The Commercial Awareness Group Newsletter

The Tricky Third Issue

What is a Flotation?

A flotation or Initial Public Offering (IPO) occurs when the company's shares are offered on a public exchange such as the London Stock Exchange, PLUS-SX and the Alternative Investment Market.

The main motivation for floating a company in to increase funds; on the initial offering the sale price of the new shares goes straight to the company allowing capital expansion without incurring debt. On subsequent sales of these shares the company will not receive the sale monies. Other benefits include exposure to the public and attracting or retaining a higher standard of management staff through share incentive schemes.

The disadvantages of becoming a public company include the expense of the flotation (often 15-25% of money raised), increased accountability under company law, the listing rules and increased legal and accounting costs to maintain these standards. There is also a higher level of disclosure required which could help competitors, suppliers and customers.

To be able to float a company must comply with the legal and regulatory standards required of a public limited company; sole traders and partnerships can't float, only companies. Public limited companies must have a minimum share capital of £50,000, £12,500 of which must be paid up.

The company's annual accounts and reports must comply with the generally accepted accounting principles of the London Stock Exchange (these are accepted as the standard regardless of which market the company is joining).

Law Firms to Float?

Charlotte Mapston

On the 6th October 2011 Alternative Business Structures (ABSs) which are provided for under the Legal Services Act 2007, will come into being. Essentially the Act provides that law firms can for the first time, be structured differently so as to raise fresh capital through external investment such as flotation, or to bring in non-lawyers such as accountants as partners.

There has been speculation over which law firms (if any) will choose to float on the stock market. In terms of external investment it is likely that most firms would look first to private equity to raise external finance.
However, a private equity investor will identify a capital return on their investment and an exit route from the outset – they will not be interested in just buying into a steady flow of income with no eventual capital return. As exit routes from private equity are limited (namely flotation, sale or recapitalisation) flotation may be a valuable option in the long term.

In terms of who will float, it has been reasoned that mid-sized firms will be the first. The largest Magic Circle firms may be reluctant to take outside capital, and the smaller firms are less likely to attract the interest of outside investors. Mid-sized firms are therefore best placed as they are innovative and aggressive with their goals, yet large enough to be attractive to investors.

One likely consequence of the ABSs will be an increase in the number of Mergers and Acquisitions (M&A). Firstly, external investment will mean that firms can fund acquisitions. This is how Slater and Gordon (an Australian Law firm who became the world's first to float in 2007) funded their expansion. Secondly, due to the increased competition which the Act will bring, some mid-sized firms will lose commoditised work and will therefore look to M&A to sustain their market share.

Another much talked about effect of ABSs and external investment is the insertion of "anti-embarrassment" clauses into partnership agreements. These clauses would allow partners who had retired from the company to receive shares of the profits generated through a capital event such as a flotation or sale. The downside of such clauses is in their potential to create a rift between the younger generations in the firm and those due to retire.

TLT Plc?

Osbourne Clarke UK Plc?

Burges Salmon Plc?

Veale Wasbrough Vizards Plc?

*clarke willmott Plc?

Paul Coulson

What is a private Equity Firm?

Private equity firms usually invest in an already operating company, to achieve a high level of return on their investment before selling the shares in the company back to the market as part of an exit strategy. In return firms will receive a management fee, a share in the profits of the acquired company and either a minority or controlling interest. Squeezing suppliers by negotiating extended payment dates, selling freehold property or other substantial valued assets, reducing staff numbers and implementing sale discounts are just some of the strategies these firms will use to reduce costs and increase operational profit. Short term this improves the health of the balance sheet and creates higher distributable profits but does not always help the company in the long term. This is by no means the only business plan for a private equity company, with many of them investing in start-up companies and research projects. They can provide specialist management or finance that would be otherwise unobtainable, and by buying shares they take on the risk of the venture. A company is free to negotiate the terms of an agreement with private equity investors, so when seeing a case such as Debenhams it is important to consider the directors' and advisors' role in the outcome.

A case in point: Debenhams flotation May 2006

In 2003 Mr Templeman and backers acquired Debenhams as an investment opportunity. The plan was to improve cash management, cut costs, increase sales and expand margins. The first priority was to reorganise the retailer's debt. Funds from a re-mortgage of some of the properties were used to pay off short-term loans and funds from bond markets replaced more expensive loans. Excess capital was used to pay owners of the company a dividend of £130m within months of the takeover. By August 2004 cash flow had tripled from £87.7m in 2002-2003 to £286.4m which was used to reduce overall net debt by £537m to £856m. Significant increases were achieved by slashing prices on slow moving goods and by 2006-2007 Debenhams were holding sales for 16 weeks of the year compared to 8 weeks for Marks & Spencer's, 6 weeks at John Lewis and 5 weeks at Next. Shortly after the acquisition Mr Templeman renegotiated contracts, moving payment dates from on average 27 to 60 days which helped raise an additional £100m. Head office staff were cut by 12%. Capital spending was cut by 39% which impacted on the refurbishment budget. In the summer of 2005 the company successfully refinanced at £1.9bn. Shareholders received £900m of the refinance with a total value received standing at £1bn (double their combined investment of £600m to acquire the company). Net debt increased considerably to £1.87bn.Shortly after the pay-out in the summer of 05, three years after the company was de-listed, Debenhams was offered to the public market at a price of 195p per share (the bottom of the 195-250p range the retailers had set). After only a few weeks Debenhams were issuing profit warnings which impacted on share value by a 15% drop in value. Whilst a percentage of the drop can be attached to a downturn in the retail market conditions, the vigorous take over strategy played an important part. By adopting such harsh cost cutting methods the company was left in a vulnerable position and unable to react to an economic downturn. What was a very successful acquisition was slowly becoming an IPO disaster. Equity firms had squeezed every possible penny out of the acquisition prior to the float, evidenced by reference to the huge returns the private equity firms had received. Investors were beginning to wonder what growth strategies Debenhams had left to adopt – Debenhams was slowly becoming an unappealing investment opportunity.

Whilst the effects of the Debenhams float had a huge impact on the future IPO market not every IPO is predicted to follow suit. An example of this is Kabel Deutschland which floated in March 2010 with a transparent and steady growth plan, and is now performing 75.5% above its initial listing price. The common trend between Debenhams, New Look, Merlin and Travelport (the latter three pulled formal plans for an IPO early last year) is the fact that they are all co-owned and managed by private equity firms. These firms often have objectives which are self-centred and in the best interests of the backers themselves; to realise profit on their investment sometimes to the detriment of the company's reputation. Any company in this position may fall victim to the "Debenhams Effect".. Why do companies decide to allow these acquisitions to take place and are such moves are really in the best interests and promoting the success of the company?