Chapter 3
Primary Market: Bringing Products to the Market

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Savings and investments between suppliers and users of capital are channeled by the capital markets from retail and institutional investors to businesses, government, individuals, and others. Capital markets are vital to the functioning of an economy since capital is a critical component for generating economic output. Capital markets include the primary markets that sell new stock and bond issues to investors as well as the secondary markets for the trading of existing securities.

3.1 An Initial Public Offering

An initial public offering (IPO) is a type of public offering of stock in a company in which shares are sold to investors and a private company is transformed through this process into a public company. IPOs enable companies to raise capital for expansion, to potentially monetize investments of early private investors and to become publicly traded enterprises. After the IPO, when shares trade freely in the open market, money is then exchanged for the shares between public investors in the secondary market.

3.1.1 Issuing Business

The objective of an issue is the creation of new fungible securities, legally and freely transferable and tradable. In practice, the issuing business is conducted predominantly by credit and financial service institutions, that is, by issuing banks.

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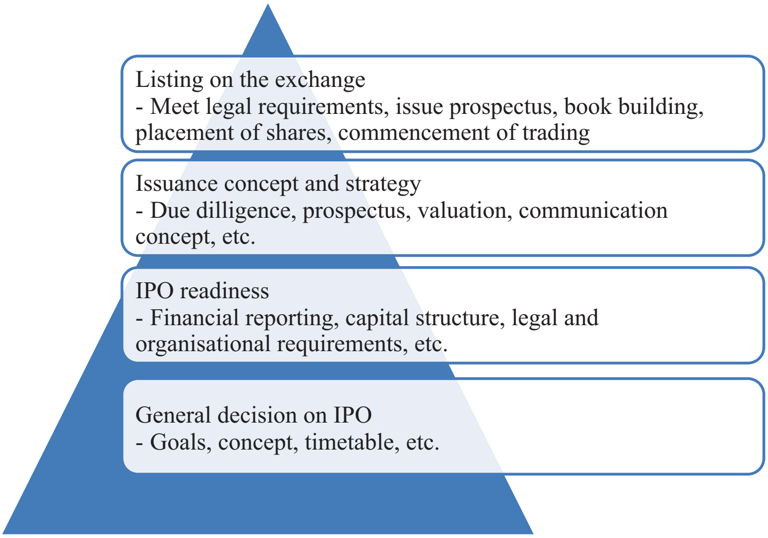

Fig. 3.1 IPO process

This covers their participation in the security-issuing process, especially in the advising, preparation, and placement of the issued securities.

There are numerous legal regulations for both the issuer and its advisors within the issuing process (Fig. 3.1). An issue of securities, namely the issuing business, does not necessarily involve a stock market listing of the newly issued securities. The issuance is, in general, completed with the placement of the new securities, i.e., their selling to the investors in the primary market. Nevertheless, a stock exchange quotation, resulting in the tradability of the newly issued and placed securities on a stock exchange in the secondary market, may benefit the issuer. As a rule, investors have an increased interest in a stock exchange quotation based on the simple proposition of exchange trading possibilities. These include price transparency, liquidity, supervision, and legal certainty of trading as well as the "information duties," which must be continuously fulfilled by the issuer. For example, there is financial reporting and ad hoc disclosure. Furthermore, capital investment and insurance companies as "institutional investors" are subject to numerous legal acquisition restrictions in the case of non-exchange quoted securities. Therefore, in practice, a share issue frequently takes place along with a stock market listing.

3.1.2 Placement of Shares

At a public offering, the new shares are offered to an unknown variety of investors for purchase. Within the scope of a public offering, different methods of placements have to be distinguished. In this respect, the tender or book building procedure is of major importance. Here, investors are requested to launch a generally discretionary bid for the new shares. Therefore, no fixed price or offering price is targeted by the issuer and the issuing bank. Instead, the price is determined by supply and demand in the capital markets, though in practice a minimum price is at least often specified.

Besides the tender or book-building procedure, the “public subscription” and the “market sale” are common. Generally, the public subscription is different from the tender or book-building procedure because, unlike the former, an offering price for the new shares is fixed. Consequently, investors may only launch the purchase bid at a predetermined price. The market sale is characterized by a placement of the new shares allocated to the members of the issuing banks with their respective customers.

