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## **Role of the investment bank**

Daniel H Klausner, UBS Investment Bank

**UBS has a wealth of knowledge regarding all aspects of listing on the US securities markets and can provide ongoing advisory services throughout the entire process**

Perhaps more than any other participant in the initial public offering (IPO) process (with the exception of the issuer), the investment bank is an essential player in the success of the IPO. The investment bank assists the issuer with a number of critical functions:

- analyzing the industry and company to determine whether there is investor demand for such a company;
- structuring the offering and valuing and positioning the company; and
- developing the 'story' to market the offering.

In a sense, the investment bank 'quarterbacks' the deal, leading the issuer's team of professional advisors and coordinating their roles to ensure that all business objectives are met and the company successfully completes the IPO process.

### The advantages of going public

An investment bank's first order of business in an IPO is to help the company sort out the relevant issues and determine whether an IPO makes sense and is feasible. Some of the main advantages of going public are outlined below.

#### Access to increased funding

A successful IPO creates access to the public equity market, potentially the deepest source of corporate funds for any company. In addition:

- going forward, the company will have access to worldwide capital markets through secondary equity offerings and debt issues;
- by balancing equity and debt, listed companies can enjoy greater flexibility in

funding and more favorable borrowing terms; and

- by tapping the vast pool of capital available through the US securities markets, a company can build up a broad investor base, thus ensuring a diverse and balanced ownership structure. This may help to stabilize the share price, especially during market downcycles.

After the first year of listing the issuer may become eligible to access the capital markets on demand through shelf or well-known seasoned issuer registrations.

#### Enhanced profile and marketing leverage

Public companies and their products attract greater media attention than private companies. A company going public may use the process as a branding opportunity.

National and international financial media (e.g., CNN, Bloomberg, CNBC, the *Wall Street Journal*, the *Financial Times*) provide up-to-the-second coverage of the markets and profiles of public companies. Online media are also an instant source of information. In addition, opening-day listing events can be used to generate company publicity. Broader media coverage invariably translates into enhanced visibility, market share and competitive position.

#### Increased appeal to institutional investors in the United States and internationally

A US listing generally leads to broader exposure to a larger investor base, including retail and institutional investors. In turn, this generates key advantages - for example:

- increased recognition of the company may stimulate greater interest in the company's shares; and
- the rigorous disclosures mandated by US regulatory agencies further ensure transparency and public access to all significant information about US listed companies, thereby promoting investor confidence.

#### Greater employee commitment and recruiting ability

Incentives such as stock options, directed share programs and stock purchase plans (generally unavailable to employees of private firms) align employees' interests with those of the company. By allowing employees to benefit financially from the company's success, these programs foster increased loyalty, commitment and productivity and serve as a strong incentive in attracting talent.

#### Shares as acquisition currency

Once a company has gone public, it can use its common shares to finance acquisitions of other public or private companies in order to gain access to new plants or expand into new markets - without taking on additional debt or liquidating assets.

#### Liquidity for shareholders

It is generally difficult to sell shares in a private company reliably and efficiently because no public market exists. Thus, large blocks of shares in private companies (or in closely held public companies) cannot easily be bought, sold or converted into cash in an organized and

efficient manner. The relative liquidity of publicly owned shares is a major advantage for retail and institutional investors alike.

### The case for remaining private

Notwithstanding the arguments for taking a company public, the following caveats should also be kept in mind.

#### Cost

IPOs are expensive. Collectively, the one-off and ongoing costs associated with going public are likely to be high, covering legal counsel, accounting and auditing services, underwriting, printing, additional personnel to handle expanded reporting and compliance activities and investor relations. In addition, planning and executing an IPO is a time-consuming process that can distract management from the company's core business and may conceivably hamper financial performance.

#### Reporting requirements

Unlike privately held companies, public corporations must file a variety of reports with the Securities and Exchange Commission (SEC) and other regulators on a regular basis.

These include:

- Forms 10-K, 10-Q and 8-K;
- proxy statements; and
- individual reporting for officers, directors and principal shareholders.

Compliance with disclosure requirements often necessitates a comprehensive and costly expansion - or outright replacement - of existing corporate information systems.

#### Sarbanes-Oxley compliance

Passed in 2002 in the wake of corporate accounting scandals, the Sarbanes-Oxley Act imposes a vast array of reporting and procedural obligations on a public company and its officers. Compliance with the law's provisions, which affect virtually every aspect of a company's operations, governance and financial disclosure, can be particularly costly and time consuming.

