# Public or private equity? How accelerated IPOs can increase competition in offerings

Tim Jenkinson

Saïd Business School, Oxford University and CEPR*

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This clinical paper analyses a new way of conducting IPOs which has recently been introduced in the U.K. The essential feature of Accelerated IPOs (aIPOs) is that investors form syndicates to bid for the entire offering, and then execute an immediate IPO (within a week). Vendors can use an auction to determine whether the valuation is higher in private equity, trade, or public equity hands. aIPOs address two problems that regulators and academics have associated with conventional IPOs conducted via bookbuilding: inaccurate valuation and questionable use of discretion over allocation. Conflicts of interest are avoided as the advisors who organise aIPOs work for the investors rather than the issuing company.

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Keywords: Initial Public Offerings, Private Equity, Auctions

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* Address: 1 Park End Street, Oxford OX1 1HP, U.K. t: +44 (0)1865 288916; f: +44 (0)1865 288805; e: tim.jenkinson@sbs.ox.ac.uk; w: www.sbs.ox.ac.uk/faculty/jenkinson . I am grateful to Humphrey Battcock, Hugh Briggs, Andrew Carey, Jeremy Ellis, Howard Jones, Bernard Lambilliotte, and Stuart Skinner for very useful discussions. All views and errors are mine alone.

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## Abstract

This clinical paper analyses a new way of conducting IPOs which has recently been introduced in the U.K. The essential feature of Accelerated IPOs (aIPOs) is that investors form syndicates to bid for the entire offering, and then execute an immediate IPO (within a week). Issuers can use an auction to determine whether the valuation is higher in private equity, trade, or public equity hands. aIPOs address two problems that regulators and academics have associated with conventional IPOs conducted via bookbuilding: inaccurate valuation and questionable use of discretion over allocation. Conflicts of interest are avoided as the advisors who organise aIPOs work for the investors rather than the issuing company.



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## 1. Introduction

Should a company conduct an IPO or seek external financing from private equity or from another company (a "trade" sale)? This question is encountered by many companies and their investors, and involves a variety of considerations – including value maximization, the objectives of the issue in terms of new money for the company or exit for the investors, and the optimal corporate control for the company going forward. However, although ideally investors might like to keep their options open regarding the method of sale, in practice it is necessary to commit – usually quite early – to either the IPO route, or an auction to potential private equity or trade buyers. Investment banks will provide advice as to their expected valuations from the alternative offering routes, and will be keen to organise the IPO or auction, but it is difficult to know *ex ante* which offering method would produce the highest valuation.

This paper analyses a new way of conducting an IPO, which we refer to as an accelerated IPO (aIPO), which has recently been introduced in the U.K. A significant feature of aIPOs is that the technique allows issuing companies to keep open all sale options (trade purchase, private equity, or public equity): the final decision depends on which investor group values the company most highly. Indeed, one of the key features of aIPOs is that they increase the competition faced by private equity firms from more traditional institutional fund managers when bidding for companies, although private equity firms themselves will benefit from any increased competition at exit.[1] Using clinical evidence from the four successful aIPOs to date, we show how aIPOs work, and how they differ from conventional IPOs.

We explain how aIPOs work in detail in the next section, but in essence an advisor[2] undertakes due diligence on the firm, and then puts together a buying syndicate

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[1] The Sunday Telegraph (18 May 2003) reports that a spokesman for Morgan Stanley – who had been engaged to advise the vendor in the first aIPO – remarked, "This is groundbreaking. These guys have competed successfully against the financial buyers. No-one has ever done an IPO in this way. It is particularly interesting in a market which is so depressed that everyone believes the activity is geared towards financial buyers".

[2] We use the term advisor as the role is not limited to investment banks. In practice, the main functions undertaken by the advisor are due diligence and valuation, along with an ability to prepare the

of institutional *public equity* investors. The syndicate then bids for the entire equity stake being sold. If they are successful in winning the auction, the syndicate takes advantage of the rules of the Alternative Investment Market (AIM) segment of the London Stock Exchange, which allows companies to be admitted very rapidly. An IPO can be conducted within a few days of the final bid being accepted, and hence the syndicate of investors receive shares that are publicly traded.

Relative to conventional IPOs conducted by bookbuilding, aIPOs have a number of important features. First, aIPOs allow competitive pressure – in terms of valuation of the issuing company, and finding potential investors – to be maintained on advisors throughout the sale process. In conventional IPOs there is considerable competition between investment banks for the position of bookrunner – conducted at IPO "bake-offs" – but having committed to a particular bookrunner the issuing company has little way of injecting competitive pressure on their pricing or allocation decisions.[3] The systematic underpricing of IPOs is long-established, but the extra-ordinary levels of underpricing observed during the 1999-2000 "IPO bubble", and the related scandals regarding share allocations, have raised questions about the bookbuilding approach to IPOs. For instance, in the U.S. the NYSE and NASD have called for an exploration of alternative IPO techniques[4], and in the U.K. the Financial Services Authority has called for the

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necessary documentation to expedite flotation. The first such advisors who have organised aIPOs have tended to be small and specialised financial intermediaries.

[3] The practice of suggesting high valuations in the bake-off for the bookrunner mandate, only to revise the price downwards later, is known in the trade as "bait and switch". Furthermore, the investment bank in a bookbuilding has an incentive to encourage over-subscription, as this increases the value of the discretion they enjoy over allocation. Corwin and Shultz (2004) show how appointing joint bookrunners may help to strengthen the negotiating power of the issuer.

[4] For example, the NYSE/NASD IPO Advisory Committee recommended that regulators review existing rules and practices in order to promote the development of alternatives to the bookbuilding process. The NASD subsequently called for views on proposals to require underwriters to retain an independent broker to certify that the initial price range used in the bookbuilding was reasonable, and to require the use of an auction or some other system to collect indications of interest to help establish the final IPO price. For details see the NASD "Proposed rules governing allocations and distributions of shares in IPOs" (November 2003), and "Report and recommendations of a committee convened by the New York Stock Exchange, Inc. and NASD at the request of the Securities and Exchange Commission", (May 2003).

establishment of pricing committees, explicit policies to deal with conflicts of interest, and the need for investment banks to conduct post-IPO reviews when trading prices rise significantly above issue prices.[5] However, innovations in the bookbuilding approach to IPOs have been few, and, indeed, this approach to conducting IPOs has become increasingly dominant internationally (Ljungqvist, Jenkinson and Wilhelm, 2003). Accelerated IPOs represent one of the more interesting recent innovations.

Second, in conventional IPOs investors signal their interest by submitting bids during the bookbuilding, which results in the information revelation issues first analysed by Benveniste and Spindt (1989). In order to induce potential (informed) investors to reveal information that is valuable in pricing the issue, the issuer gives the bookrunner discretion over allocation, which they can exercise in favour of those investors who reveal useful information. Sherman and Titman (2002) introduce costly information, and emphasise that the bookrunner should restrict investor access to the bookbuilding phase as a way of incentivising efficient information production. Evidence on participation in bookbuilding is extremely limited, however data from European bookbuilding tends to suggest that rather large numbers of investors typically participate[6]; there is no corresponding evidence available for the U.S. However, during an aIPO participation is certainly restricted, as the bank organising the investor syndicate only needs to acquire enough investors to raise the required funds. In contrast, the inherent competition between the underwriting syndicate members in conventional IPOs typically results in demand for the shares which is many multiples of the number available, and extensive scaling back of allocations relative to expressed demand. Hence, when investors are being asked for their views on the suggested valuation in an aIPO, they are certain that if they commit funds they will obtain an allocation if the bid is successful, which largely overcomes the information revelation problems associated with bookbuilt IPOs.

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[5] See "Conflicts of interest: investment research and other issues", FSA Consultation Paper 205 (October 2003).

[6] Jenkinson and Jones (2004) analyse 27 European IPOs bookrun by a particular investment bank and report that, across these issues, over two thousand separate bidders participated. On average there were 205 bids per IPO.

Third, the issuing firm uses an auction to sell the entire issue to a single investor or syndicate of investors, in essentially the same way that private sales of companies are conventionally executed. The issuing company will usually retain its own advisor (typically an investment bank) to prepare the company for sale, produce an investment memorandum, market the opportunity, and conduct the auction. Whilst such auctions are well established as the method of selling whole companies, the experience of IPO auctions – where the participation of lots of individual investors is encouraged, and shares in the company are priced and allocated via an auction (rather than by an investment bank, as in bookbuilding) – is generally disappointing. Although IPO auctions have been used in many countries, Sherman (2002) finds that auctions often result in under-subscription and have usually ceased to be used when bookbuilding has been introduced. Furthermore, the problems encountered in the recent high-profile auction used in Google's 2004 IPO have probably reinforced the belief that IPO auctions are problematic and do not necessarily result in particularly accurate pricing. The emergence of aIPOs introduces an alternative way of involving public equity investors in an auction mechanism – the important difference being that investors bid in syndicates for the whole issue, and marketing of the auction is carried out by the advisors to the issuer and the advisors to the investor syndicate(s). As Klemperer (2004) notes, encouraging the participation of bidders is critical to the success of auctions in practice, and to the extent that IPO auctions have previously failed due to insufficient encouragement of investor participation, aIPOs – which involve strong incentives for advisors to market the issue, and the involvement of private equity and trade purchasers – may be a superior alternative.