At the end of a placement via a public offering, the “allotment” or “allocation” follows with the distribution of the new shares to the bidding investors. Furthermore, the allocation has central legal importance: The individual purchase agreements are concluded only with the allotment of a specific number of shares to each purchasing investor. Additionally, the allocation is of special importance if the demand for new shares exceeds the offering, meaning the investors have launched more purchase bids than new shares are available in the oversubscribed issue. In such cases, not all investors may receive their individually requested amount of shares. Generally, a partial or quota allotment occurs in a process known as “scaling down.”

Both the issuer and the issuing banks have wide discretion in the determination of concrete allotment criteria. Investors are not entitled to claim equal treatment in reality; however, the allotment is often performed in an arbitrary manner based on the business interests of both the issuer and the issuing banks. From an issuer point of view, this includes the composition of the shareholder base while the issuing bank is usually taking client relations into account.

The price investors pay is of paramount economic importance, especially for the issuer in a new shares placement. In practice, the “open pricing” and the “fixed pricing” face each other. In the first case, there is no firm price—at most, an indicative or floor price that is determined by the issuing banks; in the second, a placement is performed at a determined price from the start.

Finally, from a practitioner’s viewpoint, the high degree of internationalization of the issuing business must be highlighted, especially the dominance of Anglo-American conventions in all areas. The growing interconnectedness of banks is not the only reason though. Another is that increasingly issues are placed internationally—in a number of countries—for both issuers registered abroad offering their shares domestically and, conversely, for domestic issuers actually placing their shares abroad. The evidence is clear. The language of prospectuses must comply with their controlling legal framework. English is the chosen language, not only in more prospectuses today but also in the international capital markets (the common language within the issuing business is heavily Anglo-American oriented). Finally, the international practice has mainly influenced the issuing business, for example the implementation of the book-building procedure within a share issue.

3.1.3 On- and Off-Exchange Trading

In principle, the issuing process is completed with the placement or the disposal of the shares to investors in the primary market. However, the shares may not be traded at an exchange in the secondary market. Generally, a separate procedure must be undertaken for admission to exchange trading. The exchange represents the legally regulated and, therefore, the public and organized part of the capital market. At the exchange itself, capital is not raised, but securities are traded.

The public offering and the admission of the shares to exchange trading must first be distinguished. A public offering is legally defined and generally covers each and every message to the public that contains sufficient information on the offering conditions and the offered securities. This enables an investor to decide on a purchase or subscription of such securities. A public offering and admission to exchange trading may be combined. This means that shares are publicly offered as well as admitted to exchange trading. If the issuer offers its shares to the capital market for the first time, it is called "going public," an "initial public offering" or "IPO."

In Europe, the rules for a public offering as well as the rules for admission of securities to exchange trading have been harmonized by EU legislation. The goal of this far-reaching step is the creation of a single market for securities, especially for investor protection and market efficiency. On the one hand, EU-wide harmonization of prospectus information ensures equal investor protection and on the other a consistent requirement profile or a level playing field for issuers. Most important, the introduction of the "European passport," the reciprocal recognition of rules and regulations, implies that issuers may execute cross-border issues with only one prospectus at the same time.

The most important part of the German implementation of this EU regulation is the Securities Prospectus Act, which contains the following key aspects: The previously separated competence for prospectus examination between the exchanges of the German federal states and the federal authority, the Federal Financial Supervisory Authority (BaFin), has been unified. Central authority for any prospectus examination is now the BaFin. Therefore, the exchanges in Germany are generally no longer competent to assess a prospectus. The approval of a prospectus permits both the public offering of the respective securities and the application for trading at an organized market, i.e., exchange trading. Nevertheless, the formal distinction between the prospectus approval and the admission to trading is maintained. Therefore, approval of the prospectus does not automatically permit admission to exchange trading. The exchanges continue to be the competent bodies in the decision-making process for the admission to trading—and a consequent listing—independently of the BaFin.

The creation of a "European passport" typically leads to EU-wide validity of an approved prospectus. That is because a prospectus approved within the country of origin of the issuer is legally valid in all other member states and does not require a new examination by the other national authorities.

The EU-wide content-related harmonization of the prospectus requirements has mandatory prospectus formats. For instance, the deadline for prospectus approval is harmonized across the EU and, therefore, grants broad equality of procedure. Accordingly, as a rule, BaFin must inform its decision within 10 business days or within 20 days in the case of an IPO.

It must be noted that the EU-legal harmonization of the prospectus system does not affect the current prospectus liability. Both the question of prospectus responsibility (who is liable) and the question of the scope of liability (being liable for what and to what amount) still have to be answered according to the respective national laws of the single member states. An EU-wide harmonization of the different prospectus liability regimes has not been achieved yet.

