Strategic Growth Markets

Globalization

Global IPO Trends Report 2007

Ernst & Young

Quality In Everything We Do

Dear Friends:

The rapid globalization of capital continues to propel global Initial Public Offering (IPO) markets forward with powerful momentum, as new issuances raised the greatest amount of capital ever in 2006 and the first quarter of 2007 saw several large IPOs. The emerging markets remain the wellspring of the world's most vibrant growth stories, with China fueling Asian markets, and Russia driving European markets. Chinese companies raised the most capital, including the world's largest IPO ever, thanks to its headline-grabbing IPOs. Regionally, European exchanges hosted the most IPOs, sparked by the popularity of London as the top listings destination for cross-border issuers, especially from Russia. Among countries, the US, which still has the most sophisticated and mature capital market, launched the highest number of IPOs in 2006 and in the first quarter of 2007.

Heated rivalry among the world's exchanges for cross-border listings has led to many attempts at bourse partnerships, including the NYSE Euronext merger, successfully completed in 2007. At the same time, with the vast surge in liquidity on local exchanges, most of the world's largest IPOs are now listing at home. Finally, in the past 18 months, private equity firms have been powerhouse players behind many of the world's large IPOs, as financial sponsors buy companies, add shareholder value, and take them public.

Trends in IPO activity can be difficult to predict. However, as long as conditions remain favorable, the packed IPO pipelines in 2007 indicate a diverse range of large, but not super-sized, profitable companies ready to come to the market on the world's exchanges in the months to come.

After extensive interviews with the world's top investment bankers, stock exchange leaders, and global company executives, Ernst & Young's *Globalization: Global IPO Trends 2007* reviews the major developments in the worldwide IPO markets in 2006 and 2007. As the fourth global IPO report produced by Ernst & Young, this review offers an in-depth examination, from a spectrum of informed perspectives, of the key issues for companies planning an IPO today.

In 2007, companies around the world continue to look to the public markets as a source of financing. We look forward to working with these companies and their teams in their transformation from a private entity to a public enterprise.

Strategic Growth Markets — Ernst & Young

Globalization

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IPO Perspectives

Global IPO Trends Report 2007

Globalization Broadens World Capital Markets Horizons

KEY TRENDS:

- **Propelled by emerging market mega-deals, global IPO markets soared in 2006, and remain buoyant in 2007.**
- **Growth-hungry investors hunt for higher returns abroad, especially in emerging markets.**
- **As local stock markets grow more liquid and well regulated, 90% of the world's companies list on domestic exchanges.**
- **Hong Kong and London lure the top global IPOs, a reflection of the rise in more world-class financial centers around the world.**
- **Global bourse rivalry leads to the transatlantic NYSE Euronext merger, and more exchange alliances are expected soon.**
- **A wide array of capital-raising options exist including private equity, Rule 144A and M&A.**
- **Private equity's impact on world IPO markets mounts as LBOs swell in size.**

Accelerated globalization of capital continues to drive the record-setting world IPO markets of 2006–2007. Around the world, companies, investors, and stock exchanges think and act much more globally, often looking outside domestic markets for high growth opportunities. In the past 18 months, key IPO trends reflect the effects of globalization: flourishing stock markets awash in liquidity, vibrant growth in the emerging markets, escalating rivalry between the world's stock exchanges, the rise of more world-class financial centers, the boom in large listings on local exchanges, and the proliferation of capital-raising options, especially private equity's emergence as a key player behind so many large IPOs. In 2007, globalizing capital and a surge in IPO ready companies worldwide are broadening the horizons of the world's financial markets.

Worldwide IPO Markets Raise Record Funds

In 2006, buoyant investor confidence in bullish equity markets fueled worldwide IPO activity. The amount of capital raised worldwide by companies going public rose to a record US$246 billion in 2006. The number of listings also leapt upwards to 1729 IPOs, the highest number in a calendar year since 2000. (See Figure 1, page 5). China's companies raised the most capital at US$56.6 billion, followed by US companies with total proceeds of US$34.1 billion, and Russia's companies with US$18 billion in funds raised. The US launched the highest number of IPOs with 187 deals, followed by Japan with 185 deals, and China with 175 issuances.

Super-sized IPOs from the emerging markets, especially privatizations in China and Russia, greatly amplified the global amount of capital raised in 2006. Indeed, the emerging markets were the source of almost half of the top 20 IPOs in value. In 2006, the world's largest IPO ever, China's largest state-owned bank, Industrial Commercial Bank of China (ICBC), raised US$22 billion, while the second-largest IPO, China's state-owned Bank of China, was worth US$11.1 billion.

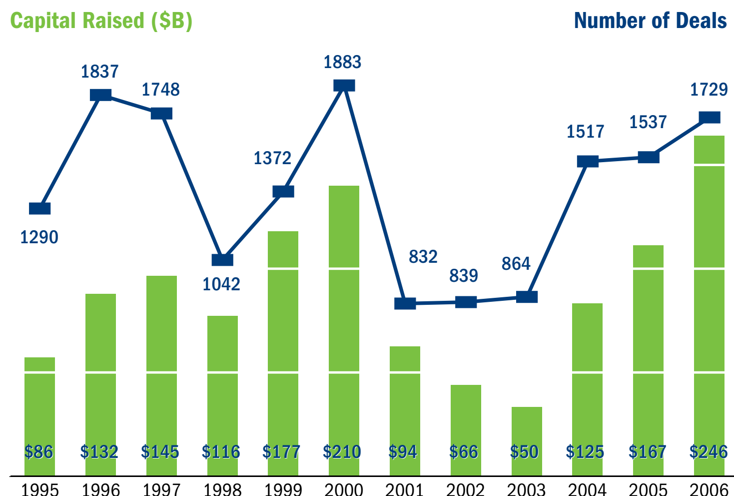
The trend for dynamic IPO markets continues in the first half of 2007. Although relatively large companies are still going public in 2007, this year's top IPOs have not been nearly as sizeable as last year's mega deals. For example, in the first quarter of 2007, the top three IPO deals raised about US$2 billion each.

A Surge in Large Listings on Local Exchanges

The growth of cross-border trading has compelled local exchanges to become more liquid, stringent, and up to date—all of which has set off a sharp rise in large listings on local exchanges. In 2006, local exchanges from around the world hosted many of the top 20 IPOs—including South Korea, Japan, Italy, Switzerland, India, Germany, Netherlands, and France. Thus, in the past 18 months, the number of financial centers that could be readily recognized by global market players as world-class has increased.

The widening of the world market perspective can also be seen in the distribution of IPO activity among regions and stock exchanges in 2006. Europe's exchanges raised the most funds with 39% of the total global capital raised (US$95 billion), thanks to the many cross-border issuers listing in London. Bolstered by Chinese mega deals, Asia-Pacific exchanges placed second, with 35% of the total value (US$85.5 billion), while North America's exchanges

Figure 1: Global IPO Activity by Year



Source: Dealogic, Thomson Financial, Ernst & Young

"The growth of cross-border trading has compelled local exchanges to become more liquid, stringent, and up to date"

came in third with 19% of the total value (US$46.3 billion). As for IPO activity on individual stock exchanges, for the first time ever, the Hong Kong Stock Exchange (HKSE) led with 19% of global capital raised (US$46.1 billion), the London Stock Exchange (LSE) came in second with 13.5% of the total value (US$33.3 billion), and the New York Stock Exchange (NYSE) placed third with 10% of the total value (US$24.5 billion) (See Figure 2, page 6).

"I believe globalization is here to stay," says Donald Straszheim, Vice Chairman of Roth Capital Partners. "As international trade and global competition grows, investors and prelisted companies are going to be looking outside their home countries, while stock exchanges and regulators will be constantly reviewing their rules with an eye toward other countries' regulations."

The Hunt for Higher Returns in Emerging Markets

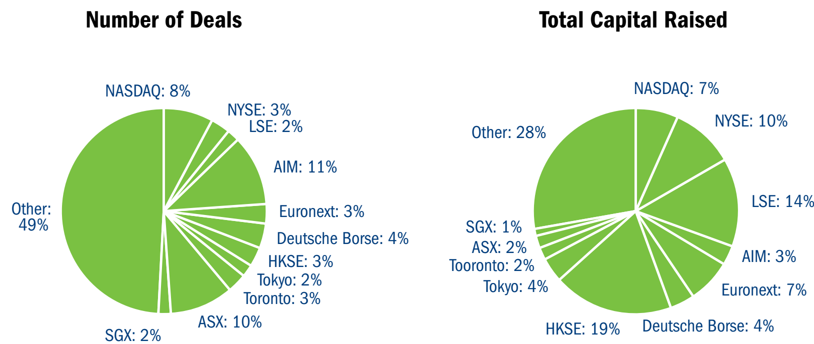
Eager investors seeking high-growth stories are heating up the fast-growing emerging markets. Jumbo-sized issuances from China and Russia are driving markets in Asia and Europe, and creating new global investment and business opportunities. "We're stuck in a European economy that is growing, but it's not high growth," says Henrik Gobel, Managing Director and Head of the Equity Syndicate Desk at Morgan Stanley. "Investors are looking for high growth, and that means the emerging markets are a big focus."

