stock market listing was probably of considerable use to companies in terms of attracting employees, because of the ability to grant stock options to new hires. But since the dotcom bubble burst in 2000, options have become less alluring than cold, hard cash.

A quotation still allows the founders to convert their equity into cash. For many, this must be the biggest remaining attraction of a listing.

But the private route gives the entrepreneur another two bites of the cherry. First, the value of his or her existing holding is increased by the bid premium, financed by the helpful venture capitalists. Then there is the chance to bring the company back to market again, at a much higher evaluation, in a few years' time.

For the last decade, free market enthusiasts have been lecturing the continental Europeans and the Japanese that their system of bank financing for the corporate sector was fatally flawed. The relationship was too cosy, they argued, allowing inefficient management to stay in charge. In contrast, the Anglo-Saxon model allowed shareholders to replace dud executives via the takeover mechanism.

But does a market-based alternative really work, if the participants in the

market are simply not interested in a large number of companies? The stock market's primary function is no longer to raise capital for the corporate sector; indeed in the US and the UK, companies have often been *returning* capital in recent years via share buy-backs. Instead, the stock market exists as a savings vehicle for the private sector and as a means for investment bankers to get rich. The ability to trade shares is valued far more highly than the ability to raise capital.

EXHIBIT 17.15 Climbing aboard the flight from flotation

Source: *Financial Times* 6/7 September 2003

Question the sanity of owners who want to float

Jonathan Guthrie

The role of the successful owner-manager appears to offer enviable freedom. If you want to come back late from holiday because the trout are biting, you can.

I was therefore surprised to learn from Neil Austin, head of new issues at KPMG Corporate Finance, that a horde of private businesses are watching market rises for the signal to dust off flotation plans. That is understandable for companies owned by venture capitalists desperate to exit. But you have to question the sanity of any owner manager seeking to float.

Running a small quoted business looks a thoroughly miserable activity. The authorities dump skiploads of red tape on to the hapless incumbent. Meanwhile the City becomes ever more distant, like a snooty waiter who has divined that Sir is not a big tipper.

The brokers, however, will be jolly friendly to private company owners if the market's upward ramble makes initial

public offerings easier to mount. But while they may be able to chivy institutions to take up newly issued shares in smaller cap businesses, I shall be amazed if they can keep the interest up for much longer than it takes to collect their fees.

'There is a real concern about that,' says Mr Austin. 'A lot of companies are switching brokers because they feel unloved by the broker that floated them. But there are too many companies on the market and they need weeding out.'

In spite of a large number of takeovers, new listings mean there are about 2,300 quoted UK businesses today, only 70 fewer than in 1998. That means there are still plenty of bosses of smaller cap companies participating in what one old hand sardonically refers to as 'the circus' – the unrewarding activity of wooing big investors increasingly focused on blue chips.

This chief executive says: 'Every year we spend weeks preparing for a results day in London consisting of

eight meetings with institutions. We always get thoroughly beaten up. Usually there's a common theme. One year they say we're over-exposed overseas. The next year they say our market share is under threat at home.'

Another chief executive I knew was grimly determined to satisfy the ever-changing demands of his City critics. He acquired here, and divested there but none of it made a blind bit of difference to the share price. Eventually he lost his job. It was like watching a tired old performing lion leaping through a series of ever smaller hoops in hope of a juicy steak, which, in the end, was never provided.

Lord Paul, chairman of private steel group Caparo, says: 'The value of a public company is not related to its performance. But that does not mean the market is failing, rather that [its main purpose] is to reflect fashions. In the fashion industry, something made by Gucci is priced four times higher than a similar unbranded item and no one thinks it is odd.'

Bosses who reconcile themselves to apparent valuation anomalies are still likely to balk at the increasing red tape that comes with a listing. A former public company director describes his five-year stint as 'absolutely awful. Every year there was something new to implement and it takes up a lot of time when you do not have a secretariat. If I'd

wanted to spend my days filing in forms I would have joined the civil service.'

Even Lord Hanson, the entrepreneur, who remains a big fan of listings, thinks the UK market is becoming over-regulated. 'The more restricted we are, the less opportunity private enterprise has to flourish,' he says, questioning the value of drafting in legions of new non-executive directors, as the Higgs report advocates.

The supposed downside of staying private is poorer access to capital. However, Lord Paul says that if you have the prospects and chutzpah to engineer a float, you could probably borrow the cash instead.

Lord Hanson adds: 'You really have to ask yourself whether you need public money to grow.' Meanwhile, trade sales can be an easier way of selling out.

One curious drawback of staying private is that without grumpy shareholders and analysts to prick their egos, company bosses can become unpleasantly overbearing. When one of these blimps phones me I hold the receiver at arm's length to avoid concussion.

Lord Paul and Lord Hanson agree that 'discipline' is one of the main benefits bosses get from running a listed business. Lord Paul, who took Caparo private in 1991, says: 'Running a public company taught me a concern for good corporate governance, the importance of keeping monthly accounts and the usefulness of board meetings in decision-making.'

EXHIBIT 17.16 Question the sanity of owners who want to float

Source: *Financial Times* 13 May 2003

Small companies urged to think big in hunt for investment

David Blackwell

Small companies – and there are 800 listed in London with a market capitalisation of less than £50m – are being increasingly marginalised by institutional investors.

At the same time, they are failing to excite the interest of private investors. Their options are limited: they can trundle along in obscurity on the Stock Exchange, move back into private ownership or sell themselves to a larger group.

The gulf between them and institutional investors is reflected in startling figures in the latest Department of Trade and Industry report on the sector.

Research showed that more than 60 per cent of small companies felt fund managers did not understand their business. Conversely, more than 70 per cent of fund managers said smaller compa-

nies had a poor grasp of what determined share value ...

[Institutions] are increasing in size as the financial services industry consolidates. Fund managers are also taking a more pan-European view of smaller companies following the introduction of the euro. As a result many institutional investors are beginning to consider any company with a market capitalisation of less than £800m as 'small' ...

In many ways the 800 companies valued below £50m risk being completely ignored, says Paul Myners, a NatWest executive director and part of the City and industry working group behind the DTI report. 'They have got to do something about it; they have got to get out there and beat the drum a bit,' he says.

EXHIBIT 17.17 Small companies urged to think big in hunt for investment

Source: *Financial Times* 9 February 1999

Notes

- 1 Except that it shows proportional voting and income rights.
- 2 Responsibility for governing admission to listing, the continuing obligations of issuers, the enforcement of those obligations and suspension and cancellation of listing was transferred from the LSE to the UKLA in 2000.
- 3 Having said this, many business angels (generally those with investments of £10,000–£20,000) have infrequent contact with the company.
- 4 Source: British Venture Capital Association.