

INITIAL PUBLIC OFFERS

**SUBMISSION TO THE BOARD OF THE LONDON STOCK EXCHANGE
AND THE WEINBERG COMMITTEE ON PRIVATE SHARE OWNERSHIP**

by

THE UNITED KINGDOM SHAREHOLDERS ASSOCIATION

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SUMMARY AND CONCLUSIONS

The proposed change to the existing Initial Public Offer listing rules is a highly retrograde step, based on inadequate consultation and research, which has met with widespread condemnation (see section 3).

The Stock Exchange's decision is particularly ill-timed. The rule change is due to come into effect at the beginning of 1996. Yet the Weinberg Committee, which will not report until the spring, is itself charged with reviewing trends in public ownership by individuals with particular regard to developments in making IPO's.

The Stock Exchange bases its decision on four claims:-

1. The present rule increases the cost of capital to companies;
2. staggering is widely practised by private investors;
3. issues are underpriced to meet existing rules;
4. these rules could not be continued on statutory grounds.

All four assertions are highly debatable (see section 5). For example, our research on issues made in 1994 and 1995 shows that placings are made at much more attractive prices than public offers (see accompanying statistical analysis).

If implemented, the rule change will be the latest and severest blow to individuals' participation in new issues since the 1986 decision permitting placing of smaller issues with institutions began the process of excluding private investors. Instead of excluding them, the Stock Exchange should be promoting their involvement in the raising of capital in an efficient way. Setting minimum application and allocation levels is one obvious step, but there are others (see section 6).

The proposed changes should not go ahead until at the very least the Weinberg Committee has reported. In the meantime the Stock Exchange itself should also examine ways to ensure that private investors are given fair access to all share offerings. It should also ensure that their views are given fair weight in future.

1. PURPOSE OF THIS DOCUMENT

The purpose of this document is to urge the Stock Exchange and the Weinberg Committee respectively to:-

- defer the proposed changes to the existing Initial Public Offer listing rules until such changes have been considered by the Weinberg Committee;
- ensure that private and institutional investors are given fair access to all share offerings. In this regard, the present arrangements for placings call for re-examination;
- give consideration to a new form of listing, the Introduction and Rights Issue;
- ensure, having regard to the government's stated aim of creating a "share-owning democracy", that representatives of private investors are fully involved in future Stock Exchange discussions and represented on Stock Exchange committees so that their views are given due weight.

2. BACKGROUND FACTS

The Stock Exchange issued its initial consultative document concerning its proposals on IPOs in April 1995. The document received very little press coverage. We understand that some 120 responses were received, almost entirely from the "senior representatives of listed companies, merchant banks, corporate brokers, institutional investors and the legal and accountancy profession" with whom the proposals had initially been discussed.

On the 16th of August, the Stock Exchange announced that there was "virtually no direct support for the rule as it stands...The Exchange is not able to maintain a listing rule under these circumstances, when it consulted in good faith." The decision was therefore taken that companies listing on the main stock market will, after the 31st of December 1995, no longer be required to make new issue shares available to private investors through Initial Public Offers. At present, all issues over 60 million pounds must be made available to institutions and private investors alike.

3. REACTION BY VARIOUS BODIES TO THE STOCK EXCHANGE DECISION

The reaction by various bodies and individuals is summarised very briefly in the following quotes:-

‘What nonsense to suggest that issues have been underpriced to accommodate private investors. What an affront to suggest that private investors are not welcome’ - Brian Winterflood, Winterflood Securities, Submission to Stock Exchange, 30/8/95

'A licence for the profiteer' - David Jones, Sharelink (The Times, 18/8/95)

'Mischievous' - David Plucinsky, President, Fidelity (The Times, 18/8/95)

'Mr Jeff Plowman (Director, Wise Speke) says it is "totally wrong". Mr David Jones (Sharelink) thinks it is disgraceful. Mr Peter Hargreaves (Hargreaves Lansdown) thinks it is the worst decision the London Stock Exchange has ever made' - Financial Times, 19/8/95

'Extraordinary and arrogant' - John Cobb, Chairman, APCIMS (The Times, 18/8/95)

'A folly of potentially monumental proportions' - The Times, 17/8/95

'Joe Public - Keep Out' - Investors Chronicle headline, 25/8/95

'Yet another nail into the private investor's coffin' - ProShare, Submission to Stock Exchange

Despite being at the time the only fully independent body run by and on behalf of private shareholders, we were not told of the consultation. It appears that we were not alone in this respect. Hence our response which is conveyed in this document is necessarily later than we would have wished.