#### Loss of privacy

Securities laws compel public companies to share many types of potentially sensitive information with competitors and regulatory agencies. Private companies are under no such obligation to disclose proprietary information.

#### Impact of stock price on business strategy

As a matter of practical necessity, the management of a public company must consider the likely impact of business decisions on the price of the company's shares. As a result, they may be constrained from making strategic decisions that will strengthen the company over the long term but may risk temporarily lowering the price of the stock.

#### Questions every IPO candidate should ask before going public

##### When is a company ready to go public?

The following prerequisites should be considered by any privately held company that is seriously contemplating an IPO.

##### Execution of a business plan

Most businesses already have a business plan. For the purposes of an IPO, a company needs a comprehensive roadmap that defines and

assesses its growth prospects (i.e., its products, markets, competitive arena, business strategies, capabilities and growth objectives) credibly, clearly and quantifiably, and in terms that will be meaningful to investors. Companies engaging in successful IPOs tend to have a clearly defined vision for future performance and have accomplished several significant milestones prior to the IPO.

##### A credible earnings projection model that details future growth

Before investing in a company, most individuals and institutions want to feel confident about the company's future growth prospects. Thus, the company should be built on a product or service with proven market appeal, a broad customer base and the potential for continued acceptance. Companies that are in mature or shrinking industries, operate within small markets or provide a narrow range of products to a small and highly specialized customer base may be unsuited for an IPO.

##### A plan for using the proceeds

By definition, a successful IPO is one that raises a significant amount of new capital. It is critical that:

- the company's need for new capital justifies relinquishing private ownership of the business and bringing in hundreds, perhaps thousands, of shareholders;
- the company has a carefully thought-out plan for using that capital; and
- the company communicates that plan clearly and convincingly to the investing public.

***A strong management team***

The company's leadership should be sufficiently skilled and experienced in the operations and finances of the company and sector to win an investor's confidence and to fulfill its mission as a public corporation. Similar principles, as well as independence standards, will also apply to the board of directors. Furthermore, officers and directors should understand the accountability that is attached to the leadership of a public company. Unlike their private company counterparts, they must answer to hundreds, perhaps thousands, of shareholders. In addition, the chief executive officer and chief financial officer should regularly discuss the business and growth prospects with the financial community, as well as addressing the questions and concerns of stock analysts, business journalists and regulators.

***Solid historical financial performance***

The company should be able to show investors a sound balance sheet and a consistent pattern of top and bottom-line growth over the past several years.

***Financial controls in place***

The company will need to demonstrate to the SEC, its auditors and the investing public that it has rigorous financial controls. Given the long lead time and complexity of the Sarbanes-Oxley requirements, financial controls are a key focus area.

**What is involved in preparing for an IPO?*****Select the underwriter***

The company should appoint an investment bank as the lead book-running underwriter.

***Select advisors***

The company should carefully consider the qualifications of the law firms and accountants that it hires to guide and provide advice to the company during the IPO process. As the successful execution of an IPO can be complicated and time consuming, the issuer should select legal and accounting advisors that have a national practice and significant experience in IPOs.

***Prepare audited financial statements***

The company's financial statements need to adhere to US Generally Accepted Accounting Principles (GAAP) in order to go public. Any internal transactions, compensation arrangements and relationships involving management or the board that might be appropriate for a private enterprise but improper for a public company must be eliminated. The company should consider whether any outside affiliations (i.e., operations tangential to the company's core business) will be negatively perceived by the market.

Requirements for a company going public include:

- two years of audited consolidated balance sheets (plus reviews of any interim period, if applicable);
- three years of audited consolidated income statements (plus reviews of any interim period, if applicable);
- three years of audited consolidated cash-flow statements (plus reviews of any interim period, if applicable);

- three years of changes in stockholders' equity (plus reviews of any interim period, if applicable); and
- two additional years of income statements and two additional years of balance sheet data, which will appear in the selected financials and may be unaudited.

***Develop and refine financial projections***

The company should develop a 'grounds up' financial model that quantifies the company's business plan and expected growth. The investment bank will work with the officers in the development of this model, conduct due diligence on the assumptions and drivers behind this model and stress test the projections.

***Determine management compensation and stock option programs***

Boards of directors usually hire compensation consultants to determine compensation for top executives and employees throughout the company. Their analysis incorporates trends in specific comparable companies as well as trends in the appropriate industry. The recommendations are reviewed by underwriters with an eye toward ensuring that the numbers are within market expectations.

***Select a board of directors, form board committees and appoint committee heads***

As a public company, an issuer will need to establish audit, nominating and compensation committees. In addition, independent directors will need to be added to the board.

