

Weil IPO Survey - Key Considerations for Private Equity Sponsors in the U.S., the U.K. and Hong Kong

By Simon Lyell, Henry Ong and Doug Warner

The global IPO trend

IPOs have been increasing in popularity as a means of providing liquidity to private equity sponsors in recent years. The *Financial Times* recently reported that Ernst & Young predicts that a surge in private-equity backed flotations could see global IPO activity for 2014 reach its highest level since 2007, with activity for Q1 to Q3 seeing \$105bn raised through 264 PE-backed offerings (from a total of \$187bn raised from 851 flotations).

The trend owes largely to the relatively strong stock market valuations currently achievable, which have proved more attractive to sponsors than the comparable private company valuations. In addition, regulatory reforms such as the Jumpstart Our Business Startups ('JOBS') Act in the U.S. have made it easier for sponsors to take their portfolio companies public, by simplifying the regulatory hurdles required to float in certain cases.

No universal IPO exit strategy

We have undertaken a survey of recent PE-backed IPOs in the U.S., the U.K. and Hong Kong. Across all of these jurisdictions, sponsors will not exit their portfolio companies outright at the time of the IPO or listing. Accordingly, it is important for sponsors to consider post-IPO governance and other rights to ensure that they will have continued influence over the management of the company and to ensure orderly post-IPO selling by the pre-IPO investor group.

In addition, it is clear that there are significant differences in the way an IPO exit is ultimately effected in each jurisdiction.

- **U.S.:** PE-backed IPOs largely follow two routes:
 1. A small primary issuance to pay down debt, with the majority sponsor shareholder(s) retaining a significant majority of the company's stock following the IPO; or
 2. The sponsor(s) sell a portion of their shares to the public at the time of the IPO (alongside any primary issuance), typically retaining either a majority or significant minority of the company's stock following the IPO.

In each case, the sell-down to a complete exit will typically be effected through a series of secondary offerings or block trades following the IPO.

- **U.K.:** The majority shareholder sponsor(s) will typically sell down a significant proportion (generally between 30% and 60%) of their shareholding at the time of the IPO, leaving them with a shareholding in the company of around 60% to 30% for the lock-up period. This initial sell down is partly driven through by the U.K. Listing Rules, which require a minimum of 25% of the company's shares to be offered to the public in the IPO. There are no comparable minimum requirements in the U.S.
- **Hong Kong:** Until recent years, most PE investments in Greater China have been in the growth capital space or otherwise in businesses where a founder or co-founders wish to retain control. In fact, of the recent PE-invested IPOs surveyed (mid-cap and above), less than a third of these were IPOs of companies in which a PE investor held equity stakes of more than 30%, and there was only one IPO where the sponsor held over 50% of the company. In other words, the majority of PE deals in Greater China have taken the form of minority investments.

Sponsor(s) can and almost always sell a portion of their shares to the public at the time of the IPO. All remaining shares not sold are locked-up for at least 6 months. In 'control' deals, the lock-up is a regulatory requirement. In non-control deals, even though the regulatory lock-up does not usually apply, underwriters typically seek a lock-up in any event.

Given the scarcity of "effective control" / majority deals in Greater China, no reliable figures can be given as to the typical scale of a sell-down by sponsors at the time of IPO. The size of the sell-down is generally commercially-driven, and investors generally prefer to see a strong level of ownership continuity in both minority and control deals, not just on the founders but also on sponsors. In fact, we have not seen a recent sizeable IPO in which a sponsor made a 100% exit at the time of IPO. Note that the HK Listing Rules require a minimum public float post-IPO of 25%.

Our survey demonstrates that post-IPO governance practices in the U.S. are quite distinct from those in the U.K. and Hong Kong. This may be due to different statutory frameworks in place as well as different market expectations. In the U.S., for example, it is now commonplace to see a number of sponsor rights baked into the organizational documents of the public company or in a separate shareholders agreement, but there is little to no such comparable practice in U.K. or HK listings, where statutory and regulatory principles dictate that all shareholders should be treated equally, with influence and control derived from votes attached to shares held. In the U.K., sponsors retaining more than 30% of the company's shares upon listing must enter into a relationship agreement designed to ensure that the company maintains independence from its controlling shareholders following the IPO.

Key takeaways

- Market norms for governance rights would rarely dictate where you list a portfolio company but may influence a sponsor's decision where to list the company on the margin.
- In the U.S., PE sponsors should consider the governance rights contractually available to them and whether there are any particular vetos and controls they wish to retain following flotation. These include board and committee designation rights and veto rights over certain board decisions.
- Sponsors listing in the U.K. and HK should be aware of the non-contractual rights available to them as significant shareholders in the post-IPO company.