Fourth, in conventional IPOs, the underwriting syndicate essentially bears no risk, since by the time they price the issue they know that they have willing buyers at that price. Although the bids in a bookbuilding are legally "expressions of interest", the repeated nature of the interaction between the bookrunner and investors means that when the investors are phoned up in the few hours after the price has been set, the bookrunner knows that the issue will be fully subscribed. Furthermore, trading in the shares commences only a few hours after the investors have confirmed their orders. In contrast, in aIPOs the gap – although short – between successful bid and flotation does introduce

certain risks that must be distributed between the issuing company, investors and/or the advisor. We discuss the risk allocation issues in more detail below, and how these compare to the risks observed in conventional IPOs.

Fifth, the aIPO technique relies upon the ability to float the company very quickly if the public equity syndicate wins the auction. The AIM market in London was, until recently, the only second-tier market with the sort of light-touch regulation that permits such acceleration of the IPO process. However, as we discuss in more detail later, one important response to the EU Financial Services Action Plan, which is due to be implemented in EU member states during 2005/6, will be the creation of additional less-regulated market segments. The first of these was opened by Euronext in May 2005, whose Alternext market segment is closely modelled on AIM. Therefore, the aIPO technique could well spread to a number of other countries across Europe.[7]

Finally, in the transactions we analyse in this paper, the vendors were initially agnostic regarding whether the company was publicly quoted or not following the sale; they were mainly interested in maximising proceeds. For many companies, becoming publicly traded is clearly an objective in its own right, and so they may rule out sales processes involving trade or private equity purchasers. However, we speculate how the aIPO technique might be used in such circumstances.

The remainder of the paper proceeds as follows. In section 2 we describe the four aIPO deals that have been completed to date. In section 3 we consider the factors that make aIPOs feasible, including legal and regulatory issues, marketing, and risk allocation. Finally, in section 4 we discuss the factors that would determine the choice

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[7] It should be noted that the quotation services offered by the Pink Sheets and the Nasdaq Over-the-Counter Bulletin Board (OTCBB) in the U.S. differ from AIM (and Alternext) in some important respects. As noted by Macey and O'Hara (2004), the Pink Sheets and OTCBB do not provide issuer listing services but rather provide a quotation service to market makers. In regulatory terminology, Pink Sheets is considered a "non-exclusive securities information processor and inter-dealer quotation system", and is neither an SEC registered exchange nor an NASD regulated broker/dealer (source: www.pinksheets.com), and the OTCBB is a "regulated quotation service" for equity securities that are not listed or traded on Nasdaq, NYSE, or any other national securities exchange. Consequently, issuers cannot conduct an IPO on either Pink Sheets or OTCBB, whereas companies do conduct IPOs on AIM, and are subject to initial and on-going requirements imposed by the London Stock Exchange and other regulators.

between an aIPO and bookbuilding, and the more general impact that aIPOs may have on the primary equity market.

## 2 Clinical evidence on accelerated IPOs

At the time of writing four aIPOs have been completed, and it is reported that three additional aIPO bids have been unsuccessful.[8] The first two aIPOs that were completed – those of Northumbrian Water and Center Parcs – involved mature businesses, although the two most recent deals – for Torex Retail and Centaur – are for much smaller, less established companies. Details of the companies and the transactions, and the timing of key aspects of the deals, are presented in Table 1 and Figure 1. In this section we describe the deals, and in section 3 we address the common issues that are raised by aIPOs.

### *2.1 Northumbrian Water*

Northumbrian Water[9] is the regulated water and sewerage business covering the north-east of England. It was owned by the French company Suez S.A. which had announced that, as part of a debt-reduction programme, it was considering selling part or all of Northumbrian Water. One complicating factor was presented by U.K. legislation, which requires an automatic referral to the Competition Commission of any proposed merger of U.K. water companies. In practice, the Competition Commission has tended to put onerous terms on any proposed mergers, so other U.K. water companies were

[8] The Financial Times (18 February 2004) reports that Collins Stewart was an unsuccessful aIPO bidder in the auction of Britain's Telegraph Group, part of Hollinger International, the US-listed publisher. It is also reported in the Financial Times (2 June, 2004) that another Collins Stewart-led aIPO bid participated in the auction of Premier Lodge (a UK budget hotel brand), but was not one of the final two preferred bidders. Finally, Reuters (12 August, 2004) reports that a syndicate of investors was bidding for Dyno Group (a drain-clearing service) and intended to conduct an aIPO. In the event, the vendors chose to sell the company to a trade purchaser

[9] We refer to the company acquired as Northumbrian Water, although formally the company acquired was Atlantic Water Limited, a wholly-owned subsidiary of Suez S.A. Atlantic Water was the holding company of Ondeo Services UK plc, which was itself the principal holding company of Northumbrian Water Ltd. The latter forms the overwhelming majority of the turnover, profits and assets of the holding companies.

unlikely to bid. On the other hand, private equity buyers faced no such restrictions, and were thought likely to be the principal bidders.

Suez engaged Morgan Stanley in early 2003 to seek competitive offers for Northumbrian Water, having rejected the IPO route. However, during the sale process one bidder emerged – involving advisory firm Econfin, broker Collins Stewart and Deutsche Bank – which intended to put together a bidding consortium comprising institutional investors. The investors they targeted focussed on publicly quoted equity, and so, if successful, the consortium intended to immediately seek a stock market quotation through an IPO. This was the birth of the aIPO concept.

A standard two-stage sale process was adopted by Morgan Stanley, whereby a shortlist of bidders was drawn up, all of whom were able to undertake detailed due diligence. The Econfin/Collins Stewart/Deutsche Bank proposal was included in the shortlist, and during March and April 2003 they marketed the proposal to potential institutional investors. This created an interesting problem, however, as Suez had been advised that an IPO was not the best option, and so extensive marketing to investors was discouraged. Unlike a traditional bookbuilt European IPO, the consortium was not able to produce an extensive pre-bookbuilding analyst report[10], but instead produced a marketing presentation[11] that was used in their meetings with potential investors. From the viewpoint of Morgan Stanley, they were running the auction, but were missing out on the lucrative IPO fees.

All bids had to be submitted by 11 April 2003, after which it was envisaged that a small number of preferred bidders would be chosen. A key aspect of the aIPO bid was that it would be highly leveraged (like a typical private equity buy-out) and so although the consortium envisaged an enterprise valuation for Northumbrian Water of around £2.2 billion ($3.66 billion), they intended the financial structure to be 75-80% debt. Deutsche

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[10] Research notes, including indicative valuations, are typically produced before the bookbuilding phase in European IPOs, but are disallowed in the U.S. (and Japan). See Jenkinson, Morrison and Wilhelm (2004) for further details and analysis.

[11] This consisted of around 20 slides and outlined the key features of Northumbrian Water and its regulatory environment, key financial data, the proposed bid vehicle and its capital structure, and a suggested enterprise valuation.

Bank agreed early on to act as lead debt arranger and underwriter, so the main challenge was to raise the equity finance. Furthermore, it became clear that Suez were interested in retaining a minority stake of around 25% in Northumbrian Water, and so the required equity participations from new investors totalled less than £400 million.

In the event a consortium of twenty-nine UK and US institutional investors agreed to take equity stakes totalling £389 million, and a special purpose bidding vehicle – Aquavit plc – was incorporated, with two non-executive directors who were willing to be board members on an on-going basis if the bid succeeded. Aquavit was successful in being short-listed, alongside two private equity partnerships.

On 16 May 2003 Suez announced that the Aquavit bid had been successful, and contracts were exchanged with completion being conditional upon, *inter alia*, flotation on the London Stock Exchange. The final bid valued the enterprise at £2.2 billion. This was exactly the valuation that the advisors had estimated in their marketing to investors. On 19 May, Aquavit announced its intention to seek admission to the AIM segment of the London Stock Exchange, and on 20 May Aquavit changed its name to Northumbrian Water Group plc (NWG). On 21 May NWG published its admission document for AIM, and two days later, on 23 May 2003, NWG shares were admitted for trading on AIM and the deal became unconditional in all respects. We discuss the regulations that facilitate such rapid IPOs in the next section. The shares, issued at 100p, closed on the first trading day at 109.5p, thereafter falling slightly to 107p at the end of the first trading week. Daily turnover averaged 1.7% of the outstanding shares during the first trading week. The aftermarket performance of each of the completed deals is presented in Figures 2 and 3.