In 2006, IPOs coming from BRIC countries (Brazil, Russia, India, and China) raised US$86.5 billion in 279 deals (See Figure 3, page 6). Reflecting the belief that more institutional investors could be tapped abroad than on the domestic exchange, emerging market IPOs raised US$20.6 billion on foreign exchanges, mostly in London. "As the emerging markets economies prosper," says Straszheim, "they are realizing that they need to develop sophisticated, up-to-date equity markets. They are therefore working hard to try to learn from the developed world what the appropriate tools are and what the right structure is for their own equity market."

Why have developed-world investors been loading up on emerging markets allocations in recent years? "From 2001 to 2003, emerging-market economies began growing rapidly," says Anton Cherny, Managing Director and Head of Equity Capital Markets at Renaissance Capital in Moscow. "By 2004, capital began migrating from the developed economies into the emerging markets, leading to the global rebound in IPO activity that continues into 2007."

The bottom line is that in recent years emerging markets have outperformed developed markets. "If you look at markets as a whole, emerging markets as an asset class are up 30% or 40% last year as opposed to global markets, which were up 15–19%. The returns and the growth have certainly been strong within the emerging market asset class," says Richard Cormack, Head of New Markets, Equity Capital Markets, Goldman Sachs International.

Figure 2: Global IPO Activity by Exchange (2006)



Source: Dealogic, Thomson Financial, Ernst & Young

There's No Place Like Home for Most Companies Going Public

Nonetheless, even as capital becomes more global, the vast majority of IPOs stay local. Around the world, companies still prefer to list where they live. The growth of local liquidity and international investor interest has enabled even the largest of companies to list at home. "For about 90% of the world's companies, their primary place of listing will be in the market where they operate, assuming it is a reasonable stock exchange," says Christoph Stanger, Co-Head of European Equity Capital Markets at Goldman Sachs International. "If they do a dual listing, it's usually because their local domestic market isn't big enough for doing a transaction."

Most pre-listed companies prefer to stay local for their IPOs since their customer base is usually local, and it is local investors who best understand their business. For most companies, the local markets are where infrastructure, investors and liquidity can most easily be found, and where investor relations, regulatory framework, and market expectations are the most familiar. "The depth of liquidity, the infrastructure for settlement and closing, and the sophistication of investors all over the world have made non-US venues for listing much more competitive," says Christopher Turner, Managing Director of Warburg Pincus.

"The same investors who are now very comfortable investing in regional exchanges, at the millennium would only have been comfortable investing in the US and London markets," notes Cormack. "It isn't so much globalization of stock exchanges that's influencing capital market activity, but globalization of capital."

Deepening worldwide liquidity is making the trend towards localization possible. Global growth in institutional and retail markets and the localization of global asset managers in the emerging markets are producing greater liquidity. Analysts point to the Asian capital markets as a good example of the localization trend—global asset managers have relocated people, capital and resources to the region in order better manage larger and dedicated pools of capital focused on Asia. As a result, most global asset managers can now invest directly in emerging markets.

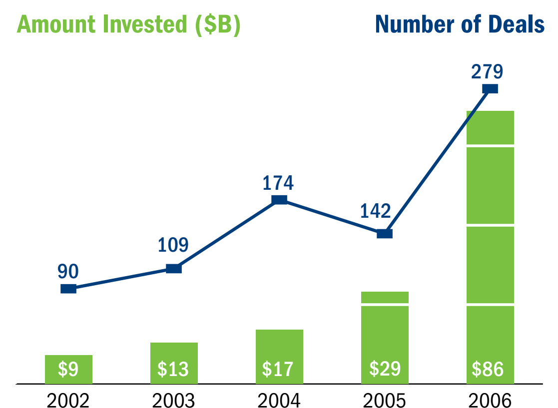
"A healthy capital market is critical to a healthy economy, and vice versa," says Larry Wieseneck, Head of Global Finance at Lehman Brothers. "We are moving into a world where there are an increasing number of viable, flourishing economies. This is translating into more sophisticated capital markets in many regions of the world. The success of the ICBC transaction without a US or European listing is an example of the increasing liquidity available around the world and should be viewed as a very positive testament to the strength of the Asian marketplace and economies."

Global Exchange Rivalry Heats Up

Although 51 exchanges existed worldwide in 2006, with a total market capitalization of US$50.6 trillion, the top six exchanges—NYSE, Tokyo, NASDAQ, LSE , Euronext, HKSE—commanded 61% of total market capitalization, while NYSE and NASDAQ alone represented 35% of the market total. "As companies become more global, and competitiveness among exchanges continues to grow, we expect more listings on non-home exchanges," says Straszheim.

Nowadays, the world's top exchanges must out-jockey each other for prime listings, especially from the emerging markets. In 2006, Hong Kong and London attracted more

Figure 3: BRIC Countries IPO Activity by Year



Source: Dealogic, Thomson Financial, Ernst & Young

Larry Wieseneck

Head of Global Finance
Lehman Brothers, Inc.

Ernst & Young: ***What's your take on the global IPO markets in 2006?***

Larry Wieseneck: It was a pretty vibrant year. There were some large transactions coming out of the financial sponsor community over the last two years (2005 and 2006), as well as a re-emergence of some of the types of IPOs that were happening pre-2001, although not to the same level of excess. In addition, we started to see some real growth companies coming back to the market again. This is compared to the prior years, 2003 and 2004, when the IPO market really was a combination of mainstream companies being re-IPO'd by sponsors that had taken them private and carve-outs from larger corporations.

So you really had a three-legged market in 2006 — you saw carve-outs from large corporates, sponsor backed IPOs and real growth companies coming to the IPO market. This combination of different types of companies accessing the public equity markets is a sign of the health of the market. It is a sign that we really have turned the corner in many respects from the down cycle that occurred after the peak in the market in 2000. Therefore, I think that this is a pretty healthy, robust market.

What we were missing in 2006, and why some people might say it wasn't as robust as it could otherwise have been, is that there is a little bit of a chill that has come over the US market as it relates to international issuers. We're just not seeing nearly the same amount of non-US issuers listing in the US as we have in the past. What has happened is that foreign issuers are accessing either their local markets, or in many cases, the London market. It is not that international issuers aren't accessing the equity markets, it is that they are accessing non-US equity markets.

Continued on page 14

Noreen Culhane

Executive Vice President, Global Corporate Client Group
NYSE Euronext

Ernst & Young: ***What are the benefits from your merger with Euronext?***

Noreen Culhane: The merger with Euronext has allowed the New York Stock Exchange (NYSE) to expand its footprint globally, becoming the world's only transatlantic exchange. It has also allowed for the continued diversification of asset classes beyond cash equities. We trade options, bonds, OTC stocks, and now with the addition of LIFFE (London International Financial Futures and Options Exchange), we are in the futures business.

The derivatives markets are growing at a very rapid rate with healthy margins. In terms of top-line growth, the merger represents an important step for the NYSE and for Euronext. We also have the opportunity to consolidate some of our post-trade processing data centers, and our trading platforms and networks. This should reduce our costs substantially.

With regard to our issuers, the benefits will certainly grow and develop over time. We are uniting the largest two investor pools: the US dollar base and the euro currency investor pool.

Through services and other support mechanisms we plan to gain greater visibility for European companies in the US capital markets, and for US companies into the European investor pool. The trading day has been extended to 13 hours. Over time, fungibility between the two markets will increase. Even now you can buy our stock, NYX, in euros in the morning and sell it in dollars in the afternoon, as we are listed in both New York and Paris.

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“The same investors who are now very comfortable investing in regional exchanges, at the millennium would only have been comfortable investing in the US and London markets.”

IPOs than New York. However, analysts believe this never-before-seen exchange pecking order is due to the extraordinary boost in value from the mega Chinese bank IPOs, and New York probably will regain its previous ascendancy.

The US exchanges are competing with other world exchanges like never before. “Ten years ago, global companies were all compelled to have NYSE listings as part of their offerings,” recalls Wieseneck. “Much of their international demand would come out of the US. Now, global companies are increasingly saying they’re not coming to the US market. Rather, if they’re going to have an international listing outside the home market it’s going to be London or Euronext. That’s a big change.”