Key post-IPO sponsor rights

The table below summarizes the results of our survey, with details of various contractual rights sponsors have been able to negotiate for in the U.S., with the contrasting position in the U.K. and HK.

Term	U.S. Trends	U.K. Position	Hong Kong Position
Classified board (where a proportion of the directors are appointed each year for a multi-year term on a rolling basis)	79% provide for a classified or staggered board of directors (potentially permitting sponsors to retain board representation disproportionate to their ownership). This is despite the position by ISS and other proxy advisory firms that such classified boards disenfranchise shareholder voting rights.	No staggered or classified board concept.	No staggered or classified board concept.
Board nomination rights	93% provide the sponsor(s) with rights to nominate or designate directors to the board.	94% provide the sponsor(s) with board nomination rights for so long as its voting rights remain above a certain threshold (usually 20-30% for the appointment of two directors and 10% for the appointment of one).	Not permitted as the HKSE requires listed companies to treat all shareholders fairly and equally. However, in post-IPO deals (e.g. PIPE deals), somewhat inconsistently, sponsors often get board and committee nomination rights (subject to board /shareholder approval).
Committee representation rights	64% provide the sponsor(s) with rights to have their directors serve on board committees.	Rights to be represented on board committees are not provided under the terms of most relationship agreements, although in practice, the sponsor(s) are often represented on such committees post-IPO.	Nomination right only. Appointment must be subject to board approval. Rare in practice given such restrictions.
Veto rights over board decisions	57% provide sponsor(s) with veto rights over certain board decisions. In some instances these vetos relate to only a limited number of material matters, such as amendments to constitutional documents disproportionately adverse to the sponsor(s), change of control transactions, liquidation of the company and non-pro rata dividends or repurchases. In other instances the sponsor(s) benefits from relatively expansive veto rights, for example over the incurrence of debt, the hiring and firing of the CEO and material acquisitions.	Veto rights are not provided under the terms of most relationship agreements, although where sponsors continue to hold more than 50% of the shares in the company post-IPO, they will be able to control or veto effectively decisions requiring a simple majority of shareholder votes, for example a change of control of the company, liquidation of the company and non-pro rata dividends.	Not permitted. However, as is the case in the U.K., a sponsor holding more than 50% of the shares in the company post-IPO will be able to control or veto effectively decisions requiring a simple majority of shareholder votes.

Term	U.S. Trends	U.K. Position	Hong Kong Position
Information rights	<p>In addition to receiving information available to all shareholders under the SEC rules, 38% provide sponsor(s) with access to non-public information and the right to consult with management.</p>	<p>All shareholders in a public company have access to the company's constitutional documents, general meeting minutes, share register and annual accounts and reports. Sponsor majority shareholders have no special rights to additional information to this.</p> <p>Shareholders' information rights derive from a combination of the law of incorporation of the listed company, its constitution and the U.K. listing rules.</p>	<p>The HKSE allows companies from a range of jurisdictions to be listed in HK. The range is wide and covers China, BVI and the Cayman Islands through to multiple jurisdictions in Europe and North America. As one of the conditions to listing, a company may be required to bake into its constitution certain additional rights not otherwise available in a particular jurisdiction but which meet the HKSE's minimum standards. This includes setting forth a minimum level of information rights.</p> <p>Shareholders' information rights therefore derive from a combination of the law of incorporation of the listed company, its constitution and the HKSE Listing Rules.</p>
Transfer restrictions	<p>75% of the IPOs surveyed involving a consortium of two or more sponsors impose on the pre-IPO investors more onerous post-IPO transfer restrictions than would be typical under customary underwriters' lock-up arrangements.</p> <p>The form of these restrictions varies depending on the pre-IPO investor base and includes: (i) restricting non-sponsor shareholders (eg management) from selling a greater percentage of their shares post-IPO than the sponsor(s); and (ii) formulaic restrictions which prevent the sale of more than a fixed percentage of shares for a fixed period of time (eg other than through a registered secondary, no more than 50% of the shares may be sold until the second anniversary of the IPO).</p>	<p>Sponsors do not benefit from contractual transfer restrictions on non-sponsor shareholders, although the majority of IPOs provide for a six month lock-up period for the majority sponsor(s) shareholder(s) and a one year lock-up period for non-sponsor shareholders.</p> <p>Following the sponsor lock-up, sponsors forming part of a consortium of two or more sponsors will generally enter into agreements to give them the right to sell down equally and ensure orderly sell-down between the sponsors.</p>	<p>In an IPO of a company owned as to at least 30% by a PE sponsor, the sponsor (along with any other person acting in concert with it) will be subject to a 6 month lock-up under the HK Listing Rules in respect of shares not sold in the IPO. In addition, after that initial lock-up period no disposals may be made within the next 6 months that will bring the sponsor's shareholding below 30%.</p> <p>Minority investors are not subject to any regulatory lock-up although it would be typical for the underwriters or the company to seek a 6 month lock-up in respect of shares not sold at the time of the IPO.</p>
Right of first offer / tag-along and drag-along rights	<p>Of the IPOs surveyed involving a consortium of sponsors:</p> <ul style="list-style-type: none"> ■ 14% provide sponsors with rights of first offer over sales by other sponsors in the pre-IPO sponsor group; ■ 29% provide sponsors with tag-along rights to privately-negotiated sales by other sponsors in the pre-IPO sponsor group; and ■ 14% provide sponsors with drag along rights over other sponsors in the pre-IPO sponsor group. 	<p>These rights are not seen in U.K. listing documents, however under the U.K. Companies Act, once shareholders holding 75% of shares have agreed to a sale, the remainder of the company's shares can be compulsorily acquired through a statutory scheme of arrangement, which effectively results in a drag right (although without the usual uncertainty of using drag mechanisms). If the listed company is incorporated in another jurisdiction, the laws of that jurisdiction provide for effective tag/drag rights—for example, squeeze-out or tag rights on a merger, on a scheme of arrangement and on a tender/ takeover offer.</p>	<p>Of the IPOs surveyed, there was only one deal that disclosed the sponsor having contractual ROFO/Tag rights post-IPO.</p> <p>The laws of the jurisdiction of incorporation of a company may provide for effective tag/drag rights – for example, squeeze-out or tag rights on a merger, on a scheme of arrangement and on a tender / takeover offer.</p>