In Germany, the exchange trading of securities at the regulated market requires an administrative admission (Listing). In legal terms, the admission to exchange trading is a decision governed by public law. Furthermore, admission to trading has to be separated from the quotation at the later introduction of the admitted securities. Legally, quotation is defined as the first price fixing at the exchange.

However, the exchange trading of securities at the unofficial regulated market (Freiverkehr) at the exchanges does not require an administrative admission. Trading here requires only an "inclusion" to the unofficial regulated market on a private law basis. Legally, it is a contract between the exchange operator and a trading member, typically without any participation by the securities' issuer. The regulated market of the exchange is an organized market regulated and supervised by state bodies. The unofficial regulated market (Freiverkehr) of the exchanges is part of the off-exchange trading (over-the-counter (OTC) market). This is mainly organized under private law and subject to only limited state supervision.

In Germany, there are currently eight stock exchanges, each legally equivalent and independent public law institutions: two in Berlin, and one each in Düsseldorf, Frankfurt, Hamburg, Hannover, Munich, and Stuttgart. If shares are supposed to be traded at more than one German exchange, then separate admission procedures have to be executed. These are usually subject to the same legal requirements. Formally, filings are separately completed per exchange. State supervision of the German exchanges is decentralized by the applicable German federal state where an exchange must have a registered seat. BaFin as central state authority for financial services generally has no supervisory functions for the exchanges.

3.1.4 Advantages and Disadvantages of a Listing

Commonly, it is at the issuer's full discretion to decide if the issued shares are supposed to be traded at an exchange. In practice, this decision is a multilevel process with the contribution of numerous external advisors, such as banks, auditors, lawyers, investor relations advisors, and marketing agencies. This usually starts several months before the formal listing procedure begins. At the heart of the decision is weighing the advantages and disadvantages connected to a company listing.

A listing offers the following advantages:

The issuer's publicity and level of public profile increase. Consequently, this may lead to an increased demand for the issuer's products and services as well as an increasing attractiveness for qualified employees. Moreover, the issuer's reputation may be boosted, especially with the inclusion in an exchange index. Investors are now able to trade the purchased shares at a legally regulated and supervised market at any time (for the most part), and at transparent pricing due to public trading. Furthermore, in practice, options for issuing additional capital market instruments (e.g., bonds) have to be named along with the creation of an "acquisition currency" (one's own listed shares could play this role) for investments in payment in asset deals.

Besides these advantages of a listing, being in the "spotlight" may create disadvantages as well. Significantly, this includes the risk of a takeover by a competitor buying up the issuer's exchange-traded shares. In addition, there is also a risk of granting extensive participation rights to external third parties. That may even lead to a loss of entrepreneurial freedom in decision making by the "old" management; for example, there is the risk of dismissal and replacement of the current management by a supervisory board increasingly occupied by "outside" persons. It must also be mentioned that there is a certain analyzability of the issuer for competitors (transparent issuer) based on the legal publication requirements of a prospectus, ad hoc disclosure, and financial statements. Additionally, there are one-off and ongoing costs of a listing, e.g., publication requirements, annual shareholders' meeting, and analysts' meetings. Finally, and this should not be underestimated, the exchange presence causes a continued pressure on the issuer towards its investors to justify its existence. The issuer may be immediately "punished" for a failure to meet publicly announced goals, which would be reflected in a decline of its stock price. This, in turn, might influence the issuer's financial standing. There is also a certain danger that the issuer's management may adjust corporate decisions more for the short-term effect on the share price rather than the company's long-term benefit.

3.1.5 Delisting/Going Private

A company could, for various reasons, also decide to delist its shares from the market and become a private company again. The reasons for a delisting could be either involuntary or voluntary. An involuntary delisting could be the result of violating regulations and/or failing to meet financial specifications set out by the stock exchange. A voluntary delisting might be the result of different considerations altogether. A listing costs money to maintain, which may not be justified, particularly for smaller companies. In addition, recurring expenditure for financial reporting requirements, ad hoc disclosures, and investor relations and the increased demands on management to develop high-quality relationships with analysts and investors need to be considered. A delisting also frees the company from certain transparency and disclosure obligations. Finally, a delisting provides greater strategic and financial freedom for a company. For instance, a delisting will facilitate long-term strategic planning as short-term considerations become less important.

Restructurings may be conducted with less public attention. In the event of a takeover by a strategic investor, a planned consolidation or reorganization can be more easily effected.