While some critics point to US regulations and litigation risks for the increase in non-US IPO listings, it is undeniable that the globalization of capital has increased the ability of many local exchanges to host large listings. “The US market is still the most open market, with the most stability of value over the long-term,” says Wieseneck. “Over a period of time, a given sector in the US market will generally trade at a premium to the same sector in the European markets. Despite that, many issuers are willing to give that up to avoid the intrusiveness they think US markets will bring them.”

NYSE Euronext: The World’s Largest Exchange Group

Increased globalization of capital markets has led the two largest exchanges in the world—NYSE and NASDAQ—to avidly pursue European partners. In April 2007, NYSE merged with Paris-based Euronext for US$14.3 billion, creating the first transatlantic stock exchange. It’s also the world’s largest exchange group, linking NYSE with exchanges run by Euronext NV in Paris, London, Brussels, Amsterdam and Lisbon. More alliances and mergers are expected among world exchanges in the near future.

NYSE Euronext will consist of 4,000 listed companies with a total market capitalization of US$28.5 trillion—greater than the combined total of US$14 trillion for the next four largest exchanges: LSE, Tokyo, NASDAQ and HKSE. Listed companies on NYSE Euronext include 78 of the world’s 100 biggest companies, such as General Electric and France Telecom. Each day, average daily trading value will be about US$120 billion. With the merged exchange, securities can be traded 13 hours a day across two continents. Cross-border trading will be made easier through cross-listings, global indexes and exchange-traded funds. However, since the exchange is not yet a single regulated platform, the US-registered companies will be regulated by the SEC and those listed in Europe will be regulated by the European markets as well as by the FSA.

Consolidation of Stock Exchanges Cuts Costs

Rival world stock exchanges view consolidation as a competitive strategy: a way to capture more listings, expand markets beyond country borders, and improve liquidity. Analysts say, as many of the world’s exchanges have gone public themselves, they are accordingly being run as businesses. They are seeking cost efficiencies, and growth of economies on a global scale.

“The consolidation of exchanges is primarily about driving down the cost of trading,” says Gobel. “Investors and brokers have been frustrated by European exchange trading costs that are higher than in the US. If the exchanges don’t get together and drive down the costs themselves, then the banks will force the issue. It’s a question of providing efficient trading, cut throat prices, and the best liquidity settlement system. That’s what the exchange is there to do.”

Gobel notes, “Capital is global today and most large investors can invest in any market in the world, so the choice of exchange comes down to location, regulation, cost and where it feels most natural to be listed. ”

Stock exchange requirements do not drive corporate governance standards. “If a company wants to do a successful offering, the banks will advise, and the company will impose corporate governance standards that will attract the best investor base,” says Anton Cherny, Managing Director and Head of Equity Capital Markets at Renaissance Capital. “In my experience, very little is driven by exchange requirements, and a lot is driven by the desire of the company to attract the best investors.”

“Stock exchanges are doing what any other company in a mature industry would do,” says James Klein from the Capital Markets Group from Ernst & Young in Moscow. “They’re consolidating—no different from steel or auto companies consolidating. It just happens to be stock exchanges.”

A Wide Array of Capital-Raising Options Exist

In addition to going public, private companies have a variety of capital-raising alternatives, including private equity, a trade sale and Rule 144A offerings. Acquisition by a private equity firm is an alternative to a new issuance, for those companies that feel undervalued by the public market, are not operationally ready to go public, and are not willing to take on the regulation and reporting requirements required of a public company. Acquisition by a private equity firm allows a private company to achieve liquidity, acquire growth capital, and focus on long-term performance. "When the equity markets are strong, the best value is often going to be realized by an IPO," says Wieseneck. "When the equity market is not as strong, the exit for a private equity player is often to sell the company to another private equity player."

Pre-listed companies keep their options open for an IPO or a trade sale by "dual-tracking"—a continuing trend. Since a multi-path approach can increase a company's strategic options, improve negotiating leverage and reduce the execution risks of exiting, businesses are wise to prepare themselves for more than one funding source. "Pre-listed companies just run those tracks in parallel," says Stanger. "They say they're going to go public, but at the same time they see whether there is another sponsor who offers value superior to the public markets."

Furthermore, many of the larger overseas transactions are accessing US capital without a US listing—through Rule 144A deals, named after the US SEC rule that permits them. Under Rule 144A , stocks of foreign issuers can be sold only to US "qualified institutional buyers," (QIBs) but are exempt from SEC registration, thereby providing quicker, cheaper access to the US capital markets. Because none of the Rule 144A shares trade publicly, these stocks operate under the radar screen of most investors. "The Rule 144A deal is a backdoor into the United States market," says Klein. "It helps you raise capital from US investors without really doing the registrations."

"A big play is to do a local equity IPO and then gain US institutional investors through a Rule 144A transaction," says Jackson Day, Global Director of Capital Markets at Ernst & Young. "In this way, your primary regulator and financial statements come from your local markets. It's very easy to tap the American markets through Rule 144A rather than doing a US listing. You can avoid US regulation, but also there is a lot more money available and at a cheaper rate through Rule 144A."

Indeed, the top three IPOs in 2006, (ICBC, Bank of China, Rosneft) did a Rule 144A offering along with a local equity IPO offering. As an example, China's ICBC raised a total of US$21.9 billion, through a Rule 144A offering in the US (US$15.4 billion) and through a dual listing on the Hong Kong and Shanghai Stock Exchanges (US$6.5 billion).

Global Private Equity Seeks IPO Exits

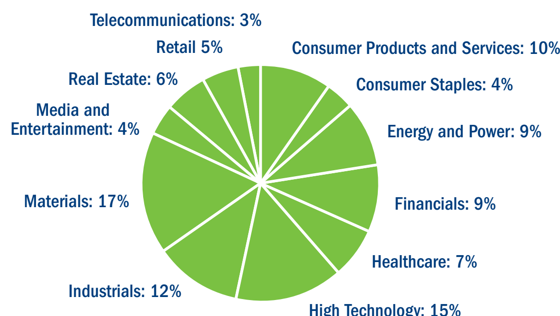
"The enormous expansion of private equity, which relates to some of the regulatory burdens and litigation risks in America, has been by far the most important development in the past few years," says Straszheim. With capital markets saturated in cash and cheap debt, well-heeled private equity firms have become key players in the IPO and M&A markets.

What's behind the surge in private equity activity worldwide? "It's global liquidity—cash looking for ideas to create value," says Wieseneck. "Both the private equity and hedge fund community have deep pockets full of cash. When you combine this with very cheap sources of capital for the debt component of the deal, many companies become quite attractive as LBO candidates."

A private equity firm can be a launch pad toward a future IPO as it improves underlying systems, in a grooming process similar to that of an IPO. Private equity firms are churning their companies at ever-greater speeds: buying private entities or taking public entities private, adding shareholder value, then quickly putting them back into the public markets. An example of the buyout trend is Hertz Global Holdings, the US rental car firm, which a private equity firm bought, restructured, and took public less than a year later at a price tag of US$1.3 billion in 2006.

Experts predict many more IPOs, as the public companies taken out by private equity become larger. The bigger the company that private equity buys, the more likely it is that the exit will be by IPO. "Because of the large size of the companies now, it's often an IPO that provides the highest value," says Joseph Muscat, America's Director, Venture Capital Advisory Group, Ernst & Young. In the past, the exit of choice for a private equity firm was usually a merger with an existing company in their portfolio. "However, now, private equity firms globally are finding very large placements of capital the most profitable, and they are seeking opportunities in the emerging markets where there is a combination of rapid growth and great potential via IPO and M&A," says Muscat.

Figure 4: Global IPO Activity by Industry – By Number of Deals (2006)



Source: Dealogic, Thomson Financial, Ernst & Young

'Public-to-Private' Trend Fuels World Equities Demand

De-equitizations or so-called public-to-private transactions are an emerging global trend. Cash-loaded private equity firms are scooping up well-established public companies and taking them private again. The value of companies taken private in 2006 was US$150 billion—a new record and almost triple the amount in 2004. "In recent years one of the drivers of the strong markets has been de-equitization," says Wieseneck. "If you look at the M&A activity, the LBOs, and the stock buy-backs, the net amount of equity outstanding has decreased more than the new issues have been able to fill that vacuum. So you have a lot of demand for equities out there."

"There are three reasons for the rising trend of taking public companies private again," says Gregory Ledford, Managing Director of the Carlyle Group. "First, companies feel under-loved and under-valued—Wall Street doesn't understand them, they are trading at a discount to their peers. Second, there is tremendous pressure to meet quarterly numbers with the knowledge that the value of the company will be penalized if the quarterly numbers are missed. Third—and this is to a far lesser extent—Sarbanes-Oxley and all other regulatory issues can be cumbersome."