This first aIPO was an innovative response to a perceived investor appetite for highly leveraged, high dividend yield, and publicly quoted, utility investments. The recent history of the UK utility sector had seen an increasing number of trade and private equity investors purchasing utility companies, and this aIPO allowed public equity fund managers to participate in the auction. There were certainly a number of special features of this case: Northumbrian Water is a mature company, with highly predictable cash flows that would have been relatively easy to value; the company had been listed on the main market in London for a number of years before its acquisition by Suez; and the desire of the previous owner to maintain a minority stake. However, as we shall see

below, the aIPO model can be applied in a range of different, and more conventional, situations.

### *2.2 Center Parcs UK*

Center Parcs are holiday villages that each incorporate a "Subtropical Swimming Paradise" housed in an enormous transparent dome. There are 19 such villages, mostly located in distinctly less-than-tropical parts of northern Europe. The business had been acquired by DB Capital Partners, the private equity arm of Deutsche Bank, and was then transferred to MidOcean Partners when the latter acquired Deutsche Banks' late-stage private equity investments in Europe and the US. MidOcean separated the 4 Center Parcs villages in the UK from the remaining continental European villages and sold a stake in the latter to French company Pierre et Vacances. One of the villages that formed part of Center Parcs UK had sustained damage during a fire in April 2002, and was closed until July 2003. Having re-opened the village, and sorted out insurance issues, MidOcean and the management of Center Parcs started discussing sale options, and the management were given permission to approach a limited number of potential private equity purchasers of the business. Merrill Lynch advised MidOcean on the sale, and a number of interested trade and private equity investors emerged, along with Collins Stewart who intended to execute an aIPO. It is worth noting that the freeholds of the UK properties had earlier been subject to a sale and leaseback arrangement, which limited the ability of potential investors to fund the acquisition through debt.

The sale process followed a similar path to that of Northumbrian Water, and during October 2003 MidOcean, in consultation with the management of Center Parcs, invited bids from Collins Stewart, three private equity funds and two trade buyers. Collins Stewart intended to retain the senior management of Center Parcs post-acquisition, and so asked MidOcean for permission – which was duly granted – to take the senior managers around their potential institutional investors to help them market the investment proposition. In mid-November the bidders were asked for their valuations, and any conditions attaching to them. Collins Stewart bid £285 million (including the issue of loan notes with a nominal value of £52.5 million) and this emerged as the most attractive bid to MidOcean. Although Collins Stewart were not given an exclusive right

to negotiate the deal at this stage, MidOcean agreed to underwrite a portion of their legal and other costs associated with finalising a deal in the event that another bidder was chosen.

A special purpose bidding vehicle was incorporated on 24 November, and was renamed Arbor plc on 26 November, with three non-executive directors unconnected to Center Parcs management. As in the Northumbrian Water deal, Collins Stewart announced that it proposed to appoint key executives of the acquired company – in particular the Chairman, Chief Executive and Finance Director – to the board of Arbor, alongside the non-executive directors, on completion of the purchase. Exclusivity was finally granted to Arbor at the end of November.

On 4 December 2003 MidOcean announced that Arbor was the successful bidder, and contracts were exchanged to purchase the company, conditional *inter alia* upon AIM admission. The same day Arbor changed its name to become Center Parcs (UK) Group plc, and an application was submitted to the London Stock Exchange for admission to AIM. On 11 December Center Parcs floated on AIM.

The AIM admissions document provides details of the thirteen institutional investors who took stakes of more than 3% at the flotation. These investors[12] included some of the most prestigious names in fund management, and between them they subscribed for 68.7% of the business at flotation. Over the first three months following flotation, one of these investors (Canada Life) sold its entire stake, another (ISIS) increased its holding, and a new institutional investor (Zurich Financial Services) acquired a stake of around 5%. The remaining investors neither increased nor decreased their holdings.[13] The shares, sold to investors for 100p closed the first trading day at 104.5p, rising modestly thereafter to finish the first trading week at 106.5p (see Figure 2).

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[12] Those holding more than 3% at the flotation were Fidelity Investment Services, Canada Life, Liberty Square Asset Management, Perry Capital, Millgate Capital, Morley Fund Management, Credit Suisse Asset Management, M&G Investment Management, Henderson Investors, Tudor Capital (UK), UBS Asset Management, Threadneedle Investment Managers and ISIS Asset Management.

[13] It is possible to monitor the investments accurately as any investor holding more than 3% of a company has to declare, via the London Stock Exchange regulatory news service, any changes in their holdings.

Daily turnover averaged 1.8% of the outstanding shares during the first trading week (see Figure 3).

The first two aIPOs therefore involved buy-outs of long-established businesses. In the case of Northumbrian Water the cash flows depend critically upon the periodic reviews of allowed prices by the UK water regulator, and are highly predictable between such reviews. Center Parcs was also a well-established business, with assets in place and cash flows that are reasonably predictable, although the fire that had affected one of their properties had seriously affected their recent financial performance. Both aIPOs were organised by Collins Stewart. However, the next two aIPOs were organised by other advisors, and involved rather different types of businesses.

### *2.3 Torex Retail*

Torex Retail[14] was the retail systems division of healthcare specialist Torex plc (which was itself in the process of merging with iSoft). In late 2003 Torex Retail was put up for sale by its parent and attracted interest from a variety of trade and private equity bidders, as well as a bid led by Robert Loosemore, who had previously been an executive director of Torex plc before leaving the company in 2000. In January 2004 Mr. Loosemore emerged as the preferred bidder and was given a period of exclusivity to complete the purchase. He was advised by Evolution Beeson Gregory (EBG), who suggested that the acquisition could be financed by public equity fund managers if an immediate flotation could be executed.

During January and early February 2004 EBG marketed the proposition to potential investors, with an acquisition valuation of £64.5m and on the basis that investments would be in two tranches: roughly half the consideration would be payable on completion of the purchase, and the remainder would be payable at the time of, and would be conditional upon, flotation on AIM. An acquisition vehicle – Lynxangel (Holdings) plc – was established on 4 February 2004. The sum sought from equity

[14] We refer to the company acquired as Torex Retail, although formally this comprised Torex Retail (Holdings) Ltd., Torex Retail Ltd. and a 69.8% stake in Logware Informationssysteme GmbH.

investors totalled £47.5 million, which would represent 78.8% of the enlarged issued share capital, with Robert Loosemore owning most of the remainder.

On 10 February 2004 Lynxangel exchanged contracts to purchase Torex Retail, and investors, to whom the issue had previously been marketed, were asked to subscribe on the basis of a placing memorandum which constituted an advanced draft of the AIM admissions document that the company intended to use at flotation. Demand for the shares was strong and the buying syndicate ultimately involved around 40 institutional investors, 9 of which had shareholdings in excess of 3%.[15] On 16 February the acquisition was completed. However, since the equity investors had at this stage only paid the first tranche – £25m in total – of their investment, the remainder of the purchase was financed by debt,[16] much of which was to be repaid out of the second tranche of equity that would be received upon flotation.

On 17 February Lynxangel changed its name to Torex Retail plc and announced that the company intended to seek admission to AIM. The company duly went public on AIM on 2 March, and the second tranche of the equity investments were received. The shares were issued at 40 pence and closed the first trading day at 60.5 pence (see Figure 2). Turnover on the first day was extremely high, totalling over 15% of the issued equity. In the first month after flotation, of the nine institutional investors with stakes in excess of 3%, two increased their holdings (Schroder and ISIS), one sold a part of their holding (Artemis) and one investor (Canada Life) sold their entire holding.

Various aspects of this aIPO are notable. The early granting of exclusive bidder status to the Loosemore/EBG team reduced the need to accelerate the IPO process to the same extent as the earlier aIPOs. It is also interesting that the public equity investors were prepared to hold unquoted shares for two weeks before AIM admission occurred. Indeed, although the second tranche of the equity investment was conditional upon flotation occurring, the first tranche was invested unconditionally, and so could – had some

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[15] These were Schroder Investment Management, ISIS Asset Management, New Star Asset Management, Artemis Investment Management, JP Morgan Fleming Asset Management, Jupiter Asset Management, Morley Fund Management, Newton Investment Management and Canada Life.