4. THE PROPOSED ABOLITION AND THE WEINBERG COMMITTEE

The Weinberg Committee's general mandate is to:

seek to identify the future role of the private investor in the stock market. It will involve...if appropriate, removing obstacles to the growth of private investor participation in the equity market.

Its terms include:

1. To review trends in share ownership by individuals with particular regard to:
 - (ii) developments in methods of making initial public offers.

The future of Initial Public Offers is therefore very much within its terms of reference, particularly since weakening of Initial Public Offer rules since 1986 has coincided with the continued decline of private investor participation in the equity market.

However, the Initial Public Offer rule change is scheduled to take effect from 31 December 1995, while the Committee is not likely to report before February 1996, at the earliest.

So the existing procedure, which traditionally assured private share owners an equal opportunity to participate in new issues, is to be removed before the Committee on Private Share Ownership has had an opportunity to report on its merits and to consider alternatives or improvements.

If the Committee were to establish that some variation on Initial Public Offers was the best way forward, it might face considerable difficulties in arguing for a reversal of the *fait accompli* of a few months earlier.

The timing of the intended rule change may effectively prevent the Committee from giving proper consideration to a crucial part of its brief. We therefore urge the Board to defer the rule change for further consideration by the Weinberg Committee.

5. THE CASE PUT FORWARD BY THE STOCK EXCHANGE FOR THE DECISION

The Stock Exchange's arguments against mandatory IPOs are encapsulated in the paragraph below, which is taken from the Stock Exchange press release of 16 August:

Respondents indicated that there was a high level of flowback of shares from private investors to institutions following their initial take-up. Further, respondents argued that, even for the larger offerings, it was increasingly difficult to stimulate the level of retail investor interest necessary to satisfy the current listing requirements. They indicated the effect of this is that public offerings are underpriced for no reason other than to generate a sufficient level of interest among private investors and thereby satisfy our rules. Most respondents argued that the rule merely inhibits or increases the cost of capital to companies. This cannot be conducive to growth in the economy or to employment generally.

These arguments appear to be based entirely upon submissions presented to the Stock Exchange by interested parties. We understand no research has been carried out to support the accuracy of statements made in those submissions.

Four main assertions were made in the press release and we discuss and challenge these below.

5a. Increasing the cost of capital to companies through underpricing of issues: placings versus public offers

The Stock Exchange press release states:

Most respondents argued that the rule merely inhibits or increases the cost of capital to companies.... This cannot be conducive to growth in the economy or to employment generally.

The present method of issuing new shares can raise the cost of capital in two ways: the holdings of existing shareholders may be diluted through underpricing of the new shares and excessive administrative costs may be incurred either during or after the share issue.

We are not in a position to determine the costs associated with IPOs, although, in Section 6, we suggest some ways in which costs might be reduced.

UKSA has supported an analysis, made by one of our members, of early price movements for shares issued in 1994 and in 1995 to date. The results, which you will already have received, are reproduced for convenience in the Appendix. These figures suggest that placings, from which private investors are excluded, achieve far higher average price premiums than IPOs. For example, in 1995 to date, placings achieved an average price rise of 11.4%, 90 percent went to a premium and 41% went to a premium of more than 10%. In contrast, issues with a public or intermediaries element, in which private investors were able to participate, achieved an average price rise of only 4.3%, with the highest premium achieved being 10%.

The above analysis appears to indicate that placings are significantly underpriced compared with IPOs. If this is so, the decision to remove mandatory IPOs will surely lead to more placings with a consequent increase in the cost of capital to companies - exactly the opposite of the Stock Exchange's declared aim. The analysis also points to the need for a re-examination of the arrangements under which placings are made.

5b. The costs of stagging

The Stock Exchange press release states that:-

Respondents indicated that there was a high level of flowback of shares from private investors to institutions following their initial take-up.

Successful stagging can only take place when new issues are significantly underpriced. We find it difficult, therefore, to understand how this argument can be put forward as a reason for changing the existing Stock Exchange rules.

Clearly a great deal of stagging took place - presumably by institutional as well as private investors - during the privatisation issues. The reason for the underpricing - the financial advice or the political imperative - is still much debated. The same situation is unlikely to be repeated. It should not, therefore, weigh in today's decision.

5c. Underpricing issues to satisfy rules for public take-up

The Stock Exchange press release states that:-

Respondents...indicated...that public offerings are underpriced for no reason other than to generate a sufficient level of interest among private investors and thereby satisfy our rules.