M&A Offers an Attractive Alternative to an IPO

Many global companies view a trade sale through M&A as an appealing alternative to a traditional IPO, especially if there's a buyer willing to pay a premium. In 2006, global M&A volumes rose to their highest peaks ever at US$3.8 trillion. The frenetic deal-making pace looks unlikely to slow down this year. With M&A's significant deal activity last year, many companies which were IPO candidates chose the M&A track instead. "In most situations, if it was available to us, strategic sale would be our top option, because there is certainty and you can get your cash much quicker than through an IPO," says Ledford.

Fueling the M&A activity is the unprecedented eagerness of banks and hedge funds to lend money to deal-makers, cash-rich private equity funds, lower interest rates, cheap credit, an "eat-or-be-eaten" pressure felt by CEOs, and the vigorous worldwide economy. "Broadly, M&A deals are actually very healthy for the equity market and for IPOs," says Wieseneck. "It creates a floor value of equities, which means equity investors tend to see better returns, and therefore they have more cash to put to work into new opportunities like IPOs."

In 2007: A Healthy, Diverse IPO Market

When the Shanghai exchange nosedived almost 9% in the first quarter of 2007, news of China's stumble helped to trigger a massive flight from risk throughout global stock markets. Global blue-chip indexes plunged between 3% and 7% in a huge one-day sell-off. Analysts say that investors had grown complacent of the global risks, including the US sub-prime mortgage loans, and possibility of economic slow-down and inflation. The global market decline seemed to draw investors' attention to the meaningful risks that did not seem to be fully priced into their own markets. At any rate, most markets quickly stemmed their losses, and were on a more even keel by the end of the first quarter, albeit with perhaps a more toned-down approach toward risk.

In 2007, high-quality companies continue to surge through world IPO pipelines with last year's momentum, albeit with smaller deal sizes. Global IPOs in the first quarter of 2007 raised a total of US$36.5 billion through 371 IPOs. A rich variety of companies fill the pipeline. Many more "basic" companies, such as industrial, financial and consumer retail companies, are going public. "You really have a three-legged global market in 2006–2007. You see carve-outs from large corporates, sponsor-backed IPOs, and some real growth companies coming to the IPO market" says Wieseneck. "This combination of different types of companies accessing the public equity markets is a sign of the health of the market. It is a sign that we really have turned the corner in many respects from the down cycle that occurred after the peak in the market. Therefore I think this is a healthy, robust market." ■

Donald Straszheim

Vice Chairman
Roth Capital Partners, LLC

***Ernst & Young:* When you look back at the last 12-18 months, what are the lessons learned about the globalization of equity markets?**

Donald Straszheim: The primary lesson is that economic activity is becoming more globalized. As a result, investors are thinking in a more global fashion. In North America, in Europe, in Japan, and in all of the developed world, investors have greatly increased their asset allocation toward the emerging markets. Why? Because they see these developing markets are beginning to have faster growth and to dominate manufacturing and trade activity. And, as trade and globalization both become more important, investors are thinking more globally.

As the emerging markets have seen their economies prosper, they are realizing that they need to develop real, sophisticated, up-to-date equity markets. They are therefore working hard to try to learn from the developed world what the appropriate tools are and what the right structure is for their own equity market.

Global financial sector leaders are becoming much more sophisticated with respect to corporate governance, the role of boards of directors, regulatory issues, insider trading, internationally accepted accounting practices, and the like, so that foreign investors will be sufficiently confident to participate in their markets. I think that the persistence of economic growth and the modernization of the emerging markets are the two most important developments in the last couple of years.

***Ernst & Young:* Was the Shanghai Stock Exchange the trigger for the decline in equity markets around the globe in February of this year, or was there another dimension to it?**

Donald Straszheim: What happened in the Shanghai markets was unprecedented. That 9% decline of 27 February was the first time in which an event originating in the Chinese domestic equity markets created a shock that was felt around the world. That fact in itself is significant. It indicates that China has gone, over the last few years, from being merely interesting to being important. Investors around the world will now pay more attention, understandably, to China than they have in the past.

A broader question relates to whether this decline in Shanghai will have an important effect on China's economy and accordingly on the global economy. For China's economy, the impact will be trivial. The reason is that equity financing is not really important yet to China's economic development and growth. Of the companies listed on the Shanghai Stock Exchange, about two-thirds are state-owned enterprises. They do not rely on raising money from domestic Chinese investors to finance their activities. They're state owned and Beijing will take care of them to whatever extent Beijing chooses, without much regard to what Western investors would see as traditional investment principles. It's also important to remember the origin of the Shanghai and Shenzhen Exchanges. They were formed in 1990 as policy arms of the government, not as places where sources of capital could meet users of capital in the standard equity market sense that Western investors understand.

In 1990, China had a host of state-owned enterprises. The government at the time thought it would be a good idea to create a domestic stock exchange in China, list the state-owned enterprises domestically, and sell shares to outside investors, thereby raising the value of the state's stake in their own companies. That was the origin of the Shanghai and Shenzhen Stock Exchanges and it remains so to this day. I don't think what happened in Shanghai and Shenzhen is all that important for China's economy. What drives China's economy is not paper gains or paper losses on equities, but rather the jobs created via trade and exports, and the income those activities generates.

In terms of whether the February equity decline in China might have a lasting effect on equity markets around the world, the answer is also no. Most investors around the world now understand that the Chinese market is not a very good model for overseas equity markets, given that it is dominated by state-owned enterprises and that the investors are predominantly retail investors who are still quite unsophisticated.

Concepts that Western investors understand such as return on equity, price earnings ratio and the like, still don't command any real mind share among Chinese retail investors. That market is much more driven by what I could charitably call technical considerations, stories, or rumors. With the rules and investor behavior still very different, Chinese equities don't tell us much about non-Chinese equities.

Continued on page 16

"As the emerging markets have seen their economies prosper, they are realizing that they need to develop real, sophisticated, up-to-date equity markets."

Noreen Culhane, continued from page 7

***Ernst & Young:* As this merger did not create a single regulatory platform, what is the impact on the pre-listed companies?**

Noreen Culhane: The merger gives private companies more choice as they consider the public markets. A company from anywhere in the world has the option to list in the US capital markets, assuming they meet our standards on NYSE or NYSE Arca, and/or in the non-US regulated markets to list on Euronext or Alternext. If a company from an emerging market wishes to access a global platform, but does not see itself reconciling to US GAAP or complying with Sarbanes-Oxley, it might choose instead to be listed on Euronext and regulated by the European regulators.

Over time, a company that did an IPO in Europe might grow its commercial business in the US and decide to dual-list in New York. We will offer issuers multiple entry points and flexibility to grow and expand their investor base in step with their business.

***Ernst & Young:* What do you think is driving this current consolidation of exchanges?**

Noreen Culhane: The financial services industry has been consolidating for several years, and the exchange space will mirror that. We will see a handful of truly global players alongside a much larger number of exchanges focused on a specific geography or asset class. NYSE Euronext will be a leader in this consolidation.

Traditionally, markets have been very national in scope, but money is fluid globally and investors increasingly seek opportunities outside their home markets. We can see that in the US capital markets, where 21% of portfolios are invested outside the United States. The consolidation of markets will eventually deliver an opportunity for investors to trade much more seamlessly in markets around the world.

***Ernst & Young:* As 90% of IPOs go public in their home markets, how do you compete for the remaining 10% that choose cross-border listings?**

Noreen Culhane: We compete by offering a compelling value proposition. NYSE Euronext represents the deepest pool of investors globally. The dollar and the euro are the number one and number two currencies, and the largest pools of liquidity. Companies from an emerging market, for example, may not have a home market as deep and as liquid, and may not have a culture of equity investing like the United States or Europe, both of which have large retail investor pools in addition to institutional investors. Third-party studies conclude that there is a valuation premium that accrues to companies listed in their home market and in the US market.

Many different types of companies seek cross-border listings. Some have a commercial footprint in the United States and seek greater visibility. Others are quite interested in acquisitions in the United States and seek a currency for these acquisitions, or may have employees in the United States to whom they wish to offer stock options as a component of compensation. Some seek the distinction of meeting the world's highest standards as a clear differentiator. Our track record in attracting international companies speaks for itself.

***Ernst & Young:* What will be the impact when emerging market exchanges attain US standards?**

Noreen Culhane: One great benefit of globalization and consolidation is that all exchanges will continue to evolve and improve. Competition enables choice. Those who wish to compete will have to offer high-quality markets, deep investor pools, and excellent service.