3.2 Financial Market Communication

3.2.1 Equity Story

The equity story presents the company's core competencies, success factors, and future prospects.

The success of an initial public offering largely depends on the communication phase ahead of the listing. The central element of the capital market communication is the company's equity story. It includes all the main characteristics including the business model and the strategy, and it positions the company in front of potential investors. Thus, the equity story is a way of "translating" the company's strategy into the language of investors and analysts. Because of its importance for the IPO's success, the equity story requires detailed work, well ahead of the listing date. It involves the company's top management and external advisers.

An explanation of the company's business model in as simple and convincing terms as possible is an important element. By the same token, adapting an outside-in view on the company to reflect the view of analysts and investors is equally important because capital market participants usually take a peer group approach in evaluating companies. In this peer group approach, investors are comparing companies with the same business model for the most attractive investment opportunities in the sectors.

Ultimately, the equity story should answer the questions what the company is doing and why an investor should participate in the IPO. The development of the equity story can be conducted in three steps:

1. Analysis of sector trends, growth potentials, and peer group positioning
2. Analysis of the strength, weaknesses, opportunities, and risks of the company (SWOT analysis)
3. Preparation of the investment case and demonstration of the concrete benefits for the company of the initial public offering

The following elements are vital in any equity story:

3.2.1.1 Company-Specific Factors

1. The company's product and/or service offering (e.g., key factors for revenue generation, development costs, profitability, product life cycles, dependencies on suppliers or raw materials, seasonal influences)
2. Prospects and sustainability of the business model (e.g., strategic goals, growth prospects, use of IPO proceeds, external growth opportunities, potential shareholder returns)

3. The company's client base (e.g., size and structure of the client base, client behavior, dependency on large clients)
4. The company history and its management (e.g., market position of the company, financial track record, patents or intellectual property rights, experience of the management, access to qualified staff, M&A track record)

3.2.1.2 Sector-Specific Factors

1. Attractiveness of the sector (e.g., description of the sector and the competitive advantages of the company, sector studies including growth assumptions, consolidation scenarios)
2. Competitive position in the sector (e.g., peer group description, benchmarking of product and/or service offering, market shares)
3. Barriers to entry (e.g., unique selling propositions, technological advantages)
4. Regulatory environment (e.g., relevant laws and regulations, subsidies)

3.2.1.3 Other Factors

1. Corporate structure of the company (e.g., legal structure, shareholdings, related parties, corporate law history)
2. Existing shareholders (e.g., anchor shareholders, blocking minority)
3. Transaction structure of the IPO (e.g., remaining shareholders, amount of capital to be raised)

The IPO will only be successful if the company can deliver and communicate an attractive and sustainable equity story to capital market participants. It can be helpful if financial communications advisors and the bank consortium support the equity story development based on the company's experience. The operational know-how of the company can be complemented with this capital market experience. If the core elements of the equity story are developed, different communication formats need to address the specific requirements of the target groups, from institutional and retail investors to sell-side analysts and the media and other stakeholders. The equity story will be the core of the entire financial communication during and after the initial public offering process. The impact of a well-crafted equity story should not be underestimated.

3.2.2 IPO Communication

In the marketing phase prior to the IPO, the equity story is presented to potential investors.

The IPO communication process can be split into four parts: preparation phase, image-building phase, pre-offer phase, and offer phase (Fig. 3.2).