Investment banks frequently help to recruit and assess potential board members for the company.

### ***Establish all necessary controls and procedures for Sarbanes-Oxley compliance***

Before going public the company must have certain financial controls and computer systems in place in order to run its business effectively. There is a specific timeline for the implementation of certain elements of Sarbanes-Oxley in order to be compliant, but not all the elements need to be completed at once. However, the company should develop an implementation plan to ensure timely compliance with the various requirements.

### **What are the criteria for selecting an underwriter?**

There are many types of investment banks, each suited to a different type of IPO. These include:

- global full-service firms;
- smaller full-service national firms with global capabilities;
- regional firms with specialized geographic knowledge and a variety of product offerings; and
- boutique firms that specialize in a particular industry or product.

When choosing an investment bank to underwrite an IPO, a company should consider a number of factors.

### ***Reputation***

The prestige and cachet of a top-tier investment bank lends credibility to an offering, especially

when the issuer is not well known to the public or potential investors.

### ***Experience***

Has the bank recently served as a book-runner for an IPO? What is the bank's general experience level and how many transactions, including IPOs, has it executed, both overall and in the company's specific industry space?

### ***Industry expertise***

Does the bank have specific knowledge of the industry? How many transactions has it completed in that industry?

### ***Distribution capabilities***

What is the geographic distribution of the investment bank's salesforce? In addition, does the investment bank employ sector-specific salespeople? It is important to assess both institutional and retail distribution capabilities, as retail distribution provides an important balance to institutional demand.

### ***One-stop shopping***

The chosen bank should offer a number of services such as equity, debt and advisory capabilities – these can all be provided by a large investment bank.

### **The IPO from start to finish – a timetable**

An IPO requires the coordination of many parties including the company, the legal teams of the company, the underwriter, auditors and printers.

An IPO can generally be completed in 15 to 20 weeks. Although the exact timetable will vary with market conditions, the scope and complexity

of the deal and a myriad of other factors, the key stages of the process are as follows.

### **Week one**

#### ***Conduct organizational meeting***

The overall purpose of the meeting is to make sure all the working parties understand the structure of the offering, timing, tasks and responsibilities necessary to take a company public. These meetings are usually held in person at the law firm or the company's headquarters and involve discussions to make sure that everyone is on the same page regarding the transaction, process, timetable and all other relevant issues. The underwriter will provide a detailed organizational book that goes through all of these issues.

### **Weeks two to five**

#### ***Conduct due diligence***

The overall purpose of due diligence is to ensure the accuracy, truthfulness and completeness of the company's registration statement and prospectus, and to understand any issues associated with the company. While each professional advisor performs a different role in this process, the investment bank will focus on the diligence of the company's operations, management, financial prospects, historical performance, competitive position and business strategy. The investment bank will also look closely at factors such as the company's workforce, suppliers, customers, creditors and anything else that might have a bearing on the offering or viability of the company as a public entity and on the accuracy and completeness of the prospectus.

Due diligence comprises many interrelated processes. Business due diligence is conducted mainly by the investment bank and is designed to verify the company's business strategy and potential for future growth. As part of the information and fact-gathering process, investment bankers will conduct on-site inspections, particularly for manufacturing and property-intensive businesses. They will also interview company officials, suppliers and customers to understand fully every aspect of the company's business and its financial statements. The knowledge obtained will later help underwriters and management to craft a strong, consistent message that can be used during the marketing process. Business due diligence generally focuses on such issues as:

- overall business model and growth strategy;
- relevant macroeconomic trends;
- industry trends;
- pricing structure;
- analysis of operating results;
- products, markets, customers and suppliers;
- marketing and distribution;
- management strategy;
- manufacturing;
- facilities;
- competition and competitive position within the sector;
- environmental issues;
- patent positions;
- labor;
- management systems;
- management structure;

- corporate governance, including board of directors and audit/compensation committees; and
- reference checks.

Financial due diligence is geared toward confirming the company's historical financial results and understanding its future operational and financial prospects. Key focus areas include:

- audited and interim financial statements;
- capital structure;
- breakdown of historical financials by business;
- detailed review of monthly/quarterly budgets (for two years) and yearly projections (for three to five years);
- meetings with auditors;
- budget versus actual financial statements for the last eight quarters;
- accounting policies and auditor management letters;
- use of proceeds;
- financial control systems and Sarbanes-Oxley compliance; and
- debt covenants.

Legal due diligence is conducted by the attorneys and is the process of verifying the company's legal records, material contracts and litigation. Key areas of focus include:

- litigation;
- compliance with local, state and national laws and regulations;
- title to principal assets;

- corporate structure;
- debt covenants;
- environmental issues;
- intellectual property; and
- registration rights and rights of first refusal.