Emerging markets will catch up, but companies with a global footprint will also seek an expanded investor pool and the visibility that comes with listing on a global exchange such as NYSE Euronext. Companies that wish to differentiate themselves will seek to list where both standards and valuations are high.

Let's look at two examples. India's capital markets have a long history and China's are very new, yet we have many companies from India, China and, for that matter, Latin America and Europe listed on the NYSE in addition to their home market. I see this continuing for quite some time.

***Ernst & Young:* When you look at the global IPO landscape over the last 12 to 18 months, what were some of the key trends or takeaways that stood out for you?**

Noreen Culhane: In both the domestic and the non-US markets, we saw strong activity in industries such as energy (Western Refining Exco, Verasun, Venoco, Valero) and consumer brands (Sealy, Burger King, Chipotle, J. Crew). In the domestic markets, the financial sector in particular (Nymex, KBW, Mastercard) was quite active. We also saw strong regional concentrations outside the United States, such as China, India, and Latin America.

***Ernst & Young:* What is your view on the outlook for IPO activity in the next 12 to 24 months?**

Noreen Culhane: I would characterize it as a continuation of last year. We have an active domestic and international pipeline. Talking to the intermediaries, including bankers, venture capitalists, and private equity shops, I think they too would echo the sentiment that the market is quite active at the moment. IPO activity is always subject to market conditions, which can change quickly, so predicting 24 months ahead would be very difficult. Certainly for the near term, we see a strong IPO market, characterized by a discriminating investor base looking for companies with proven management and

"Traditionally, markets have been very national in scope, but now, money is fluid globally and investors increasingly seek opportunities outside their home markets."

sustainable business models. Several companies are coming back into the market from the portfolios of private equity firms. Last year, sponsored deals accounted for 55% of the proceeds raised in the form of IPOs. Our international business is looking stronger than last year, which, in turn, was stronger than the year before. Our transfer business from other markets is also successful and building momentum.

***Ernst & Young:* What's your view on the fact that Hong Kong and London were the top global exchanges in 2006?**

Noreen Culhane: This ranking indicates that the markets are global and very, very competitive. If you look at the top 25 IPOs from last year ("top" is defined by market value), only two registered in the US capital markets, yet more than three-quarters of them did Rule 144A placements in the US capital markets. So the US market remains a very critical component for large companies placing their shares, whether public or private, but we see some factors influencing the competitiveness of the US capital markets. One is regulatory in nature and Sarbanes-Oxley, particularly Section 404, is part of that. Second are the costs of reconciling financials to US GAAP. Another is the litigious nature of doing business in the United States. The plaintiff's bar is a concern. Companies in other countries do not experience this in their home markets.

With regard to regulation, specifically Sarbanes-Oxley, the NYSE has been very active over the last two and a half years. We've worked with legislators, regulators, CFOs and audit committee chairs of our listed companies toward finding a better costs-benefits balance in Section 404. We believe that Sarbanes-Oxley is generally good legislation and that CEOs and CFOs should be accountable to investors. Transparency around financial statements benefits all involved. Internal controls themselves are a good business practice, but with regard to Section 404, we feel that the cost and benefit are out of alignment.

We have made solid, credible progress with the SEC and the PCAOB, as well as the legislative bodies, toward a meaningful modification to align the costs and the benefits of Section 404. Chairman Cox of the SEC has said publicly that Section 404 will be modified. We believe that the recommendations that we made to both the SEC and PCAOB will largely be reflected in the changes.

***Ernst & Young:* What do you think would be the impact of these reforms to Sarbanes-Oxley?**

Noreen Culhane: The impact of the reform to Section 404 would be significant: companies would get more comfortable as costs and benefits were better aligned. We are encouraged by the progress in mutual recognition of US GAAP and IFRS, which we expect in late 2008. We have supported this work and see the resultant reduction in cost as a factor in making the US markets more attractive. With regard to tort reform, I don't foresee much meaningful change, and this will continue to be an issue for the competitiveness of the US capital markets. ■

Larry Wiesneck, continued from page 7

***Ernst & Young:* Why are cross-border issuers listing more on non-US exchanges?**

Larry Wieseneck: For many, many years the US had the advantage of being the only real liquid market with transparency, proper disclosure, and straightforward accounting rules, among other traits. This led to the US market being by far the best market for companies that wanted to get the best price for their issues. By definition the most open market is the one with the best disclosure and the least friction costs, and that market should have the most liquidity and should be the best place to maintain a stable price — for many years, that has clearly been the US market.

If you went back ten years ago and looked at the big global companies doing big transactions, anything from Deutsche Telekom to the big Asian entities, when they went to the market they were compelled to have New York Stock Exchange listings as part of their offerings. Often, much of their international demand would come out of the US.

Now, the reality is that when those same kind of companies look to come to the market place, they are increasingly not coming to the US market; rather — if they're going to have an international listing outside of their home market — it is going to be in London or on Euronext and I think that's a big change.

If you look at the data what you'll see is the percentage of global IPOs that list in New York is down significantly on a relative basis versus a decade ago. A number of factors have combined — the increased liquidity of the European market combined with what is perceived to be greater friction costs created by the current environment in the US — and have made the US market somewhat less competitive.

One of the factors that has changed the equation is that the US market, in many respects, basically relies on litigation as a form of regulation. When you combine the highly litigious nature of the US market — which has been there for many years — and the changes in the market place brought on by Sarbanes-Oxley, I think it feels from a foreign issuer's standpoint that the long arm of litigation risk is always there if their company is listed in the US. The implementation of Sarbanes-Oxley in this decade has made the litigation risk more pronounced. Furthermore, the global markets are continuing to grow and therefore there has been an increase in the liquidity available in foreign market places, particularly in London. These factors are impacting foreign issuance in the US. While there may still be a small cost benefit to issuing in New York, the European markets no longer suffer from significantly less liquidity than the US market.

Issuing in London, or elsewhere, has the benefit of having significantly less litigation risk going forward for companies and their management teams. That risk is described by people as Sarbanes-Oxley related, including too much disclosure required in the US and too many delays related to SEC reviews, etc. The bottom line is that these laws which are intended to protect investors in the US framework seem at this point to have become real friction costs that many companies don't want to incur unless they absolutely have to — and with the growth of the global markets in many cases they don't have to.

The other piece of this is growth companies. The US market had traditionally always been the best market for those companies to come to, but today, if you are a Swiss biotechnology company or a German technology company, your first thought might not be a listing on NASDAQ, it might be to list on either Euronext or the London Stock Exchange as your global outlet to appeal to growth investors. That's a big change.

That being said, the US market is still the most open market, and is still ultimately the market with the most stability of value over the long-term. If you look at most periods of time, a sector in the US market will trade at a premium to the same sector in the European markets. Despite that, as I said, many issuers are now willing to give that up to avoid the intrusiveness that they think US markets will bring them.

***Ernst & Young:* What's behind the huge rise in private equity sponsorship of IPOs?**

Larry Wieseneck: There are really two issues — the first is we have a glut of cash. There is global liquidity, cash looking for ideas to create value. Both the hedge fund community and the private equity community have significant amounts of cash available and are actively looking for deals to put that cash to work. Some of that money in the hedge fund world finds its way to activist investors who are looking for ways to create more value than just being a passive shareholder or investor. So part of what's driving this is the ability of an investor to actively help a company to take an action which creates value. The surplus of cash is causing these active investors to seek out and respond to these types of opportunities.

On the private equity side, the large amount of available cash has created an environment where private equity firms have lots of liquidity being put to work in transactions. It is this same macro trend, this glut of cash looking for returns, that has driven the credit markets to what are very, very attractive levels for financing deals. And so we have a combination of lots of money available on the private equity side to put to work in transactions, combined with very cheap sources of capital for the debt component of the deal, which results in many companies appearing to be fairly attractive LBO candidates that in a different environment may not have been as compelling.

So, in summary, if you are looking for a root cause, it is the significant amount of liquidity in the global markets that is driving this LBO activity. Combine that liquidity with the many corporate management

teams that have historically chosen to operate their businesses with capital structures without a significant debt component and it creates an opening for the private equity world to step in and, predominantly by simply modifying the capital structure, create a lot of value for equity holders. That is really the opportunity side of the equation.

***Ernst & Young:* What's your perspective on the ICBC offering and rapid growth in the emerging markets?**

Larry Wieseneck: The reality is that the markets around the world have all become far more efficient. This offering is just a commentary on the fact that ultimately there is depth of market, particularly for the largest names, in all marketplaces around the world. And so the fact that ICBC could accomplish that large a deal without issuing either in one of the European markets or the US is a statement about the quality of the capital markets globally. To me, it's neither a negative nor a positive from the US perspective, but rather it is a positive for the capital markets that there are pools of liquidity globally available for transactions.