Weil's Global Private Equity Practice

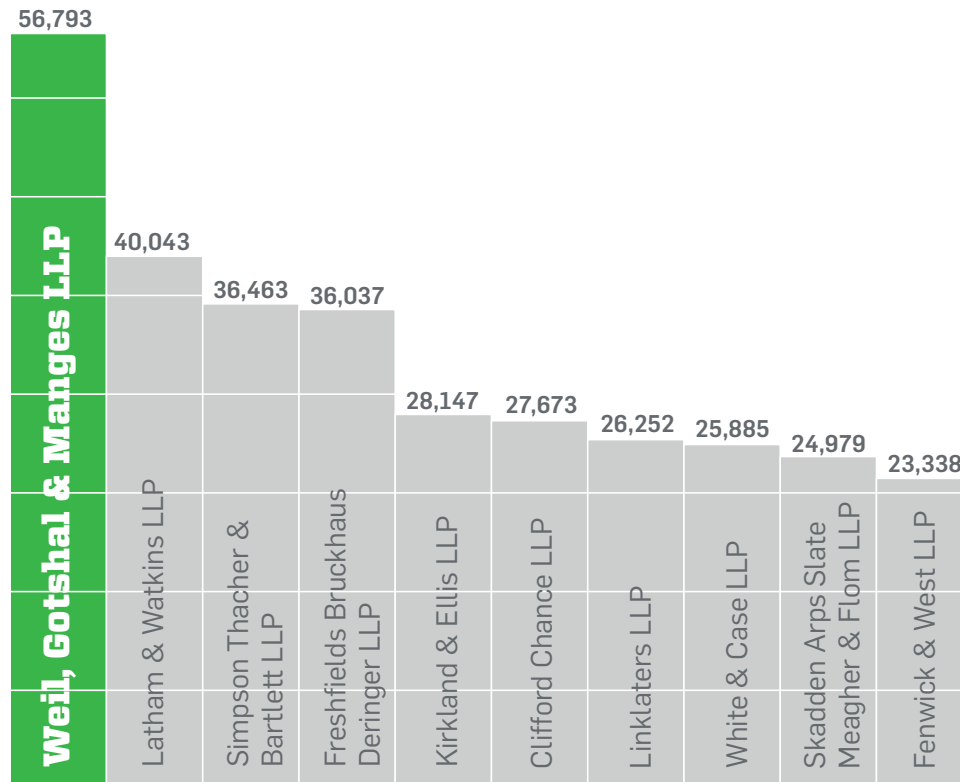
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Global Private Equity Update provides updates on current topics and trends in global private equity and is published by the Private Equity practice of Weil, Gotshal & Manges LLP, 767 Fifth Avenue, New York, NY 10153, +1 212 310 8000, www.weil.com.

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