### ***Draft the registration statement/prospectus***

Before a company can be listed, it must first register its securities with the SEC. Although the form of the registration statement or prospectus to be used varies according to the IPO, all companies must meet common disclosure requirements, as well as including any additional material information to ensure that nothing in the registration statement is misleading or omitted. Although the registration statement is a legal document, it is also a marketing tool to help to sell securities to potential investors. It is the role of the investment bank to assist the issuer in crafting the appropriate marketing story.

In particular, the registration statement must address the following:

- business information:
  - description of the company, its business and main products and services;
  - strengths and strategies;
  - general business developments over the past several years;
  - industry trends and background;
  - risk factors;
  - planned use of the proceeds;
  - description of the security;
  - underwriting; and
  - taxation;

- financial information:
  - audited financial statements for at least the last three financial years and selected financials for the last five years;
  - depending on the actual timing of the IPO, interim financial information; and
  - capitalization information;
- prospects, including management discussion and analysis of the company's financial condition and operations over the past three years:
  - analyses of historical financial results;
  - future trends in operations;
  - success or failure of specific operations;
  - trends in liquidity;
  - the company's significant capital expenditures (whether current or proposed);
  - expected sources of funding; and
  - any additional relevant trends and areas of uncertainty;
- management and governance:
  - composition of the board of directors and background of individual officers; and
  - compensation disclosure and analysis regarding the philosophy and practice behind the company's compensation programs;
- board committees:
  - compensation, nominating, corporate governance and audit committees;
- capital stock – all voting, dividend liquidation, pre-emptive and other rights attaching to the shares; and
- full disclosure on direct or indirect ownership or control of the company, including the identity of shareholders holding more than 5% of the company's shares;
- material related-party transactions, which are intended to provide investors with a clear understanding of actual and potential conflicts of interest; and
- other matters:
  - a description of the company's property;
  - pending legal and regulatory proceedings in which the company is involved; and
  - relevant details on the material contracts, exchange controls and other limitations affecting shareholders and the company's tax position.

***Legal documents and agreements***

During this stage, the company's management, underwriters and legal counsel work together to draft the necessary legal documents. The collective purpose of these documents is to assure investors, regulators and others that the offering has been objectively vetted for gaps, irregularities, ambiguities, misleading statements and other potential problems. The documents include:

- the underwriting agreement;
- the comfort letter;
- lock-up agreements; and
- legal opinions.

***Continue to prepare the issuer to become a public company***

The investment bankers will assist the company on a number of matters critical to its transformation into a public entity.

These include:

- discussions of valuation;
- the composition of the board of directors and committees; and
- internal controls, in compliance with stock exchange requirements.

Although all these issues need not be resolved at this stage, most companies find it prudent to address board composition and internal control issues in their prospectus as a way of demonstrating that adequate corporate governance controls are in place.

***Determine whether the company is eligible to list on a US securities exchange***

At this stage, the company needs to:

- determine on which stock exchange it wants to list;
- decide what level of listing it will seek; and
- reserve a symbol.

***Weeks six to eight***

***Complete the registration statement and file with the SEC***

After the company's investment bankers and other advisors have finished drafting the registration statement, the lawyers will electronically file the registration statement with the SEC. Once the registration statement has

been filed, the company becomes subject to the provisions of Sarbanes-Oxley. Some of these provisions will have an immediate impact on the company, such as the prohibitions on loans to executive officers and directors and the need for auditor independence.

#### ***File the application to list the company on a stock exchange***

The listing application must be filed at this stage.

#### **Weeks nine to 16**

##### ***Receive SEC preliminary approval of the registration statement***

Approximately 30 days after the registration statement is submitted, the SEC will send a comment letter to the company. The listing company and its advisors will then revise the registration statement and file an amendment, as well as a letter in response to the SEC.

Subsequent rounds of comments, revisions and amendments may ensue; the process continues until the SEC gives its preliminary approval to begin the marketing and roadshow for the offering. As every IPO is unique, it is impossible to predict exactly how long this process will take. However, as a rule, the timeframe is approximately six to eight weeks from initial submission of the registration statement to the SEC to preliminary approval to launch the transaction. All issues need to be resolved with the SEC and the registration statement must be declared effective before the IPO can be priced.

##### ***Receive stock exchange approval for listing***

The company and its lawyers will be informed

by the stock exchange that the company is approved for listing. Approval must occur prior to launching the roadshow for the IPO.