[16] This comprised a £21m bank loan, and the issuance of secured loan notes to Torex plc which could be redeemed for £16.6m. Lynxangel also took on some other liabilities totalling £5.3m.

problem been encountered with the flotation process, or had a material adverse change occurred – have remained unquoted. This case shows, therefore, an increasing tolerance among investors to accept such risks, presumably in part due to the experience of the earlier aIPOs which had demonstrated the feasibility of rapid flotation, and a willingness to adapt to the special circumstances of the sale process.

### *2.4 Centaur*

Centaur Communications (CC) was a privately-owned business magazine publisher. The investors, led by U.S. private equity fund VS&A Communications Partners II LP, and including Griffin Land & Nurseries Inc. and Graham Sherren – who founded CC and was its chairman – sought to sell the company in December 2003. An informal auction was conducted and bids were received from 11 private equity funds and trade buyers. In addition, an aIPO bid was organised by advisor Numis, who planned to purchase CC with the support of the existing management, with equity financing coming from public equity investors. Graham Sherren was to be the Chairman and Chief Executive of the new company, and the proposed CFO was to be the existing Group Finance Director of CC.

In January 2004 preferred bidder status was granted to Numis, with whom the vendors then negotiated the sale on an exclusive basis. A new company – Centaur Holdings plc – was created and a share purchase agreement was signed on 27 February, which valued CC at around £145m. The directors of Centaur Holdings accepted shares in the new entity as payment for part of their equity holdings in CC, resulting in an equity stake of just under 5% being held by the directors (who agreed not to sell any shares for at least one year). A placing agreement was also signed on 27 February whereby Numis undertook to find investors conditional upon AIM admission occurring by 10 March (or at a later, mutually agreed, date not later than 1 April). The AIM admission document was also published on 27 February.

On 1 March Centaur Holdings announced its intention to see admission to AIM, and flotation duly occurred on 10 March. The shares were issued at 100p, and finished the first trading day at 102.5p before falling below their issue price in subsequent trading (see Figure 2). Turnover on the first trading day was high, representing 7% of the

outstanding shares. The only shareholder with more than a 3% stake at flotation was Griffin Land and Nurseries Inc., who retained a stake of 4.4%. In the first month of trading, three fund managers[17] declared stakes in excess of 3%, representing in total around 20% of the issued equity.

One interesting aspect of this case is that one of the leading trade bidders in the auction was Incisive Media, whose broker was Numis. Incisive Media were not pleased to have been out-bid by their own broker and claimed that permission had not been given for Numis to work on a competing bid. This allegation was denied by Numis, but press reports suggest that Incisive Media proceeded to lodge a formal complaint with the UK Financial Services Authority, citing the rules relating to acting with integrity and managing conflicts of interest. Numis is no longer broker to Incisive Media.

The CC deal, therefore, has similarities to the earlier Center Parcs deal in that a private equity vendor was looking to exit and an aIPO bidder was successful in the face of competitive private equity and trade purchasers. The aIPO involved no lock-up provisions for the private equity owners, who were able to realise their investments immediately, as was Graham Sherren who realised a large part of his investment in the company at flotation.

It is clear that the innovation – initially introduced by Collins Stewart and Econfin – has been very rapidly copied. Indeed, it is possible that rival bidding consortia, promoted by different advisors, may appear in the future, each proposing to conduct an aIPO but with different institutional backers. In the next section we investigate some of the important questions that are raised by aIPOs, which we discuss in relation to the conduct and regulation of traditional IPOs conducted via bookbuilding.

[17] These were Jupiter Asset Management, AXA, and UBS Global Asset Management.

## 3 The critical features of aIPOs

The case studies analysed in the previous section highlight some important differences between a standard IPO conducted by bookbuilding, and an aIPO. In this section we start by considering the legal, due diligence, and marketing issues raised by aIPOs. We then discuss the regulatory environment which makes it possible to go public so rapidly in the UK, the allocation of risks between the various parties and how they compare with traditional IPOs, and the liquidity observed in aIPOs.

### *3.1 Legal issues*

In a traditional IPO, the issuing company makes a prior decision to go public and will appoint a lead manager (or co-lead managers) to run the whole process, and, along with various legal and accounting advisors, to undertake due diligence and prepare the prospectus upon which the issue will be marketed. The situation with an aIPO is quite different: the vendor has made no absolute commitment to undertake an IPO, and, as in the cases considered in the previous section, may be considering alternative sale options such as private equity or trade purchasers. This has some important consequences.

First, the entity that is bidding ("BidCo") for the company, and which ultimately goes public, is a shell company without any history. Indeed, BidCo will not typically even be incorporated until late in the bidding process. Consequently, all the negotiations with the vendors are carried out by the advisors – sometimes referred to as "virtual bidders" – who do not intend to buy the company themselves.

Second, when the BidCo is eventually incorporated, it is necessary for it to appoint initial directors. These directors cannot include, at this stage, executives of the target company, although it is possible to announce an intention to appoint such executives. However, the founding directors of BidCo will face important issues regarding their ability to give warranty protection to potential investors in relation to the business they are intending to acquire. In a traditional IPO, the management (and in some cases selling shareholders) are required to give general warranties in relation to the business as part of the underwriting agreement. In a trade sale, such warranties are usually more comprehensive and detailed. However, in an aIPO the founding directors of

BidCo are only able to give warranties to the extent that they obtain corresponding warranties from the management and/or vendors. In practice, the aIPO deals have managed to overcome such problems, usually with a set of warranties closer to those observed in traditional IPOs.[18]

Third, in traditional IPOs the underwriters typically insist on significant lock-up clauses which restrict the ability of private equity vendors and management shareholders to sell their stakes in the company until some months after the IPO. Such clauses are not observed in trade sales, nor when a private equity firm is the purchaser, and have not been observed in the aIPO bids. This reflects the hybrid nature of the aIPO transactions which involve the purchase of the entire company and an immediate IPO by BidCo. This ability for private equity investors to realise their investments immediately certainly increases the attractiveness of aIPOs to such investors as compared with traditional IPOs.

However, ultimately, much depends on whether the aIPO route results in a more accurate valuation of the company being sold, and this in turn depends in part upon the ability of the advisors to conduct due diligence effectively even though they do not enjoy the sort of franchise obtained by the lead investment bank(s) in a traditional IPO.

### *3.2 Due diligence*

A major role of the advisor during an aIPO is to conduct due diligence prior to approaching potential investors. For this they clearly need access to data and management. In the first aIPO the advisors had a significant task in explaining the concept to the vendors, and convincing them that adequate financial resource could be raised to support the bid. Furthermore, it is normal in such sale processes for bidders to sign confidentiality undertakings which limit their ability to share the results of their due diligence with third parties. Since the advisors in aIPOs are not the investors, it is clearly necessary for vendors to relax such rules and allow the advisors to approach potential investors (normally within defined limits).

Having gained the approval of the vendors, an aIPO bidder is in much the same position as a private equity or trade bidder. They enjoy even-handed, but not exclusive,

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[18] See, for example, the analysis produced by Simmons & Simmons, legal advisors to Aquavit, in "Northumbrian Water: making a virtual spash", *PLC*, November 2003.

access to management, until such point as they achieve preferred bidder status. Furthermore, the costs associated with conducting the due diligence, and in preparing the required documents upon which to market the issue and obtain entry to the stock exchange, are borne initially by the advisors. In the case of an aIPO, in order to expedite flotation should the bid be successful, advisors have tended to focus their due diligence on producing the admission document (similar in content to a prospectus) required by the London Stock Exchange for flotation on AIM. We discuss the regulatory requirements in more detail in section 3.4, but one potential drawback of aIPOs is that they involve the production of admissions documents that may never be used. The size of such sunk investments depends in part upon whether a competitive process is maintained throughout the sale process, and in part upon the way the issue is marketed to potential investors.

### *3.3 Marketing to investors and exchange of information*

In a traditional IPO, the mandated investment bank conducts all its due diligence investigations, finalises the deal structure and negotiates with the issuer before marketing the deal to investors. In practice, it enjoys a virtually[19] exclusive mandate to sell the company at this point. The situation with an aIPO is somewhat different.

In order to gain admission to the sale process, the advisor promoting an aIPO bid has to get some indications from investors that they would be interested in participating in a bid. In practice, this early marketing has typically involved little more than a short presentation regarding the business and an initial valuation range, which is given in one-on-one meetings with selected institutional investors. Having gained some initial support, and access to the sale process, the advisor then conducts due diligence with the objective of producing a draft of the AIM admissions document to present to interested investors, and upon which commitments of funds will be made. However, although this draft

[19] It is, of course, possible for the vendors to withdraw the issue and sell to another party during the IPO process, although such examples are rare. One example from the U.K. was the case of betting shop chain William Hill who were in the process of going public in February 1999 when the lead manager, Warburg Dillon Read, advised an issue price of 135p. This was significantly below the indicative price range of 155-175p. Press reports suggest that the vendors – Nomura's private equity unit – quickly received an offer of 150p from private equity firms Cinven and CVC Capital Partners and a deal was concluded within 48 hours. The IPO was cancelled and negotiations over abort fees for the advisors began.

admissions document will have many of the features of the formal prospectus issued during a conventional IPO, some of the important details – such as warranties from management, and vendors, or 10B5 statements from legal advisors – will not be available at this stage. However, since such issues are only being marketed on a private basis to institutional investors, there are no regulations that govern the basis upon which investors can be invited to subscribe.