We do not understand this argument since there is no listing requirement that a proportion of IPOs be taken up by private investors - merely that private investors are afforded an opportunity to apply. If there is insufficient private and institutional demand for an issue, it must be that the issue has been poorly timed, poorly promoted or overpriced.

5d. The statutory grounds for removing the IPO rules

The Stock Exchange press release stated that, on statutory grounds, it could not continue with its existing rules:

The basis for the Listing Rules, since the enactment of the Financial Services Act in 1986, is that of investor protection. It is difficult to see that the IPO rules can be included in the Yellow Book as they do not appear to serve any such purpose.

We would argue that mandatory IPOs both protect existing investors by removing the opportunity for shares to be underpriced in placings and afford all potential investors fair access to new share issues. That being so, the IPO rules are entirely consistent with the basis for the listing rules - i.e. investor protection.

As indicated by the New Issues analysis, what appears to be needed is a re-examination of the arrangements for placings.

6. SOME VARIATIONS ON ALTERNATIVES TO INITIAL PUBLIC OFFERS

The intention of this section is to indicate that the cost of Initial Public Offers can be reduced, to consider the alternatives and to suggest a fresh option, the Introduction and Rights Issue, for consideration.

6a. Cutting the cost of Initial Public Offers

One practical way of cutting administrative costs is to avoid creating large numbers of very small shareholders by setting **ni ni num applicati on and allocati on levels**, and setting them realistically high. This requires no changes to the rule books.

Promotional costs associated with Initial Public Offers can also be kept low, where appropriate, by a variety of means. It is not necessary to promote most issues aggressively and at great expense: the minimum requirement should be that the issue is announced to the press through official Stock Exchange channels, and that a prospectus is available in good time to potential applicants.

A major cause of difficulty with Initial Public Offers and Intermediaries Offers has been that a definitive issue price has to be determined before the prospectus can be released. This means either that investors have only a few days to assess the quality of an issue - a frequent complaint - or that the issue price has to be set weeks in advance. In either case,

the issuing house has no opportunity to assess public demand before fixing the issue price.

Companies should be permitted to issue a definitive prospectus well in advance, including a guide price or price range, but to announce the issue price only a week before the subscription deadline. This would both satisfy private investors and assist the issuing house in determining an issue price that will match supply with demand.

6b. Existing alternatives to the Initial Public Offer

An existing alternative to the Initial Public Offer is the **Intermediaries Offer**

Another alternative is the **Sharelink New Issues Application Service (SNIPS)**. Sharelink aims to use this new service to provide direct distribution of new issues to private investors and cut out underwriters, substantially reducing the companies' issue costs.

In the United States, **distribution of new issues to private investors via stockbrokers** is apparently the normal procedure. However, this is in the context of a country where 50% of share are owned by individual investors, making it difficult for issuing houses to ignore them. Sadly, private investors in the UK cannot rely on strength of numbers to ensure an equitable distribution of shares to brokers.

There are two objections to both the Intermediaries Offer and the SNIPS approaches:

Firstly, in the event of an oversubscription it is not possible for issuing houses to scale down applications to a minimum allotment level, since they receive only one aggregate application from each broker.

Secondly, only a fixed proportion of the share issue is generally allocated to an Intermediaries Offer or participating broker, so that institutions still have privileged access to the greater part of an issue, while private investor applications for the same issue may be drastically scaled down. This month's Placing and Intermediaries Offer for Vero provided fresh evidence of a disturbing trend: the Intermediaries Offer covered only 10% of the shares being issued, and as a result was 18 times oversubscribed.

The same objection applies to new issues that are part public offer, part placing.

Furthermore, there is no obligation on the issuing house to make **any** shares available by any of the above mechanisms, so the danger still arises that private investors will only be allowed to participate in issues for which there is insufficient institutional enthusiasm.

SNIPS is a valuable effort to allow private investors some access to selected new issues, but it was only introduced because private investors had become entirely excluded from most new issues, and it is no substitute for public offers.

The common alternative, the placing, has been discussed elsewhere in this paper and fails to provide either fair access to private investors or protection to existing shareholders.

Allocation of shares between private investors and institutions must be on a fair and equal footing, and must be seen to be fair. All these alternatives to the Initial Public Offer fail on these grounds.

6c. The Introduction and Rights Issue

Where the introduction of a company to the Stock Market involves a share issue, an **Introduction and Rights Issue** might be permitted. There is no public offer or placing. Instead, the company is introduced onto the Stock Market and a Rights Issue takes place simultaneously, or shortly afterwards. As with ordinary rights issues, the exercise price is set at a discount; existing shareholders receive rights in proportion to their existing shareholding, and may sell these in the market or may exercise them.