Generally, I think that, as economies become more advanced and have more success, the capital markets in that region grow in line with the overall growth of the country and economy. A healthy capital market is critical to a healthy economy and vice versa and, as you know, we are moving into a world where there are an increasing number of vibrant economies around the world and, by definition, that means you are going to develop more sophisticated capital markets in many regions of the world.

***Ernst & Young:* Why are we seeing a broader spectrum of IPO deal types in most global IPO pipelines?**

Larry Wieseneck: I think that is a true statement, that we are seeing a broader spectrum of types of IPO deals. However, it's less a reflection of something unusual going on in today's market and more a reflection of what was unusual in the markets in the late nineties and the very early part of this decade. If you look over a longer period of time you would expect to see the companies that are funding themselves to be representative of the economy generally and particularly those areas of the economy that are growing. It was really only during the late nineties and the early part of this decade, where we had such an exceptional focus on certain growth areas like technology, telecommunications, and healthcare, that companies from this sector began to represent a larger proportion of the equity markets than one would expect, and appeared to be out of line with the rest of the economy.

There was a moment in time, in the late nineties and early 2000s, where companies that were really nothing more than a business plan were able to get funding in the public equity market. Those kinds of deals, those kinds of companies, are back where they are supposed to be, which is in the private market getting private equity funding and are only coming to the public markets when the business plan has been proven out. That is the way that the markets have worked for decades and the way they should operate, and there was only a brief period when they operated differently than that.

Now there is a more stable sort of marketplace with more diverse types of deals happening on a regular basis. Companies are growing and going public; we are seeing private equity firms who have purchased companies then turn around and sell those companies to public markets; we are seeing large corporations carve out subsidiaries and take those public. The reality of all these types of deals is that we are seeing a lot more basic industrial, financial, and consumer/retail companies coming to market than we did six or seven years ago. This is a more steady-state market and I think we should expect more of this to come.

The other thing is the deals that are happening now are primarily for companies that are profitable and have lots of cash flow. It is much less of an "options market" where investors are buying a company with the hope that the company is going to triple in value over the next five years. Instead, it is a more durable and sustainable market where investors are buying into companies that have real, stable earnings power and are looking for sensible returns for their investments.

There is greater investment activity because people won't go out as far on the risk curve in the public markets as they did back in 2001. There is a greater focus on ensuring that companies have a real business model and a greater burden on management teams to articulate that business model. ■

"Currently, it is a more durable and sustainable market where investors are buying into companies that have real, stable earnings power and are looking for sensible returns for their investments."

Donald Straszheim, continued from page 11

“Globalization is putting an increasing burden on exchanges and regulatory officials to consider the global landscape as they make competitive decisions on how to operate.”

***Ernst & Young:* How do you describe the current competitiveness of the US equity markets and what, if anything, needs to change?**

Donald Straszheim: What we have seen in the last couple of years, since the passage of the Sarbanes-Oxley legislation, is that an increasing number of firms, especially small, high-growth firms, have concluded that the regulatory and administrative costs of listing in the United States have risen so much that listing elsewhere is more desirable.

This is significant for the US, simply because New York, during the last century at least, was regarded as the center of the financial world. That position is being partially eroded. Accordingly, other exchanges around the world have taken advantage of their opportunity and, understandably, courted many of these emerging-market firms. Officials in the US are beginning to realize that they need to rethink the regulatory structure here with respect to whether the burden for emerging companies has simply become too great relative to alternative places around the globe. This issue now has the attention of Washington policy-makers. It will likely become a hot issue over the next couple of years as they try to strike a balance between protecting investors from the misdeeds that might be committed on them, versus the ever-increasing cost of some of these regulations, costs that are simply prohibitive to smaller companies who want to focus on growing their companies rather than on what many regard as needless paperwork.

Also, the litigation situation in the US is a factor. This is a real issue for small companies that do not want to run the risk of legal entanglements eroding their real business focus.

***Ernst & Young:* Most companies tend to list in their home markets. Do you see any change in this trend?**

Donald Straszheim: No. Most companies have listed at home historically simply for the reason that it is their domestic investors who are most familiar with them and so these companies are most comfortable with listing domestically. What is happening though is that, as the economy becomes more globalized, the country of a company’s headquarters and its corporate charter is becoming in many ways less relevant.

We now talk of Toyota as a Japanese car company. Increasingly in the future we may talk of Toyota not as a Japanese car company, but simply as a car company, as they produce, distribute, market, and sell all over the world. This phenomenon will likely grow over the coming years, and as a result you will see more companies with global ambitions, perhaps listing not at home but wherever they feel most comfortable.

In the old days, when a company was started by an entrepreneur, it produced and sold its product in its own city, then in a wider area, then perhaps across the entire nation, and then ultimately it might grow into selling it worldwide. Now with the advent of the Internet and other advanced communications technologies, the very first sale an entrepreneur might make could be from halfway around the world rather than from their own home town. This globalization is putting an increasing burden on exchanges and regulatory officials to consider the global landscape as they make competitive decisions on how they operate, or run the risk of companies listing elsewhere.

China is a good example. There are quite a few young Chinese entrepreneurs who have chosen not to list their companies on the Shanghai or Shenzhen domestic exchanges, but to list them in the US or in London, for example, for precisely the reasons just specified.

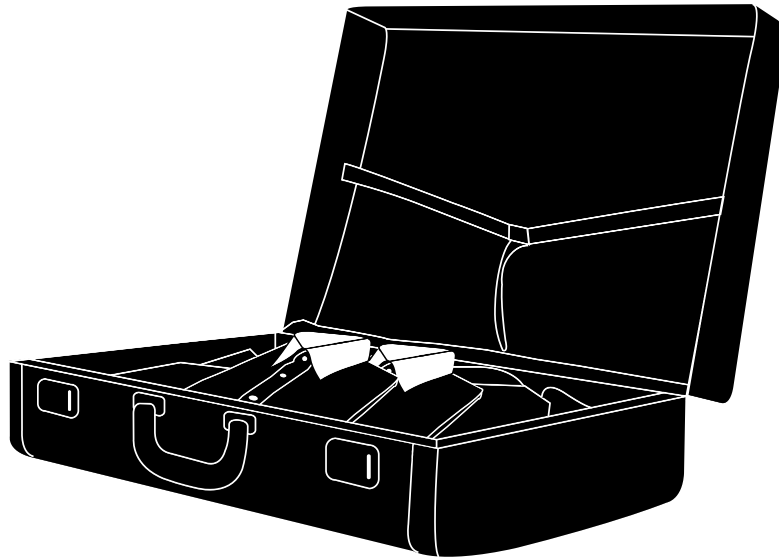
Also, there is a global competition among the exchanges that I find to be quite favorable. Competition in virtually any endeavor is good—not bad. And as trade becomes more important, operating companies, and institutional, and individual investors, are looking outside their home country for financing, listing, and trading. In this context, regulators of all different sorts in the business and financial sphere will be constantly looking at and reviewing their rules and regulations, with an eye toward similar rules and regulations in other countries and how that dynamic, one to another, plays out.

***Ernst & Young:* What are the primary reasons for Chinese technology companies to choose overseas listing?**

Donald Straszheim: It all gets back to regulations, litigation, competitiveness, access to capital and a long-run growth vision. The companies that we see coming to the US for listing are in many cases companies founded by young Chinese entrepreneurs who came to the West for their college education, fell in love with capitalism and the markets, saw a great opportunity, and perhaps stayed on after college to work in, say, a technology company or on Wall Street.

But in the long run, the entrepreneurs are Chinese, and will go back to China to make their fortune. With that global vision established, they want to list their companies where it is most advantageous. In most cases, this is still likely to be in overseas markets where the rules are more established, rather than in markets like Shanghai or Shenzhen where the rules are still under development.