Concerning the information flows between the investors and the advisor, in many respects the early stages of the process are actually similar to those observed in conventional IPOs, at least in Europe (for a discussion of the differences between U.S. and European IPOs see Jenkinson, Morrison and Wilhelm (2005)). Having chosen the investment bank(s) to act as the bookrunner(s), a syndicate of other banks is put together which sells (and underwrites) the issue. For European IPOs the bookrunner will co-ordinate the production of a research report, which typically contains factual information about the company along with forecasts of future earnings and, normally, a suggested valuation range (often based upon a variety of valuation techniques). This research is then distributed to selected institutional investors, who are often asked to fill in feedback forms giving their views about the strengths and weaknesses of the firm going public, the appropriate valuation, whether they want a one-on-one meeting, and whether (and how much) they intend to bid during the bookbuilding. In the U.S. (and Japan) such a report is not distributed to potential investors, although the sales teams may well have conversations with potential investors that cover much the same issues.

The initial stage of an aIPO is similar, although there is no necessity to put together an underwriting syndicate. As noted above, the advisor produces a research note or presentation, and suggests a valuation range within which it is proposed that the syndicate will bid. Investors are then asked for their views on the proposed valuation, and whether they want to invest. However, there are three key respects in which the interaction with investors is potentially different in an aIPO.

First, the information revelation problems that characterise bookbuilding – whereby potential investors are asked to invest in researching the company and then reveal information to the agents of the vendors, who can adjust the price in the light of this information – are clearly much reduced in an aIPO. The syndicate only needs to

secure enough commitments to cover the proposed bid. There is no benefit to generating huge over-subscription, and associated scaling back of investments, as often happens in conventional bookbuildings.[20] Consequently, the advisor can commit to allocating investors a share of the deal, and investors have an incentive to become informed but no incentive to low-ball their views on the appropriate value. The advisor organising the aIPO is not receiving any payment from the company being sold but is *acting exclusively for the potential investors*, thereby avoiding conflicts of interest.

Second, an important issue in an aIPO is whether – in the cases where the advisor is proposing to retain some or all of the existing management team – they are allowed to include the existing management in their meetings with investors, as happens in a traditional IPO "roadshow". To the extent that such meetings with management may enable investors more accurately to assess the value of the company, then a conflict may arise between keeping competitive tension in the bidding process and maximising the value of the company. If an objective of the auction process is to retain competitive bids for as long as possible then access to management has to be provided on an even-handed basis to all bidders and management cannot be used to sell any particular bid(s) to potential investors. A key issue, therefore, is at what stage to declare a "preferred bidder", who can then negotiate the final details of the transaction, and market the proposition to potential investors. Figure 1 shows when preferred bidder status was granted (and the regulatory compliances which we discuss in the next section) for the aIPOs considered in this paper. As can be seen, the main difference between the deals is the period between being granted preferred bidder status and flotation. In the Northumbrian and Center Parcs cases, the sale process remained competitive until a very late stage, and so management were not used in roadshow presentations at all. In contrast, in the case of Torex Retail, a previous executive of the company was spearheading the bid, and so was able to market the deal to potential investors. In the case of Centaur the Numis bid was supporting a buy-out by the existing management, and the long period of exclusivity enabled key executives to present the deal to investors.

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[20] For instance, Jenkinson and Jones (2004) report that in one-half of the European IPO bookbuildings in their sample, the issue was more than 10 times subscribed at the offer price.

Third, although the aIPO clearly overcomes the information revelation and free-riding problems relating to the investors in the syndicate, a conventional IPO may involve a wider range of investors who may provide information that is useful in pricing the issue. However, whilst this is probably true in respect of institutional fund managers, an auction of the company allows the involvement of private equity investors and/or trade purchasers who may bring valuable incremental information to the sale process. Furthermore, the advisor will be able to choose optimally the number of institutional investors to involve, until the marginal value of information equals the marginal cost. Ultimately, the effect on issuers will depend on how accurately the market price reflects the price achieved in the aIPO or bookbuilding. It is clearly too early to conduct a statistical analysis on the comparison of aIPO bids with the resultant market price, but, as Figure 2 shows, the deals completed to date have closed the first trading day at premia of between 2% and 10%. The one-month performance shows premia ranging from -5% to +20%. There is little evidence to date, therefore, that aIPOs result in more money being left on the table than bookbuilt IPOs. Note also that the direct costs of aIPOs are borne by the investors, rather than the issuing company.

Fourth, aIPOs may differ from conventional IPOs in terms of the types of investors to whom the deals were marketed and shares allocated. In the case of bookbuilding, Jenkinson and Jones (2004) show that one of the key determinants of allocation is whether the investors are perceived as long-term investors. Indeed, in the U.S. the bookrunner is able to track the shares in the initial trading period to check who is selling, and potentially punish syndicate members whose clients flipped the issue. In contrast, the aIPO bids seen in the UK have, to date, imposed no such restrictions, and, indeed a number of hedge funds (who are prime candidates to be flippers) have been included in the deals.

Finally, in an aIPO the investors – and the vendors – have to be convinced that the advisor can duly achieve their intention of conducting an immediate IPO with a few days of exchanging contracts. In the next section we discuss the stock market rules that allow the acceleration of the IPO process.

*3.4 How can companies go public so quickly?*

The key to going public so rapidly is the existence, and rules governing, the AIM segment of the London Stock Exchange (LSE). AIM markets itself as the LSE's "global market for smaller growing companies", although there are no specific eligibility requirements for AIM, which might restrict larger companies from choosing AIM rather than the main market (as witnessed by the case of Northumbrian Water).[21] For admission to the main market – previously known as the "Official List" – it is necessary to comply with the rules of the UK Listing Authority,[22] and the rules imposed by the LSE, before the shares can be admitted for trading. Together these rules impose requirements such as a minimum of 25% of shares being in public hands, a 3-year trading record (normally), and that all admission documents are pre-vetted by the UKLA. According to the advice issued by the LSE to companies thinking of going public, admission to the main market takes at least 12 weeks.[23]

In contrast, admission to AIM does not entail becoming "Listed", and therefore the UKLA is not involved in the admission process. The main responsibility for ensuring companies are appropriate, and prepared, for public trading rests with the issuing company's nominated advisor or NOMAD. The LSE maintains a register of NOMADs, which range from large investment banks to very small advisory firms. All companies seeking admission to AIM are required to retain a NOMAD, who guides the company through the process and certifies that the company has satisfied all the requirements for admission to AIM. Consequently, there is no *ex ante* vetting by the LSE or UKLA to check compliance, which results in a much accelerated timetable, and greater certainty regarding admission.

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[21] As at May 2005, 1197 companies had AIM quotations, with a total equity market value of about £36 billion. The number of companies quoted on AIM has been growing very rapidly: in 2004 294 new companies joined AIM, which represents over 70% of all European IPOs in this period. In comparison the number of companies listed on the main London market has been falling in recent years, and currently stands at around 900.

[22] Often an exchange is itself the listing authority (this was also the case some years ago for the LSE). However, to encourage competition between UK exchanges, the regulatory function was removed from the LSE, and the UKLA was established within the UK Financial Services Authority.

[23] See "A practical guide to listing" published by the LSE.

The only rules regarding timing are (1) that a company seeking admission to AIM should provide the LSE with basic descriptive information about the company at least 10 business days before the expected date of admission (the "rule 2 announcement"), and (2) that at least 3 business days before admission, an applicant must submit an admission document, a completed application form, and the relevant fee (the "rule 5 application"). Note, in particular, that there are no rules regarding the minimum number of shareholders, unlike, for example, the New York Stock Exchange and NASDAQ who require a minimum of 2000 and 400 investors[24] at the IPO respectively.

However, as Figure 1 shows, even these minimal rules can be relaxed in appropriate circumstances. In the case of Northumbrian Water, the LSE agreed that gap between the announcement of expected AIM admission and actual admission could be reduced to five business days (rather than ten).