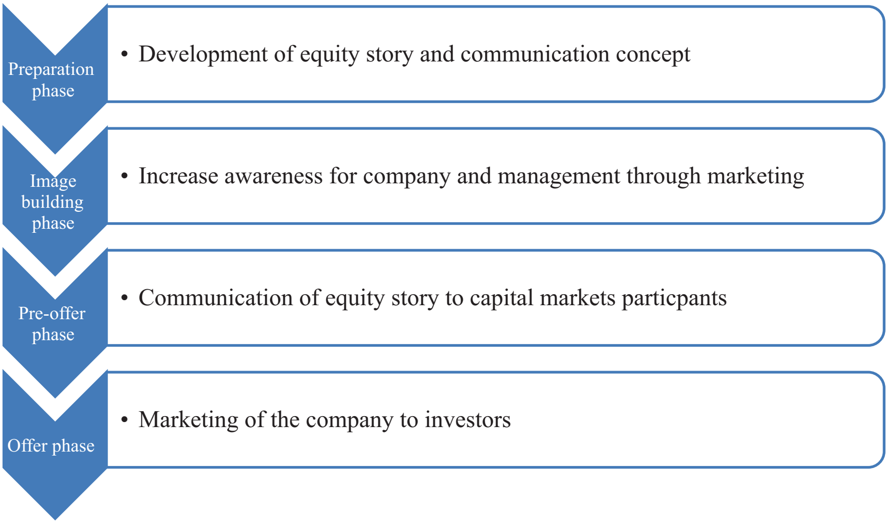

Fig. 3.2 IPO communication steps

In the preparation phase, the detailed communication concept for the IPO has to be developed. The heart of the concept is the equity story, serving as the basis for marketing the company to sell-side analysts and investors. As part of the communication concept, a clear plan is required with a view of the most important company stakeholders, of who should buy shares in the IPO process, and of who can serve as opinion leaders for investors and the wider public.

The image-building phase focuses on marketing the company and its products. In this phase the potential IPO is not actively mentioned, but the phase helps to increase awareness for the company and its management in the market generally, and with the media and investors in particular. Thus, this phase is especially important for companies less known to the public, or with more complex business models. The main marketing instruments in this phase are media relations work; company publications (e.g., annual reports); and image campaigns in newspapers. During the image-building phase, the equity story should also be presented to, and discussed with, sell-side analysts of the bank consortium. This is a further opportunity to collect feedback from capital market participants with a broad overview of the peer group. This also prepares the analysts to write the research reports for the IPO.

The pre-offer phase starts with the announcement that the company is preparing an IPO. At this stage, the company normally does not disclose timing details of the going-public date. The pre-offer phase allows the issuer to finally evaluate the IPO readiness and make adjustments to the equity story. In the pre-offer phase, all of the communication formats including financial reporting, investor and media relations, a website, and company presentations should be set up. In the pre-offer phase, the company can also ensure that there is sufficient sell-side research coverage after the IPO. This can be achieved by meeting with banks and research houses that are already covering the sector or peer group companies.

Research from sell-side analysts, who are opinion leaders, is an important conduit to increase penetration of the equity story in the capital markets. The media is similarly important. This applies especially to companies that are targeting retail clients with their equity story. Institutional investors can also be reached through news coverage.

The offer phase is kicked off with a conference for analysts and investors as well as media. At this point, the securities prospectus is publicly available and all details on the issuance structure are known. In an ideal world, the documents do not include major negative surprises for the market, such as an unexpected use of IPO proceeds and unknown risk factors, since this would undermine the company's credibility and its management. Following the conference, the company's management will meet investors during a road show.

Ultimately, institutional investors, including pension funds, hedge funds, and wealth managers, are the most important stakeholder group in the pre-IPO marketing process. They expect that company management presents the equity story ahead of the IPO in one-on-one or small group meetings. Those meetings serve as a basis for the investors to evaluate management's credibility. These investors expect a high degree of capital market orientation that includes transparent, up-to-date, and key company information. Moreover, institutional investors will be focusing on the quality and accuracy of the company guidance within the applicable legal framework. For investor meetings, a clear and crisp presentation should serve as the documentation. In addition, the company should try to anticipate as many questions as possible ahead of the meetings, drafting possible responses in a Q&A document.

The day of the listing is the highlight of the IPO process. This is also when all the measures for the unending investor relations activities must be ready.

3.2.3 Ongoing Investor Relations Activities

Key elements of an effective communication with investors are transparency, consistency, and credibility.

A successful IPO is an important milestone in a company's development. From the moment of the IPO, the company has a new product: its own shares. The shares need to be supported and promoted, like other products or services the company is offering. In this sense, the IPO is a landmark, the beginning of a new company era. The primary goals of investor relations are a fair capital market valuation, and an optimized cost of capital. The investor relations function can achieve these goals through a stakeholder-oriented, transparent, consistent, and credible financial market communication (Fig. 3.3).

Transparency: Early in the process, the company has to identify the key business and financial metrics it plans to provide to investors after the IPO. Special consideration should be paid to the metrics that peers use to describe their businesses and to provide guidance on their future performance. Understanding and adapting these standards will keep the company aligned with what investors are accustomed to receiving from the peer group of the issuer, and the issuer must demonstrate a commitment to transparent communications.