You are likely to see this global vision persist for some time,. We believe that, particularly in the technology sector, an increasing number of Chinese companies want a direct link with America, via financing mechanisms that are mature and developed in America, but are primitive and still quite immature in the rest of the world. ■



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Top 20 Largest IPOs (2006)

Top 20 Largest IPOs

Name	Domicile Country	Industry	Proceeds (US $M)	Primary Exchange
1. INDUSTRIAL & COMMERCIAL BANK OF CHINA-ICBC	China	Financials	21,929	Hong Kong
2. BANK OF CHINA LTD	China	Financials	11.186	Hong Kong
3. ROSNEFT	Russian Federation	Energy and Power	10,656	London
4. NATIXIS	France	Financials	5,296	Euronext
5. STANDARD LIFE ASSURANCE CO	United Kingdom	Financials	4,444	London
6. LOTTE SHOPPING LTD	South Korea	Retail	3,738	Korea
7. AOZORA BANK LTD	Japan	Financials	3,218	Tokyo
8. SARAS SPA	Italy	Energy and Power	2,637	Milan
9. MASTERCARD INC	United States	Consumer Products and Services	2,579	NYSE
10. CHINA COMMUNICATIONS CONSTRUCTION CO LTD	China	Industrials	2,379	Hong Kong
11. PETROPLUS HOLDINGS AG	Switzerland	Energy and Power	2,318	Zurich
12. KAZMUNAIGAS EXPLORATION & PRODUCTION	Kazakhstan	Energy and Power	2,255	London
13. CHINA COAL ENERGY CO LTD	China	Materials	1,945	Hong Kong
14. DEBENHAMS LTD	United Kingdom	Retail	1,924	London
15. DAQIN RAILWAY CO LTD	China	Industrials	1,921	Shanghai
16. SYMRISE AG	Germany	Consumer Staples	1,846	Frankfurt
17. RELIANCE PETROLEUM LTD	India	Energy and Power	1,832	Bombay
18. SNS REAAL GROEP NV	Netherlands	Financials	1,724	Euronext
19. BIFFA PLC	United Kingdom	Energy and Power	1,691	London
20. SPIRIT AEROSYSTEMS HOLDINGS INC.	United States	Industrials	1,647	NYSE

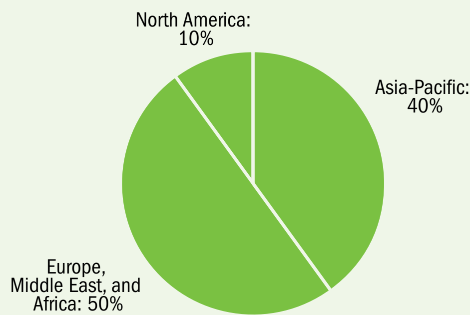
Source: Dealogic, Thomson Financial, Ernst & Young

Top 20 Largest IPOs (2006)

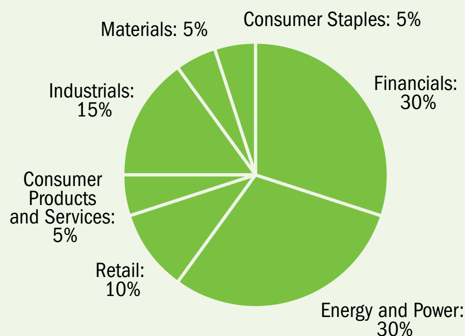
Top 20 IPOs by Industry, Region, and Exchange – Number of Deals

In 2006 the Top 20 IPOs raised about US$84 billion, representing 35% of the total capital raised by IPOs. Membership in the Top 20 IPOs Club required a minimum of US$1.6 billion in capital raised. In keeping with the historical norm of companies listing at home, all 20 went public on their domestic exchanges, except for 2 cross-border IPOs on the LSE from Russia and Kazakhstan. Among the Top 20, the dominant industries were energy/power/oil and financial services.

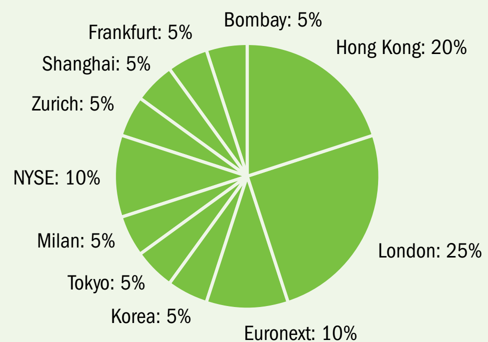
Region



Industry



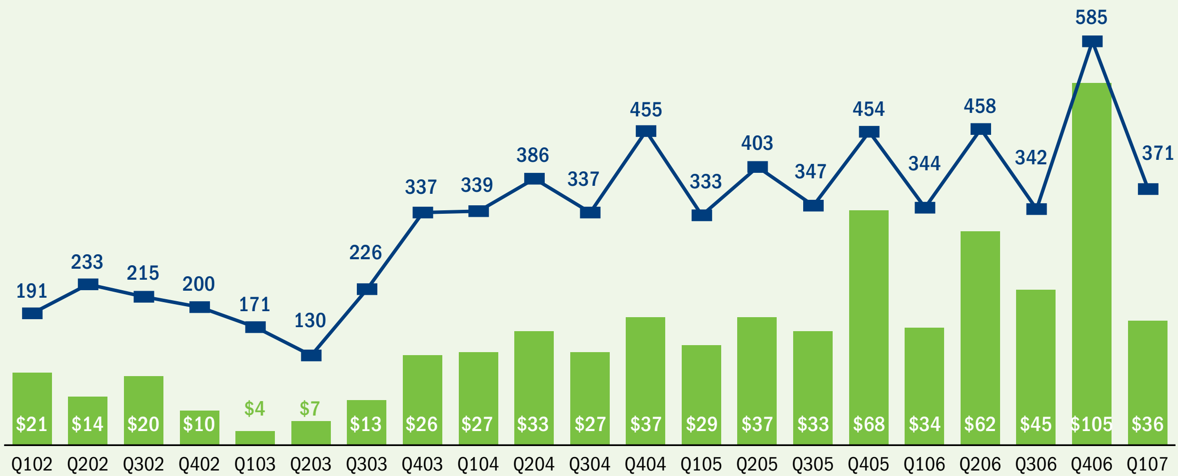
Exchange



Source: Dealogic, Thomson Financial, Ernst & Young

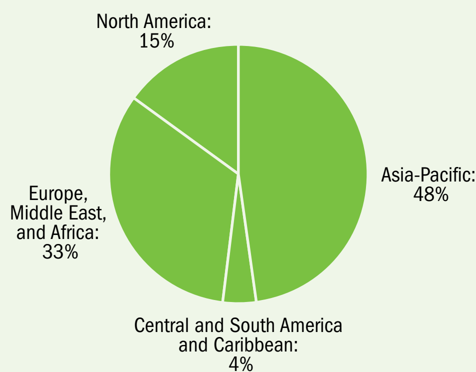
Q1 07 in Perspective

Global IPO Activity by Quarter

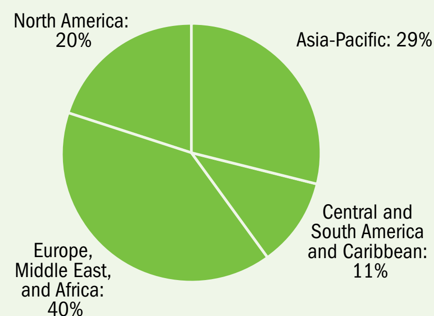


2007 Q1 IPO Activity by Region

Number of Deals



Total Capital Raised



Source: Dealogic, Thomson Financial, Ernst & Young

Q1 07 in Perspective

Top 10 IPOs January-March 2007

Name	Domicile Country	Industry	Proceeds (US $M)	Primary Exchange
1. INDUSTRIAL BANK CO LTD	China	Financials	2,050	Shanghai
2. SMURFIT KAPPA GROUP	Ireland	Materials	1,943	Dublin
3. SPORTS DIRECT INTERNATIONAL PLC	United Kingdom	Retail	1,828	London
4. OIL REFINERIES LTD	Israel	Energy and Power	1,529	Tel Aviv
5. NATIONAL CINEMEDIA INC	United States	Media and Entertainment	882	NASDAQ
6. JBS SA BRAZIL	Brazil	Consumer Staples	777	São Paulo
7. INTEGRA GROUP	Russian Federation	Energy and Power	767	London
8. GEM DIAMONDS LTD	United Kingdom	Materials	664	London
9. FORTRESS INVESTMENT GROUP	United States	Financials	634	NYSE
10. POLYMETAL OAO	Russian Federation	Materials	605	London

Source: Dealogic, Thomson Financial, Ernst & Young

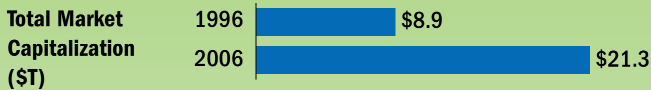
The World in Focus
Global IPO Trends Report 2007

Global Capital Markets and IPO Activity (2006)

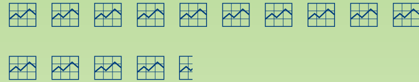
North America

4 Exchanges

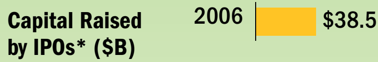
Total Market Capitalization ($T)