The admissions document contains similar information as that found in a normal prospectus[25] but also has to include statements from the directors that they have adequate working capital, and that forecasts, estimates or projections included in the admissions document have been made after due and careful enquiry. Furthermore, the NOMAD has to make a declaration to confirm itself satisfied that the directors of the company seeking admission have discharged their responsibilities, have received satisfactory advice and guidance as to the nature of their obligations, and that the company and the securities which are the subject of the application are suitable to be admitted to AIM. This reliance on certification by NOMADs explains how AIM admission can happen so quickly.

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[24] The regulations are formally stated in terms of "round-lot holders" of at least 100 shares.

[25] Specifically, the rules state that the admissions document must disclose "information equivalent to that which would be required by the POS Regulations [Public Offer of Securities Regulations, 1995] whether or not it is required to produce a document under those regulations". Thus, even if, as in aIPOs, the public are not being involved in the offering, the admissions document has to include similar information and address all relevant risk factors. In the case of Northumbrian Water, with its wide range of assets and holding company/subsidiary structures, the admissions document was 148 pages. The other companies considered in this paper had fewer complexities, and so the admissions documents for Center Parcs, Torex Retail and Centaur were 96 pages, 64 pages and 90 pages respectively.

This very light regulation of AIM is being maintained despite the forthcoming implementation of the EU Financial Services Action Plan.[26] In anticipation of the requirements imposed on "Regulated Markets" by the FSAP, AIM has relinquished its status as a Regulated Market. Since October 2004 it has become an "Exchange Regulated Market", partly in order to retain the permissive and streamlined admissions process that facilitates aIPOs. As noted earlier, Euronext launched the Alternext market segment in May 2005 which has a similar light touch regulation, and may encourage aIPOs in other European countries.

### *3.5 Who bears the risks in aIPOs?*

In an aIPO the investors participate on condition that the shares will be publicly quoted within a very short period. Therefore, at least three risks exist: (1) that the public quotation is either delayed or denied by the LSE (2) that some material adverse change in the business occurs between the end of the auction and the completion of the sale, and (3) that systemic, or *force majeur*, risk occurs in the period before flotation. The allocation of risks between the vendors, the investors, and those acting as advisors to the aIPO can be shared out in various ways, but it is interesting to analyse how these risks were distributed in the completed aIPOs.

The model used by Northumbrian Water has been followed quite closely by the other deals, and consisted of a sale and purchase agreement (SPA) between the vendors and BidCo, and a placing agreement between BidCo and the advisors. Given the competitive nature of the bidding process, it was necessary to have as little conditionality or delay between exchange and completion of the SPA as possible. However, the AIM rules implied that there would be a delay of a few days before flotation could occur. Consequently, the material adverse change (MAC) risk was the first main concern of the SPA, and in the event this was limited to "no material adverse change … in the condition (financial or otherwise), business, assets, operations, properties or performance of the Group from 16 May 2003, having occurred." This is a very specific business MAC

[26] The main directives that comprise the FSAP relate to (i) Market Abuse (ii) Prospectuses (iii) Transparency and (iv) the Market in Financial Instruments. The FSAP is due to be implemented throughout the EU during 2005/6.

clause, and does not cover material adverse changes in either the industry or financial markets more generally. Usually these latter are captured by *force majeur* clauses that are common in conventional IPOs (and give the underwriters the option of withdrawing the issue), but in this deal such risks were borne explicitly by the investors.

The second main condition in the SPA was that admission onto AIM should have occurred by 3 June 2003. If admission had not been granted by this date then the deal would have fallen through, and so the vendor took on this risk, although in the knowledge that the advisor had an extremely strong financial incentive to achieve flotation by the required date.

The placing agreement, which is also conditional upon AIM admission being achieved, specifies the fees paid to the advisors for procuring investors, and commits the advisors to "underwrite" the issue. However, the underwriting risk is essentially minimal, as the placing agreement is only signed after the advisor has received written undertakings from the investors that they will subscribe for the shares. This is similar to the situation in conventional IPOs where the final price of the issue is set at the end of the bookbuilding period to ensure that sufficient demand exists, and so underwriting risks are negligible. The costs charged by the advisors are detailed in Table 1, and range between 4% and 5.1% of funds raised. These fees are comparatively high for UK IPOs: Ljungqvist, Jenkinson and Wilhelm (2003) report average gross spreads for 333 UK fixed price offerings and 83 bookbuildings of 2% and 4.4% respectively, with conventional placings tending to cluster at the lower end of this range. On the other hand, the advisors only recoup their costs if their syndicate of investors is successful and admission to the stock exchange occurs. This is quite unlike a conventional IPO where the investment banking syndicate is given a franchise to execute the deal.

Similar risk allocations have been observed in all the aIPOs considered in this paper, although one interesting development is that in the case of Torex Retail the investors paid the first instalment unconditionally, and so took on the risk that AIM admission would not be achieved. This may reflect the lower perceived risks associated with AIM admission as the aIPO technique has started to become established in the UK.

The conclusion from the above analysis, and evidence to date, is that although the lag introduced between winning the bid and going public can be reduced to about a week,

this nonetheless introduces risks for the issuing company and/or investors. Regarding the flotation risk, in an aIPO the vendors take the risk that flotation will not occur in the knowledge that the advisors – who as NOMADs are the ones who certify the company's compliance with the AIM rules – will only receive their fees if flotation occurs quickly. Provided the NOMAD makes the appropriate declarations, and adheres to the minimal rules laid out by the LSE, flotation *will* occur – the LSE has no ability to interfere. It is arguable, therefore, whether the floatation risks are, in practice, either significant or any greater than those observed in conventional IPOs (given that in conventional IPOs acceptance by the relevant exchange and/or regulatory authorities is very occasionally delayed at the last minute).

On the other hand, the vendors do not face the type of price risk that frequently afflicts conventional IPOs, where the bookrunner will often advise, at the eleventh hour, a price reduction to ensure a "successful" flotation. Nonetheless, the gap between the announcement of the successful bid and flotation inevitably introduces risks. For the aIPOs considered in this paper, such risks were borne in the main by investors. In large part the allocation of risks depends on the scope of the "material adverse change" clause that is agreed between the issuer and their advisors. In conventional IPOs there is typically a fairly general MAC clause, including *force majeur,* which enables the issue to be withdrawn at the last minute by the bookrunner. However, since market trading typically starts just a few hours after allocations have been finalised, and any major changes in the value of the business (or major market movements) that occur during the bookbuilding period can be reflected in the final price (since the indicative price range in a bookbuilding can be amended[27]), such risks are limited in practice. Consequently, the risks borne by investors in a bookbuilding probably are somewhat lower. The experience of aIPOs to date suggests, however, that such risks need not impede successful execution, and the perceived risk associated with not achieving admissions onto AIM within a short time scale will surely decline significantly over time as more aIPOs are completed.

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[27] Some regulators impose limits on the extent of price range revisions, and require re-filing if greater adjustments are sought. Whether to relax these regulations is currently the subject of debate in the U.S.

### *3.6 Is after-market liquidity low?*

An important consideration in judging the performance of aIPOs is the effect on after-market liquidity. Given that the number of investors participating in the syndicate is fairly low, there might be concerns that after-market trading would be limited. To investigate this issue, information on the volume of trades (relative to outstanding shares[28]) is presented in Figure 3. For comparison, a control sample of conventional IPOs that took place on AIM in the same period was constructed.

The pattern of turnover being high in the first trading week, before falling sharply to settle at less than 1% of outstanding shares per day, is common across all the companies and the control sample. It is noticeable that the aIPOs generally had significantly higher turnover in the first two trading weeks than the control sample, before converging to similar levels of turnover over the next two weeks. Therefore, the evidence to date suggests that after-market liquidity is not compromised by employing an aIPO.

## 4. Discussion and conclusions

In this final section we discuss the key distinguishing aspects of aIPOs and consider whether such a technique is likely to be applied more widely, both within the UK and elsewhere.

Many of the issues raised in this paper relate to the question of how best to stimulate competition between investors to maximise the price received by the vendor. Traditionally there have been two rather separate approaches: the private sale and the public offering. Auctions, of varying degrees of formality, have long been used successfully in private sales, and investment banks are often employed to prepare the company for sale, to market the opportunity, and to run the auction process. Although such auctions are often highly competitive, the question remains as to how the valuation achieved relates to that which potentially could have been realised by conducting a public

[28] Similar results are obtained if turnover is measured relative to the estimated free float. Such a free-float adjustment would apply to Northumbrian Water (to reflect the 25% stake held by Suez), Torex Retail (to reflect the 20% stake owned by Robert Loosemore) and Centaur (to reflect the stakes totalling approximately 10% held by the management and an existing investor, which were subject to lock-ups).

offering. On the other hand, although formal auctions have been used for public offerings in a variety of countries, they seem to be dominated in practice by bookbuilding (Sherman, 2002). While bookbuilding involves public equity investors in the process of arriving at an issue price, the process is clearly highly intermediated and lacks transparency. Affording investment banks discretion over allocation *may* potentially be beneficial in reducing underpricing – even relative to formal auctions (see Biais and Faugeron Crouzet, 2000) – but such potential benefits may be out-weighed in practice by the conflicts of interest that inevitably arise between the investment bank, the investors, and the vendor. The aIPO approach means that the vendor can harness competitive bids from trade buyers, private equity *and* public equity investors simultaneously, whilst avoiding conflicts of interest.