The number of existing shareholders is likely to be small, and, since there is never any 'scaling down' of allocations, no unrealistically small shareholdings are created; the exercise price may be set at a deep discount, eliminating the need for underwriting; administrative expenses are therefore kept to a minimum.

Stagging is eliminated: the difference between the exercise price and the market value of the shares goes to the existing shareholders, so they are fully compensated for the dilution of their holding.

This form of issue is likely to be appropriate only in some instances, for example where the amount of money being raised is small as a proportion of the existing value of the company or where demand for an issue is particularly difficult to determine in advance.

Safeguards would have to be considered. For example, existing majority shareholders might be required to sell all or some of their rights in the market.

The Introduction and Rights Issue may not be suitable in most cases; but it protects the interests of existing investors, who can obtain the full market value of their rights, and it gives equal access to all potential investors.

NOTE: This section was not included in the original submission; instead, a summary of the analysis was included.

The following analysis of price movements on Initial Public Offers and Placings was intended to determine the degree to which

- (a) existing investors in companies that are listed suffer from underpricing of New Issues;
- (b) institutions are gaining exclusive access to the most promising New Issues, at the expense of private investors.

The Stock Exchange has argued that publicly available New Issues are underpriced. If this were true, it would be reasonable to expect these issues to move to a premium after the start of trading. In fact, Placings moved to a far higher premium than publicly-available New Issues, and did even better in 1995 as they became more dominant. Similar results were obtained a month after the start of trading.

The figures compare ISSUE PRICE with the first 'latest price' reported in the Investors' Chronicle. This is generally the price on the first Monday on which the shares are traded.

Only listings on the MAIN MARKET that started trading during 1994, or during 1995 to date (as reported in the Investors' Chronicle up to 10 November 1995) are covered. Investment Trusts, Venture Capital Trusts and Lloyds Trusts are generally excluded. Introductions and Reverse Take-overs are excluded, as no shares are on offer. The BSkyB issue, which was by tender, is also excluded. The figures are calculated arithmetically: there is no weighting for size or value of issue.

Not all New Issues are reported in the Investors Chronicle, so the list is not fully comprehensive; and some issues may be highly volatile during the initial trading period. For 1995 (to date), there were so few offers open to the public that they cannot provide a decent statistical base for analysis, but the volume of data for all New Issues in 1994, and for Placings in 1995, provides consistent and reliable evidence.

During the periods, the Investors Chronicle reported:

	<u>1994</u>	<u>1995</u>
Placings	66	29
Placings/Public Offers	20	4
Placings/Intermediaries Offers	13	0
Public Offers	<u>1</u>	<u>5</u>
TOTAL	100	38

These figures show that private investors had access to 34% of issues in 1994, but only 24% of issues in 1995 to date.

The average profit following a Placing moved from 7.4% in 1994 to 11.4% in 1995.

The likelihood of an immediate paper profit following a Placing rose from 80% in 1994 to 90% in 1995.

The incidence of placings that were deeply underpriced (by 20% or more) rose to an alarming 21% in 1995 - NO publicly available issues were this underpriced.

The likelihood of an immediate paper loss on a Placing fell from 17% in 1994 to just 3% in 1995.

A breakdown of the figures is presented overleaf.

For the 66 Placings reported in 1994, and the 29 Placings reported in 1995:

	<u>1994</u>			
<u>1995</u>				
Greatest loss			8%	
2%				
Greatest gain			40%	
58%				
Average premium		7.4%		11.4%
Shares falling to a discount:	11	16.7%	1	3.4%
Shares not moving:	2	3.0%	2	6.9%
Going to premium 0.1% - 9%	34	51.5%	14	48.3%
Going to premium 10%-19%	13	19.7%	6	20.7%
Going to premium 20% - 29%	2	3.0%	5	17.2%
Going to premium 30% & over	4	6.1%	1	3.4%

For the reported issues that were partly or fully available to the public: 34 in 1994 and 9 in 1995:

	<u>1994</u>			
<u>1995</u>				
Highest loss			10%	
2%				
Highest gain			19%	
10%				
Average premium		3.3%		4.3%
Shares falling to a discount:	9	26.5%	2	22.2%
shares not moving	2	5.9%	1	11.1%
Going to premium 0.1% - 9%	16	47.1%	5	55.5%
Going to premium 10% - 19%	7	20.6%	1	11.1%
Going to a premium 20% & over			none	

Toby Keynes, 16 November 1995

