Alternative Transaction Structures: Germany's New Normal

Law360, New York (February 27, 2014, 6:40 PM ET) -- During the past two years, the European equity capital markets have shown clear signs of recovery. However, these markets continue to experience more volatility than before the global financial crisis. Virtually every market participant — corporations, private equity firms, institutional investors, as well as investment bankers and lawyers — has been searching for a competitive advantage by using alternative transaction models to raise capital without excessive delays.

In Germany last year, market participants relied on several transaction structures to shorten the time to market, maximize flexibility and generally reduce risk in the capital -raising process. We expect these models to increase in popularity and usage in 2014.

Shelf Registrations

Although the shelf registration process, which permits the approval of a disclosure (registration) document for a securities transaction well in advance of an actual offering, has been available since the EU Prospectus Directive was implemented in 2005, German companies previously made little use of it.

Under the EU shelf registration regime, a company prepares a registration document, a securities note and a summary note — together, the three documents comprise the prospectus for a securities offering. The preparation of a registration document in advance of an actual transaction may significantly shorten the period between preparation and launch of an initial public offering or a large capital increase.

Companies can front-load the most time-consuming preparatory tasks (e.g., due diligence, prospectus drafting, etc.) and the process of obtaining the registration document approval by the German regulator, BaFin. (The registration document is valid for 12 months following BaFin approval. Upon approval and publication of the securities note and the summary note, the prospectus also is valid for 12 months.)

Because the registration document is made public by BaFin upon approval, the company has an up-to-date and thoroughly prepared disclosure document available to support early investor meetings and other premarketing efforts in anticipation of a subsequent equity offering. The downside of this process is that the company needs to spend time and incur legal, accounting and other costs prior to knowing if and when an IPO or capital increase transaction actually can take place.

In prior years, the shelf registration process has been used mainly by large German financial institutions such as Deutsche Bank, Commerzbank and Allianz. To increase financing flexibility, we believe that a broader spectrum of German companies will consider this approach, as documentary preparedness should enable them to take advantage of capital markets windows, which have been much narrower and more difficult to predict in the wake of the global financial crisis.

Pre-IPO Placements

In an attempt to reduce risk, German companies continue to seek contractual commitments from cornerstone (i.e., large institutional) investors in advance of an actual IPO. This requires the availability of certain public company information, which investors can use in making investment decisions and conducting comprehensive due diligence reviews.

Pre-IPO cornerstone investors typically will ask for some discount off the subsequent IPO price, and their involvement needs to be disclosed in the IPO prospectus. Cornerstone investors normally do not accept lock-up periods, and their share-holding typically will count toward the minimum free-float requirement for stock exchange listing purposes.

In 2013, Evonik AG completed the largest-ever pre-IPO placement in Germany. Several dozen institutional investors purchased Evonik shares in an aggregate amount of €1.7 billion on the basis of two rounds of global private placements.

Because the pre-IPO private placements ended up accounting for more than 10 percent of Evonik's share capital, the company met the free-float and other listing requirements of the Frankfurt Stock Exchange without the need to implement a public offering of its shares. The pre-IPO investors bought their Evonik shares on the basis of publicly available information (without a prospectus), at a discount to the subsequent IPO price and with a lock-up period lasting until the shares were listed on the exchange.

Although a 2013 landmark equity capital markets transaction in Germany, the circumstances of the Evonik pre-IPO placement were quite unique: After three failed IPO attempts and because of public information made available by Evonik to its then-existing bondholders, institutional investors already had sufficient information about the company, enabling them to make an informed cornerstone investment decision without significant further due diligence. The transaction was implemented within a very short time frame (less than two months) with investors from the United States, Europe, the Middle East and Asia.

Because of the special circumstances surrounding the Evonik pre-IPO (including those related to disclosure), meeting the entire free-float requirement for a stock exchange listing on the basis of cornerstone investments will remain the exception. However, privately and bilaterally negotiated investments by institutional investors prior to an IPO undoubtedly will increase, including in connection with spinoffs of well-documented divisions of public companies or for IPOs of frequent bond issuers, particularly those in the high-yield market.

Block Trades and Accelerated Book Building

Undocumented block trades remain an appealing method for German public companies to secure quick access to equity capital markets while avoiding a comprehensive due diligence investigation and preparation, review and approval of a lengthy disclosure document. The block trades involve an accelerated book building, which means that the time between launch of the transaction and pricing typically is 24 hours or less.

From a German corporation law perspective, companies accessing the capital markets to raise funds on a block-trade basis rely on Section 186 (3) of the German Stock Corporation Act (Aktiengesetz), which permits the exclusion of the subscription rights of existing shareholders if (1) the capital increase in question does not exceed 10 percent of the company's issued share capital and (2) the placement price is not less than 3 to 5 percent below the then-current market price at the time of the placement.

Block trades frequently are implemented overnight, with the German issuer or shareholder contacting a number of investment banks on the evening prior to the intended placement, soliciting bids in an auction-type process (on the basis of prepared documentation) and awarding the trade to the bank committing to the highest backstop price.

The decision to launch the block trade typically is made following the stock exchange's close because of BaFin's ad hoc publication obligation, and the placement with institutional investors happens overnight with a pricing occurring most often within 12 to 24 hours after launch.

Dual-Track Structures

As a result of recent capital markets volatility, selling shareholders, in particular private equity firms, have decided to run parallel IPO and mergers and acquisitions processes to increase transaction certainty for a contemplated exit at the highest possible price. While there are certain synergies between the capital markets and M&A processes (e.g., with respect to due diligence and certain documents, such as the IPO prospectus and the information memorandum provided to the bidders in the M&A process), there also exist significant challenges to align the timetables for the two processes.

During the past two years, almost all German dual-track situations ended up in an M&A trade sale, because selling shareholders often prefer transaction certainty with a full exit at a defined valuation. A partial exit in an IPO, possibly with a higher valuation and valuation upside, is subject to share price and capital markets volatility for many months — and possibly years — to come.

We believe that German capital markets volatility and unpredictability will need to be taken into account for the foreseeable future. As a result, alternative and, at times, innovative new transaction structures will continue to be developed.

Increasing the documentary preparedness for an equity capital markets transaction early, shortening the time-to-market period through block trades and reducing risk in transactions through pre-IPO and dual-track structures are the new normal. So is the institutional investors' willingness to transact with companies directly without investment banks as intermediaries. These developments will continue to change how transactions are structured, marketed and documented.

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