The possible implications for investment banks of this new approach are considerable: the aIPO changes their role in the two areas – valuation and allocation – where they have recently been most criticised. Whilst the advisors will be expected to perform due diligence and to suggest a valuation to potential investors, the incentives for either party to suggest low valuations are much reduced by the auction process. As such, information revelation problems are largely avoided. Furthermore, discretion over allocation ceases to be an issue as the advisor, who works for the investors, has no incentive to generate investment commitments in excess of the syndicate valuation. Clearly, the main requirement for a successful aIPOs is that the auction process should be competitive, and the issuer is likely to retain an investment bank or some other intermediary to stimulate interest and undertake, perhaps, some preparatory vendor due diligence. Although the IPO market has increasingly become the domain of bulge bracket international investment banks, the competitive threat from more specialised advisors – such as those involved in the deals analysed in this paper – who might establish a strong reputation for due diligence and valuation, could increase if aIPOs were to become established.

What are the possible drawbacks of aIPOs? First, it might be argued that aIPOs have the disadvantage of not involving retail investors. This is true, but then neither are retail investors involved in the bookbuilding stage of conventional IPOs, and so contribute nothing to valuation accuracy. Should the aIPO bid succeed, clearly retail

investors can make purchases in the secondary market. For many companies, any perceived advantage of having retail investors involved at the initial offering may be outweighed by winners curse problems and/or increased regulatory burdens associated with making a public offer involving retail investors.

Second, aIPOs are likely to involve fewer institutional investors than conventional bookbuilding. Again this is probably true, but it is not obvious that this will result in lower valuation accuracy. Although bookbuilding may overcome information revelation problems, the existing literature stresses that the bookrunner may need to *restrict* the involvement of investors in order to elicit accurate information. Even a single advisor can easily market an issue to 50 investors in a relatively short period of time (as witnessed by the cases considered in this paper). A large IPO syndicate may approach several hundred investors, but it is not clear that result would be superior valuation accuracy.

Third, are aIPOs only relevant to sales of UK companies? Certainly the deals observed to date have all involved companies whose main business is located in the UK, but there is no reason in principal why the aIPO approach should not be used in respect of non-UK companies. Even if a company's "home" stock exchange does not have a market segment with the light regulation of AIM – thereby creating a significant lag between the sale and market trading – foreign companies increasingly go public on AIM. In May 2005, of the 1197 companies traded on AIM, 144 were non-UK (of which 94 had joined the market since the start of 2004). There is no need to be incorporated in the UK, shares can be traded in any (freely available) currency, and accounts can be produced according to International Financial Reporting Standards, UK GAAP or US GAAP. Clearly the choice of floatation on AIM may restrict the set of international public equity investors who would be able to participate, but this may not be a significant impediment. Indeed, the initial quotation on AIM could be used as a stepping stone towards joining the main market in London (as has already happened in the case of Northumbrian Water ) or listing on a foreign exchange.

Fourth, although aIPOs have succeeded in gate-crashing a few buy-out auctions, will this innovation have wider-reaching effects? What about companies where the prime motivation of the (majority of the) investors is not to exit but to raise new capital for the company, and to go public? In this case the original investors may not want to sell-out to

a private equity or trade purchaser. Although no such transactions have as yet taken place, it is possible to speculate how an aIPO approach could be applied. For instance, the company could announce that it intended to offer part of its equity capital (which could include both primary and secondary equity) and invite competing groups of investors to bid for the shares, on the basis that the shares had to be publicly quoted within a specific time-period. The company could engage its own advisor to prepare a data room to provide documentation, or even conduct vendor due diligence, that could be made available to competing advisory firms to use in preparing valuation proposals. These advisors could then market their propositions to potential investors, and prepare bids. As in conventional buy-out auctions the competing syndicates would submit bids, and the issuer would retain control throughout the whole process. In this case there might be no need for a separate BidCo, and the existing management could be engaged to meet with investors on an even-handed basis (perhaps once a few advisors had been shortlisted).[29] The shares would be allocated to the highest bidding syndicate, and AIM admission could then happen almost immediately.

The main advantage of this approach would again be the maintenance of competitive tension throughout the IPO process rather than giving a lead-manager franchise to a particular investment bank. The issuing company is not relying upon valuations asserted by rival advisors in the bake-off for the mandate, nor is the advisor subject to any conflicts of interest in respect of allocation.

Therefore, although aIPOs were first introduced in the context of buy-outs, the technique may have more widespread application. Of course, the relative efficiency – from the point of view of the issuing company – depends ultimately on the accuracy of valuation and direct costs of aIPOs versus bookbuildings. The latter *may* involve more investors, who *may* reveal more accurate information on the appropriate valuation, although as noted by Sherman and Titman (2002) participation in bookbuilding may have to be restricted to reduce the free-riding of investors on information produced by others. On the other hand, the information revelation problems associated with bookbuilding are

[29] A separate BidCo is needed, in particular, when the bidders intend to change the capital structure, as in the Northumbrian Water case. However, this case also illustrates that it is possible for the existing owners to retain an equity participation in such deals by accepting BidCo shares as (part) payment.

overcome in an aIPO where the advisor is working for the investors rather than the issuing company, and participation is naturally limited by the highest valuation of the syndicate.

In conclusion, the aIPO is one of the more interesting innovations to have been introduced to the primary equity market in recent years. From the point of view of the company, it is possible to let the market decide whether the value of the company is higher in private equity, trade, or public equity hands. Although bookbuilding has some features of an auction, in practice the bookrunner has considerable control over the final issue price, and invariably encounters conflicts of interest. Such conflicts led the IPO Advisory Committee, established by the NYSE and NASD in the U.S., to consult on possible regulatory steps to promote transparency (and presumably accuracy) in IPO pricing.[30] One conclusion of this paper is that changes in regulations that facilitated rapid flotations – or the creation of relatively lightly regulated market segments similar to AIM – might be alternatives worthy of consideration. From the viewpoint of institutional investors, aIPOs are likely to be attractive to those who are informed and want to be assured of participation in return for sharing their views on valuation, and unattractive to those investors who contribute little in the way of information but who nonetheless benefit from the discretionary allocations by investment banks in bookbuildings. Finally, the aIPO process would seem to encourage the entry of specialist advisors into the market that compete on the basis of their due diligence and valuation skills, and who avoid any conflicts of interest by working solely and unambiguously for their syndicate of investors.

[30] These alternative suggestions were: (1) the requirement for an independent broker/dealer to verify that the initial price range used for the bookbuilding, and the final price, were reasonable; (2) the use of a formal auction to establish the price, and (3) the requirement for the lead underwriter to disclose their valuation methodology in the prospectus.

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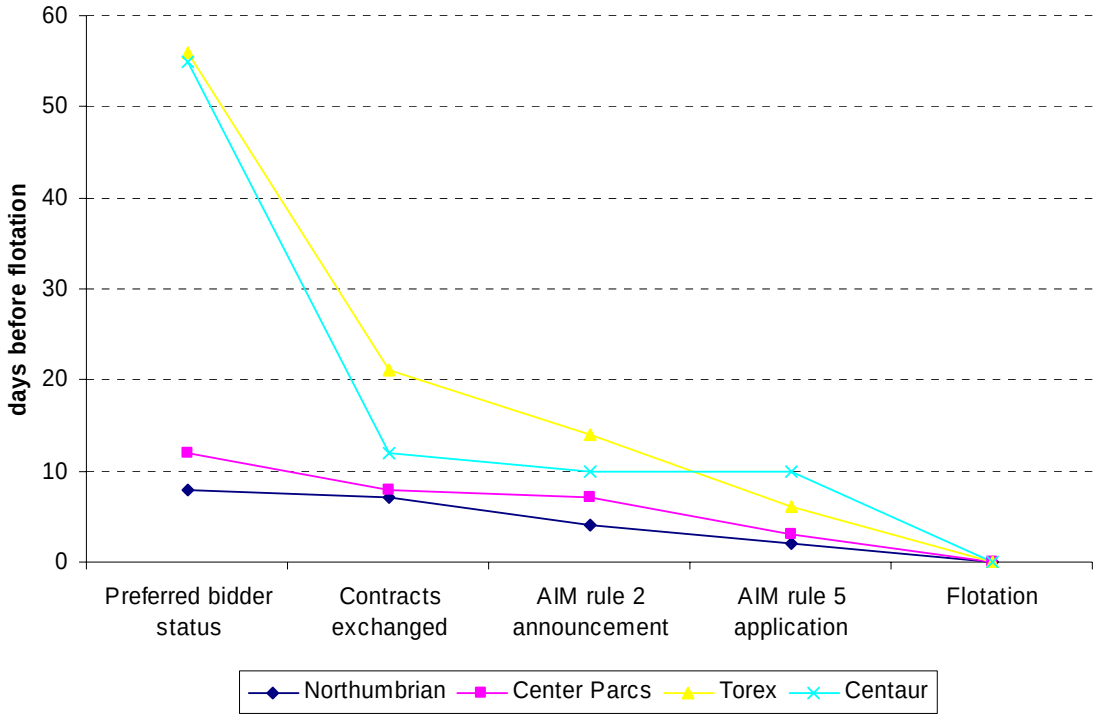
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## Figure 1

