Practice Guide: IPO vs RTO

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Discussion of key points of differentiation between reverse take overs (RTO), initial public offerings (IPO) and Secondary offerings (SO) and acquisitions.

Overview of the issues involved in listing, secondary offerings and acquisitions from an equity market and investor perspective.

1) Equity Market – Initial Public Offering (IPO)
Scenario: Initial Public offering – new share placement
An unlisted company must get itself well understood and liked by the equity market investors and have good analyst coverage. This is achieved by having pro-active senior management engagement with the equity market and an effective financial investor relations function. After this, initial public offerings very likely to be liked and supported by the equity market, giving rise to overall firmness and an upward trend in share price.

If the company is unknown, misunderstood, and not supported by good analysts, the offerings are likely to be dis-liked and unsupported by the equity market, giving rise to continuous prolonged weakness and a downward trend in share price. Simply having a pro-active and professional financial investor relations function in the preceding six month to a secondary offering can have a major impact upon funds raised.

A listed company has an obligation to communicate with the financial Community throughout in order to increase shareholder value and share price is strongly based on perceived value.
Please see Annexure 1: Initial Public Offering Price & Liquidity Trends - Analysis of secondary offerings in Singapore in the 2004-2006 timeframe.

2) Reverse Take Over (RTO) versus Initial Public Offering (IPO)
An IPO needs extensive marketing to both institutional and retail investors to place shares. Listing rules specify an equity market free float of 25% of issued shares. The IPO road-show may be within one country or several. The road-show and share placement use a combination of events such as: pre-pre-marketing, pre-marketing, IPO placement and post IPO marketing. An IPO favours the listing of medium to large market capitalised companies. The purpose of an IPO can be either a compliance listing with the minimal 25% free float or a larger placement to raise funds for specific growth plans. The free float can come from new issued shares, which means the listed company raises funds, or vendor shares, which means the company does not get additional funding but only the original owner. The RTO process also known as a reverse merger involves a company that has already been listed, either still trading or suspended. It is a financial transaction that results in a privately held company becoming a publicly held company without going the traditional route of filing a prospectus and undertaking an initial public offering (IPO). The listed company has an installed share registry and investor base. The RTO process is like a reverse takeover of a listed

company and so in the process the acquirer gets listed. The RTO process favours listing a company that is complex and/or very technical, which would require extensive equity market consultation for investor to understand the business model. Going public through a reverse takeover allows a privately held company to become publicly held at a lesser cost, and with less stock dilution than through an initial public offering (IPO). An RTO is often better for small to medium listings as the extensive road show marketing and underwriting fees may be avoided. It often has minimal new issuance of current and vendor shares. The objective is the listing and access to subsequent equity fund raising in secondary offerings. An RTO tends to have more certainty than an IPO for a small to medium sized market capitalised company. Often the listed shell company has nominal asset value however the shareholders and Board know of the

RTO process value so usually is bought for much higher than asset value. The value placed upon the shell listed company less the actual assets is goodwill and written of in the accounts in the period of the transaction in Singapore accounting practices.

3) Equity Market – Secondary Offering (SO)

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Scenario: Secondary offering – rights issue or new share placement
For any PublicCo to do a secondary offering or acquisition, it is imperative that the equity market understands:
- PublicCo Corporate Goals, strategy, milestones and management track record
- PublicCo justifies the rational for the strategic fit
- PublicCo justifies the action plan for capturing the synergy
- The earnings and cash flow accretion (short term dilution and medium term accretion) is easily seen and understood.

A listed company is generally well understood and liked by the equity market investors when it has both good analyst coverage and above average share transaction volume, known as thick liquidity. This is achieved by having pro-active senior management engagement with the equity market and an effective financial investor relations' function. Maintaining credibility with the investors plays a critical role in building market confidence and achieving key financial objectives. Secondary offerings are very much likely to appeal to the equity market, be supported, and give rise to overall firmness and upward trends in share price. Typically, if a finite quantum of shares were issued due to price firmness and support the actual funds raised would be -5% to +15% than expected.

A listed company is generally not well understood and often disliked by equity market investors when it has too few analysts providing research coverage and below average share transaction volume (known as thin liquidity). This occurs when senior management dis-engage from the equity market and relies upon public relations and corporate communications to inform the professional investment community. Secondary offerings are very much likely to be dis-liked by the equity market, unsupported, and give rise to continuous and prolonged weakness and downward trends in share price. Typically, if a finite quantum of shares were issued due to price weakness and lack of support, the actual funds raised would be -5% to -25% than expected.

Simply by having a pro-active and professional financial investor relations function in the preceding six-month to a secondary offering can have a major financial impact upon funds raised.
Please see Annexure II: Secondary Offering Price & Liquidity Trends - Analysis of secondary offerings in Singapore in the 2004-2006 timeframe.

4) Equity Market – Listed Company buying a Private Company's Business Unit
Scenario: PublicCo Buying PrivateCo
Some of the key issues and aspects of this transaction are as follows:
- A PrivateCo is valued based upon assessment of the business and independent asset valuations relative to both known market transactions and listed peers. PrivateCo's are usually valued below listed peer companies with a discount of 20 to 40%.
- The PrivateCo final valuation is often set on a willing seller & willing buyer negotiation basis. A quantitative analysis to often made to determine the overlap or size of the valuation gap before for final price negotiation takes place. The final price will often be based upon qualitative issues rather than quantitative.