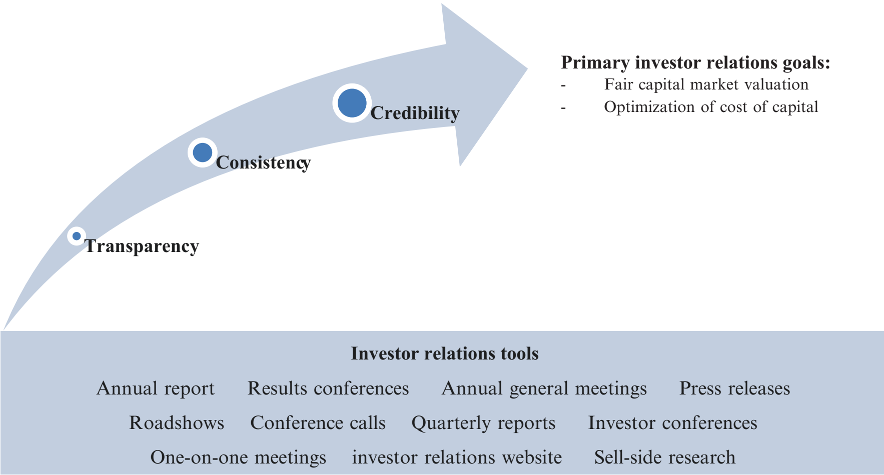

Fig. 3.3 Investor relations tools

Consistency: Investors are looking for new information in every interaction with the company. Any difference in messaging, content, tone, or frequency/timing of communications can be perceived as an indication of changes in the business or outlook that could affect the company's share price. Therefore, consistency in communications is very important. But the company must also be flexible enough to adjust to different business conditions.

Credibility: A major communications goals is building trust and credibility with capital markets' participants. To this end, credible financial market communication is essential to maintain the trust of investors in a long-term investment. The company has to inform capital market participants in an honest and fair way about the strategy, its objectives, and its business development. Furthermore, changes of relevant assumptions and parameters in the business model must be communicated on a proactive and timely basis. Greater trust among investors in a company normally results in higher demand for its shares; this might result in a valuation premium when compared to the company's peer group.

3.2.4 Investor Relations Tools

A wide range of mandatory and voluntary investor relations tools support a company to achieve the primary investor relations objectives.

Internet: The investor relations website is one of the first places for investors seeking more company information. Therefore, it should be user friendly, interactive, and easily accessible. Investors and analysts visiting the website must be supplied with all the information they need to conduct initial due diligence on the company, and to help them advance their investment decisions.

Results Releases: Reporting financial results to investors is an important medium for commentary about the business to the financial community. Typically, the earnings process includes a press release with financial data, an annual or quarterly report, and a conference call for sell-side analysts and institutional investors. These important communication formats help the company to demonstrate transparency regarding the way management speaks about the company's successes, challenges, strategy, and forward-looking guidance. Effective preparation is critical to management anticipating investor questions and proactively responding.

Investor Meetings: There are different formats with which management can engage with investors: road shows, where the company meets with institutional investors in one-on-one or group meetings; investor conferences, often with a presentation, followed by one-on-one or small group meetings for more detailed discussions; and company events such as analyst or investor days at the company headquarters, which allows access to the broader leadership team and company facilities. Webcasts are also increasingly used at investor events to increase global participation. Regardless of the format, these meetings provide valuable opportunities for context on financial results, explanation on strategy, and development of relationships with investors.

Media Releases: The company's media releases should be drafted with an eye towards what the content means for the business and how it will be perceived by the investment community. If applicable, media releases should tie news events to the company's stated strategy and show progress towards its objectives. If the announcement impacts the company's guidance for the quarter or year, these issues should also be addressed in the announcement. If the news has a high level of importance and complexity, a conference call for market participants can allow management to provide additional information on the event that prompted the media release.

The investor relation tools help the company to actively manage its shareholder base. Investors that are less well informed about the company, or whose investment style does not fit with the company, are more inclined to sell their shares. Diligent work is continuously required to identify the most important shareholders, to monitor changes in the investor base, and to engage investors in a dialogue to help keep them informed about the company.

Beyond this, there is also a continuous need to identify and attract new investors, the ideal target group being long-term-oriented investors. There will certainly be interest from sell-side analysts to help to market the company to prospective investors. But given the potential conflict of interests the sell side has, the company should be in charge of managing the investor base and targeting potential new investors.

Nevertheless, sell-side research analysts can help to increase visibility among investors. The company should therefore develop relationships with these analysts who play an important role in communications between management and the investment community. Still, prioritizing management's time with sell-side analysts can be challenging. Several factors should be considered by management when deciding which research firm to support: the quality of research, marketing events, and general opinion on the company. Finally, it is important to treat all analysts equally when interacting with the sell side in order not to give an information advantage to anyone.

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