## Timelines for the aIPO deals

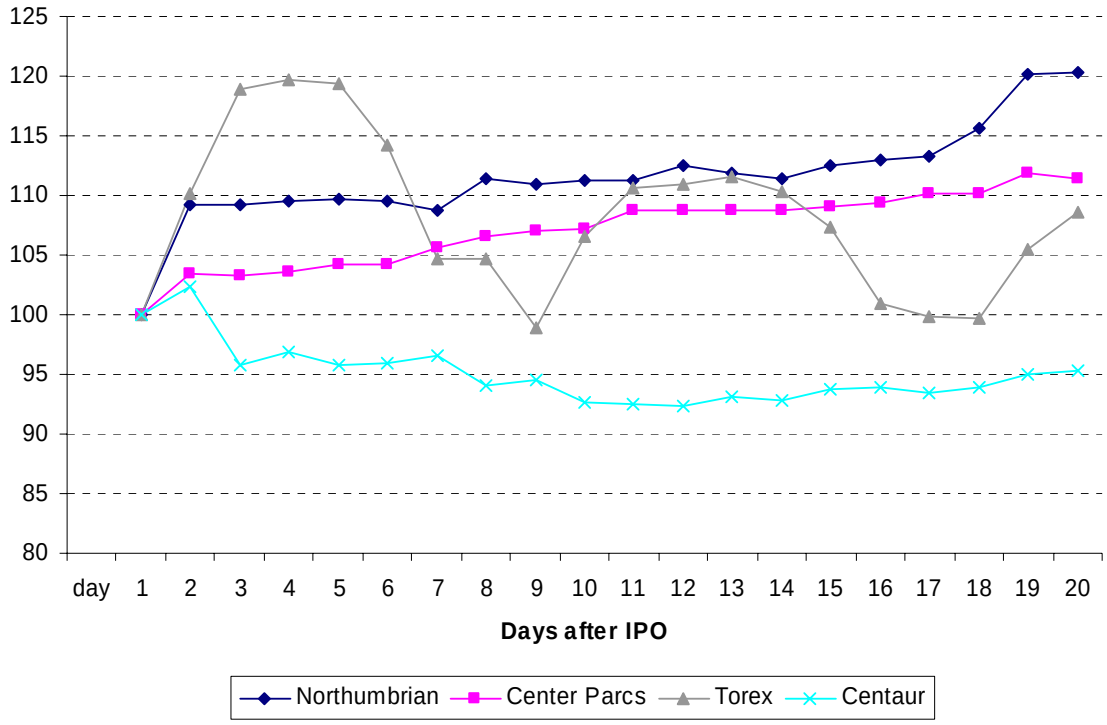
For each of the deal this figure shows the date, relative to the day of flotation, that the aIPO bid was given exclusive rights to negotiate the sale (preferred bidder status); when contracts were exchanged in respect of the share purchase agreement (which would be conditional upon flotation occurring amongst other conditions); the notification to the London Stock Exchange that AIM admission would be sought (rule 2 announcement); and the publication of the AIM admission document (rule 5 application). See section 3.4 for further discussion. The sources of this information are the latter documents, and discussions with those involved with the transactions. The timing of the granting of preferred bidder status is, in some cases, a best estimate rather than definitive.



## Figure 2

## Trading prices (relative to market)

This figure shows the closing price index on each of the complete aIPOs for the 20 trading days following flotation. For each company, the index is computed by normalising the issue price to 100 and subtracting market movements (as measured by the UK FT-A all share index).

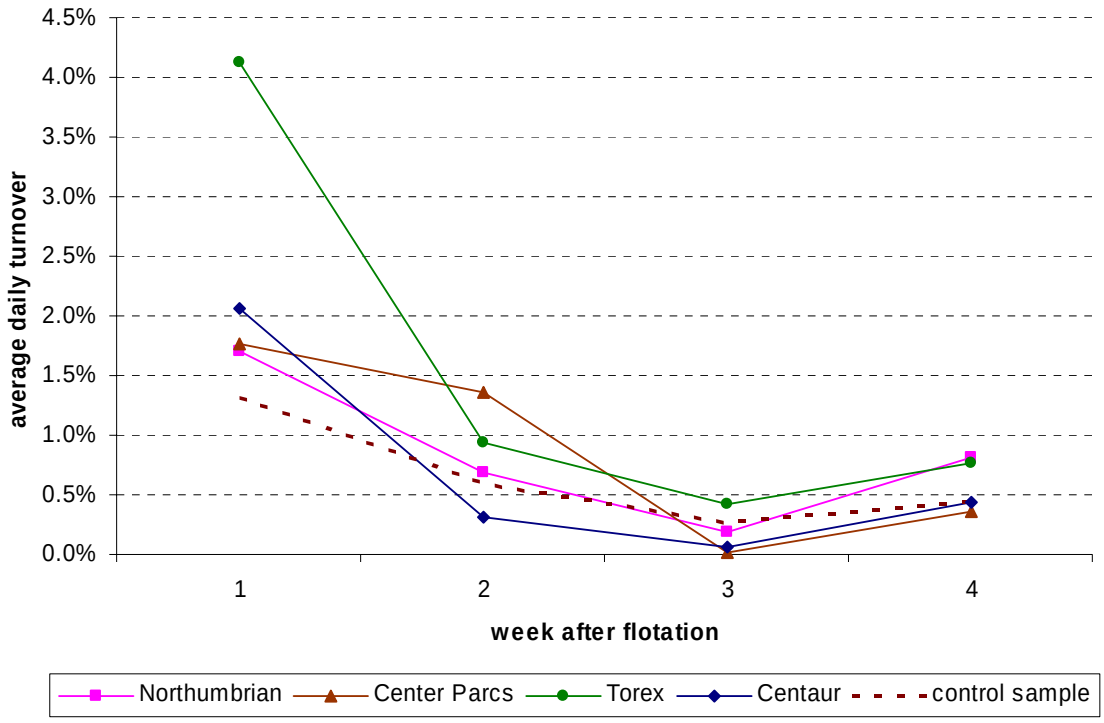



Source of data: Datastream

## Figure 3

## Turnover following floatation

This figure shows the daily trading volume as a proportion of the outstanding shares, averaged over each of the first four trading weeks. Results for a control sample of 9 IPOs that took place during the same period as the 4 aIPOs (May 2003 to March 2004), and that had market capitalisations at IPO of greater than £60m, are presented for comparison. In the case of the control sample, the daily percentage turnovers were averaged over the 9 companies for each period.




Source of data: Datastream

**Table 1: Information on the four aIPO bids**

Turnover and earnings before interest, tax, depreciation and amortisation (EBITDA) are from the last full-year accounts prior to flotation. Sources: AIM admission documents for each company, and London Stock Exchange Regulatory News Service.

| | *Northumbrian Water* | *Center Parcs UK* | *Torex Retail* | *Centaur* |
|---|---|---|---|---|
| Nature of business | Water Utility | Resort hotels | Retail point of sale systems | Magazine publishing |
| Previous year: | | | | |
| - Turnover | £504.0m | £160.7m | £67.6m | £62.0m |
| - EBITDA | £250.6m | £35.3m | £11.3m | £6.7m |
| Acquisition price | £2200m | £285m | £64.5m | £145m |
| Equity value at flotation price | £519m | £245m | £60.3m | £148m |
| Funds raised from public equity investors | £389m | £245m | £47.5m | £134m |
| Number of investors at IPO | 29 | 20 | ~ 40 | |
| Advisor | Collins Stewart & Ecofin | Collins Stewart | Evolution Beeson Gregory | Numis |
| Advisor fees - % of funds raised | 4% | 4.6% | 5% | 5.1% |