Due diligence by an acquirer of a PrivateCo is usually more difficult than a PublicCo. Therefore a PrivateCo is often valued at 20 to 50% lower than a PublicCo. Often there are also performance covenants on the acquisition to protect the acquirer. For example a peer listed company may have a equity market valuation with a PER of 9 times and so the purchase price of a similar PrivateCo is likely to be 20 to 50% lower at a PER of 5 to 7 times.

5) Equity Market – Listed Company buying a Listed Company's Business Unit
Scenario: PublicCo1 buying PublicCo2
PublicCo2 will be valued based upon assessment of the business and assets. The valuations will be relative to both known market transactions and listed peers. PrivateCo1 will also have to make public statements as to the strategic fit and anticipated synergy justifying the acquisition.

Even for listed companies, PublicCo2's final valuation is always set by the willing seller & willing buyer negotiation. This is done by the Board of Directors on behalf of the shareholders. Often the Board will seek independent advisory support and an EGM to gain shareholder approval. The deal and final price will be justified by a combination of quantitative valuation and qualitative strategic issues. The upside to shareholders is from the strategic issues, which are often not very transparent and shareholders need to trust and rely upon the track record of management. Often the Board of Directors and both the majority and minority shareholder interests and their sentiment are taken into consideration.

PublicCo1 will not wish to see short-term earnings dilution, excessive goodwill right off, and adverse equity market reaction. For example, If PublicCo1 is trading in the market at a price equal to a PER of 9 times, then to avoid earnings dilution and they would only acquire PublicCo2 if the PER

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was equal to or less than a PER of 9 times. In fact due to the likely good will right off, the top PER will be less.

PublicCo1 may acquire a company, which dilutes short term earnings if they believe medium and long term earnings will greatly improve due to strategic fit and the ability to capture synergy. The key issue is that PublicCo1 must demonstrate to their shareholders the rational and sense of the deal. If they fail to do this then investors will sell and their PER will fall. The key is for PublicCo1 to have had a successful investor relations engagement with investors. Investors understand the company's goals, strategy, track record and management team capability. Often in acquisitions between PublicCo's the acquirer's share price decreases and the seller's share price increases –because of "cash is king" and this avoids investment risks and a lack of complete confidence in the acquirer's ability to capture the promised synergy.

Due diligence of PublicCo2 will take place. Assuming the acquisition is friendly and a collaborative than often full and rich due diligence can take place. However in the situation of a hostile bid access for due diligence is constrained The sell and buy-side analysts have even less visibility and often do not see or believe in the strategic rational and suggested synergy. Therefore it is imperative to keep the equity market better informed.

Annexure I:

Table I - Initial Public Offering price and liquidity trends				
	Pre IPO Prospectus	IPO Prospectus Offer minus 4 weeks	Placement Period & Book Buil d	Initial trading in 4 to 12 weeks
Company is well understood and liked by equity market.	Extensive Pre-marketing to ensure investors understand the company and meet the management team.	Grey share price exists.	Grey share price firms with oversubscription in retail and institutional book build.	Share price firms 5 to 30%. Steps up on good news flow. Liquidity based upon short term investors taking profits, and long-term investors getting full allocation. Price movement and liquidity determined by news flow.
Company is not well understood and disliked by the equity market.	Limited Pre-marketing and few investors understand company and believe in the franchise and management team .	Grey share price exists.	Grey share price weakens. With under subscription in retail and institutional book build and underwriter taking shares.	Share price is volatile as short-term investors dump shares and long-term investors buy shares. There is often a price and turnover peak followed by steady decline in both.
Source: Analysis of secondary offerings in Singapore in the 2004-2006 timeframe				

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Annexure II:

Table II: Secondary Offering price and liquidity trends

	Announcement and EGM, offer minus 12 weeks	Offer minus 4 weeks	Offer Period	Offer plus 4 to 12 weeks
Company is well understood, liked by equity market, with above average liquidity.	Share price weakens a little, 1 to 5% .	Share price neutral, +/- 1 to 5%.	Share price firms a little, 1 to 5%	Share price firms 1 to 10% and steps up good news flow. Share price 5% to 15% above pre deal.
	Liquidity increases further due to fright sell-out.	Liquidity stable as long term investors top up and short-term investor sell-out.	Liquidity decreases until deal is done.	Liquidity increases in anticipation of management using the funds wisely on growth and positive news flow .
Company is not well understood and disliked by the equity market, with below average liquidity.	Share price starts falling, 1 to 10% on announcement as investors not wishing to participate in rights issue and/or perceived dilution sell-out. Certainty of EGM outcome means further sell-down.	Share price weakens further, 1 to 10% as investors not wishing to participate in rights issue and/or dilution sell-out.	Share price steps downward, as investors seek further 5 to 10% discount on average price in market over last 30 days.	Share price temporally firms 1 to 5% as certainty that offering gets done. Offer price sets a new trading support level, which is tested. Share price 7% to 25% below pre deal level plus dilution effect.
	Liquidity increases due to sell-out.	Liquidity decreases as unsure investors have exited and no new news flow.	Liquidity stays thin - investors already set or exited.	Liquidity stays thin until new news flow .

Source: Analysis of secondary offerings in Singapore in the 2004-2006 timeframe

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