

## Issues for private equity investors contemplating exit by way of IPO.

IPOs have always been regarded as one of the principal exit routes for private equity investors. With the rapidly increasing amount of private equity money under investment, private equity-backed IPOs should become more prevalent. This article considers the

issues relevant to private equity investors contemplating an IPO exit, noting that the IPO route does not typically create a clear path to 100% liquidity.

### Achieving full exit?

Private equity investors are typically focussed on achieving a 100% exit with minimal or zero ongoing exposure from their investments for two reasons: the need to return the proceeds of sale to fund investors within the

lifetime of the fund; and a focus on avoiding contingent liabilities which can erode exit returns. Potential post-IPO investors, however, are less likely to support a full exit, concerned that this might demonstrate a lack of ongoing commitment by the incumbent owners to stand behind the business and forecasts given and/or skeletons in the closet.

Underwriters will usually advise that a stake be retained post-IPO, the size of which often depends on the nature of the company, the length of time the investment has been held pre-IPO and other investors' (if any) retained stakes. Duration for the lock-up is

usually between 6 to 18 months, with timing often affected by the need to ensure the shares are still held after the announcement of the company's results relative to forecasts. In practice, a balancing act occurs, influenced by the effect a full exit of the private equity investor would have on price. Markets are also becoming more aware of the reality that a private equity investor is driven principally by a desire to liquidate an investment. That being the case, a significant locked up stake, and its potential overhang, could result in a negative price effect.

Ultimately, lock-up arrangements should not pose too many concerns

since they tend to be relatively short term and because at least theoretically it is possible for such stakes to be hedged or monetised through derivative arrangements. Having said that, this may depend on whether the fund is mandated to enter the derivatives market. Additionally, managing the liquidation of residual private equity investments on the public markets can be a complex practical and legal process. In this regard, legal issues arising out of takeovers and insider dealing laws become very pertinent, and are made all the more interesting where several funds have jointly invested in a (now listed) investee company. Further, depending on the liquidity of the stock post-IPO (and post any lock-up period), and the size of the stake, a sale can adversely affect the market price of listed stocks. Listed security prices are also often affected by general events outside of any investor's control. Understandably, therefore, fund investors may often not see the benefit in their fund holding listed investments that they could otherwise readily hold directly, should they so wish.

Examples of complete exits by private equity investors are the exits by Bain and Pacific Equity Partners from Vertex Group Holdings in June 2002, Catalyst from Just Group (an Australian IPO marketed in New Zealand) in May 2004 and Credit Suisse from Feltex Carpets in June 2004. In contrast,

stakes were retained by Quadrant in the Pumpkin Patch IPO in 2004, Pacific Equity Partners in the Frucor IPO in June 2000 and AMP Private Equity and Pencarrow Private Equity in the Methven IPO in 2004.

### **Contingent Liability Issues**

In the IPO context, an underwriter or manager usually seeks to obtain warranty and indemnity protection from both the company and selling shareholders with respect to the content of the prospectus and the business.

Private equity investors typically focus on achieving an exit with minimal contingent liabilities. Generally a very limited warranty and indemnity package is available from them. This is typically justified on the basis of their involvement with the funded entity being more akin to that of a significant financier than that of operator/founder/key manager. Exit assurances from private equity investors are a matter for negotiation, and there have been outcomes across the spectrum.

Other potential contingent liability areas for private equity investors include issuer risk, promoter risk and liability through representative directors, to the extent that they remain on the board. Any private equity investor who sells down directly in an IPO is regarded as an issuer, and takes (with

its directors) direct responsibility for prospectus content and compliance. There are, however, many structures which eliminate this particular issuer risk. For that reason promoter responsibility can be the more significant aspect under New Zealand securities law.

Promoter liability in New Zealand attaches to anyone (other than professional advisers, and the issuer's directors who are themselves already directly liable) who is instrumental in the formulation of a plan or programme pursuant to which the relevant securities are offered to the public. In many private equity backed IPOs, this will include the selling out/down private equity investor, who is often the catalyst for the offering, and intrinsically involved in all aspects of the sale process.

Clearly these risks are mitigated by, and indeed could reasonably be regarded as acceptable in the context of, the due diligence defences enshrined in the Securities Act when combined with an appropriately managed and robust due diligence process, and applicable insurance (if any).

### **Control and Information Flows Following IPO**

A concern for private equity investors which maintain an ongoing stake in the company after IPO is their ability to

manage and control their investment against the background of their pre-IPO controlling stake. In this regard, post-IPO, a private equity investor is in a position no different to any other cornerstone shareholder of a listed company. Their degree of influence depends on the size of the stake retained and degree of board representation. Influence is affected by corporate governance requirements, particularly the normal requirement of any listed company board to demonstrate that at least one-third of its directors are independent. This requirement disallows significant association with key shareholders.

A function of this is the reduced information flows available from the company. Other than through any board positions they might hold, consistent with the Listing Rules, information flows should be the same as those provided to shareholders generally.

## Reorganisation Issues

Often a reorganisation is required prior to an IPO. There are two key reasons for this. The first is to present a clean company to the IPO market, rather than trying to float the special purpose vehicle which has been used for the purposes of holding the debt and equity interests of the private equity investor and management. The second is the need to present a suitable bal-

ance sheet to potential investors going forward (particularly the equity component of this).

Any such restructuring needs to contemplate and potentially adjust for: (a) the presence of tax efficient debt instruments existing within the pre-IPO structure; (b) an equity structure that facilitates a partial sell down by the private equity investor and management of their current interests in the company (often not simply ordinary shares); (c) the mechanics of repaying any bank debt which exits pre-IPO and is intended to be repaid contemporaneously with the IPO.

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An abridged version of this article was originally published in *The National Business Review (NBR)* in September 2005.



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