##### ***Sizing and valuing the offer***

The investment bank will gauge the interest in the IPO within the investment community and ascertain whether the IPO is indeed viable. The investment bank will also determine the number of shares to be offered.

The price range for the offering will be determined on the basis of the information gathered from due diligence and drafting, along with feedback elicited from the capital markets. The investment bank and company should also consider the following variables:

- valuation analysis (using appropriate comparable methodologies);
- the issuer's objectives – notably the amount of capital it needs to raise and the degree of control it wishes to retain;
- the issuer's financial performance and growth prospects;
- the competitive arena;
- general stock market conditions;
- market requirements;
- the level of investor interest – both institutional and retail; and
- management.

Although the company may want to price the shares as high as possible, it will be at a disadvantage if the price range presented to investors fails to attract adequate demand or to ensure a healthy performance following the IPO.

##### ***Marketing strategy***

The underwriters will set up a comprehensive marketing plan incorporating the company's investment themes to target specific investors.

##### ***Preparation of roadshow slide presentation***

Scripted and orchestrated by the investment bank and the issuer, the roadshow is a series of meetings with potential investors in key cities across the country and, if appropriate, overseas.

The roadshow includes a formal presentation on the company's business operations, financial results, performance, markets, products and services delivered by the company's top management. It is typically followed by a question-and-answer session. The roadshow provides the company with an invaluable opportunity to meet investors face to face, showcase its managerial talent and communicate its strategy, vision and objectives.

The investment bank's role in the preparation of management for the roadshow includes:

- assisting the issuer in the preparation of slide presentations;
- organizing rehearsals;
- preparing salesforce education materials;
- mapping the roadshow itinerary;
- targeting investors for one-on-one meetings with senior management; and
- organizing roadshow logistics.

#### **Weeks 17 to 19**

##### ***Salesforce calls to investors***

Once the transaction has been launched, the role of the salesforce takes on increasing

importance as the underwriters begin to contact appropriate investors to educate them about the company and arrange meetings with senior management.

### ***Launch the offering and roadshow***

The beginning of the offering is kicked off by a management presentation to the investment bank's salesforce in order to discuss the offering, business, financials and the company's prospects.

Afterwards, the management meets potential investors in key cities and, if appropriate, overseas. Many IPO roadshows last approximately two weeks.

### ***Building a book of orders***

No firm sales of stock are permitted until the SEC has declared the registration statement effective. Upon launch, the syndicate's salesforce approaches investors and compiles indications of interest. The book-building process is the mechanism of assessing institutional and retail demand for the issue and determines the final size, timing and pricing of the issue. The syndicate desk receives orders and other feedback from the salesforce about each investor's demand for stock and alters the book accordingly.

### ***Pricing, allocation and closing***

Working with the company's senior management, the investment bank recommends the price at which the shares will be offered to the market. Only when the

company's board of directors has approved the offering price can final allocation take place (the stock is usually priced after the close of the market on the day on which the registration statement is declared effective). Allocation is made by the investment bank following consultation with the company. The objective is to ensure the quality of the investor base by allocating to investors which are likely to hold the shares for the long term and possibly increase their holdings after the IPO.

### ***Print the final prospectus***

After the pricing of the IPO, the lawyers will revise the prospectus with the final pricing and size information and file the prospectus with the SEC. Once printed, the investment bank will distribute copies of the final prospectus to investors.

### **Week 20**

#### ***Closing***

The exchange of securities for funds typically occurs three business days after pricing.

#### **After listing: the role of the investment bank**

Achieving a successful IPO generally marks an exciting new chapter in the company's life, where it enjoys the prestige associated with listing on a high-profile stock exchange, increased publicity and new access to capital.

However, it would be a disadvantage for the company to be complacent. Instead the company, with the assistance of its investment

bank, should actively target current and potential investors to communicate the company's strategy effectively. The company's senior management should be accessible to investors through conferences, non-deal roadshows and other venues to increase the company's exposure to current and target equity investors.

The company's management should be prepared to ensure that the company continues to perform well in the long term to meet investors' expectations. The company should also ensure that:

- the management team can effectively communicate the company's strategy and financial results to institutional investors and the public;
- the company's corporate culture encourages compliance with its internal controls and procedures; and
- periodic public disclosure filed with the SEC is timely, complete and accurate.

The investment bank will provide market intelligence on trends in the industry, updates on trading activity in the company's stock, as well as advice on acquisitions and disposals and the viability and need for any follow-on financings.

Through such activities, the investment bank can help drive the company to accomplishments beyond a successful IPO.



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