292 Companies Gone Public*



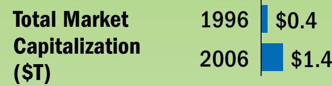
Capital Raised by IPOs* ($B)



Central and South America and Caribbean

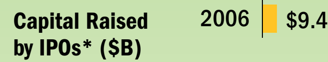
7 Exchanges

Total Market Capitalization ($T)



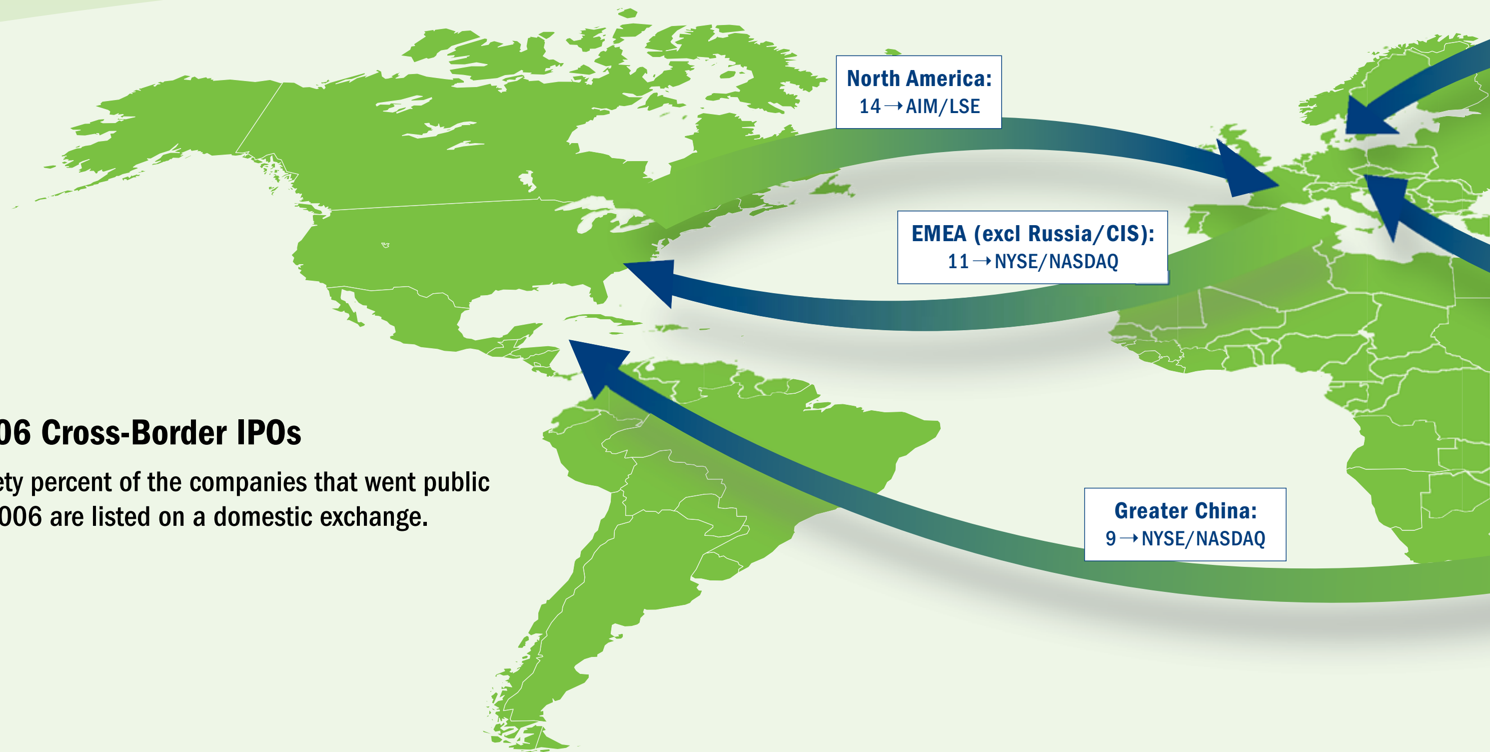
31 Companies Gone Public*

Capital Raised by IPOs* ($B)



* By country domicile

= 20 units



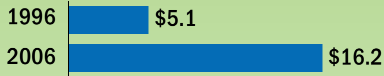
2006 Cross-Border IPOs

Ninety percent of the companies that went public in 2006 are listed on a domestic exchange.

Europe, Middle East, and Africa

23 Exchanges

Total Market Capitalization ($T)



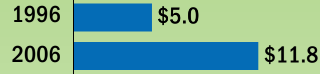
464 Companies Gone Public*

Capital Raised by IPOs* ($B)

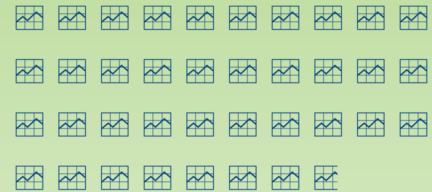
Asia-Pacific

17 Exchanges

Total Market Capitalization ($T)



758 Companies Gone Public*



Capital Raised by IPOs* ($B)

Russia/CIS:
15 → AIM/LSE

Greater China:
16 → AIM

Greater China:
28 → SGX

Greater China: Hong Kong and Shanghai Host the World's Largest IPO Ever

KEY TRENDS:

- **Greater China's IPO markets launched mega–IPOs in 2006, with more large (but no longer super-sized) IPOs in 2007.**
- **HKSE led world exchanges in fundraising in 2006, and showcasing its world-class liquidity and corporate governance standards.**
- **As global resources migrate to China, foreign investors grow more comfortable investing locally, especially in state-owned enterprises.**
- **A dual-listing trend and budding rivalry emerges for the Hong Kong and Shanghai stock exchanges.**
- **Many large Chinese companies offer shares to US institutional investors under Rule 144A.**

Driven by yet another year of rapid economic growth and robust secondary markets in 2006, Greater China's IPO market soared to an all-time high, with US$56.6 billion raised in 175 offerings (See Figure 2, page 28). With conspicuous success, the Hong Kong Stock Exchange (HKSE) hosted privatizations of China's two largest state-owned banks — including the world's largest IPO ever, the Industrial and Commercial Bank of China (ICBC) with US$21.9 billion raised, and the second largest offering, Bank of China (BOC) which raised US$11 billion. The ICBC issuance was also the first time in China that shares were dual-listed on both the HKSE and Shanghai Stock Exchange (SSE) simultaneously, at the time of the IPO. In 2007, the trend for big IPOs in China continues. For example, in the first quarter, the state-owned Industrial Bank issuance raised approximately US$2 billion.

Mega-IPOs Showcase HKSE's World-Class Status

The ICBC and BOC issuances clearly demonstrated that HKSE has become a global capital markets player, with ample liquidity and world-class corporate governance standards. In 2006, HKSE hosted 4 of the world's top 20 biggest IPOs. Also, for the first time ever, HKSE came out No. 1 among world exchanges for total proceeds, with US$46.1 billion raised, topping LSE in second place with US$33.3 billion raised, and NYSE in third place, with US$24.5 billion raised. However, the first-place ranking of the HKSE is viewed by most market-watchers as a "one-off," largely due to the inflated size of the ICBC offering, and the US is expected to re-establish its traditional dominance in 2007.

Global Investors Plant Stakes in China's Growth Story

China's mega IPOs exemplify the massive migration underway of global capital market resources into Greater China's local markets. Global asset managers have relocated people, capital, and resources into China as they manage larger, dedicated pools of capital focused on the region. Global investment houses have set up branch offices in Hong Kong or China, allowing foreign investors for Chinese funds to buy IPOs locally. Analysts observe that because many of the global investors who are going to buy the stocks are already based in Hong Kong, it is no longer necessary to list in the US. As Greater China's markets have become easier to access, foreign investors are clearly becoming more comfortable purchasing investments in the local markets.

At the same time, investors are also growing more at ease with the Chinese regulatory environment. Investors are focusing primarily on state-owned enterprises and dominant industry players, perhaps since the biggest companies seem to represent pivotal stakes in China's vibrant economic growth story.

With the long pipelines and increasing investor selectivity, a prelisted company in China may be facing higher quality hurdles. Says Jocelyn Choi, Senior Vice President, Equity Capital Markets Asia of Lehman Brothers, "Investors in China are picking apart the particular equity stories, making sure the financial models make sense and demanding higher standards of corporate governance and transparency."

Hong Kong-Shanghai Exchange Rivalry Emerges

"The story does continue to be mainland companies listing in Hong Kong," says Matthew Sutton, Capital Markets, Ernst & Young China. HKSE has become the preferred fundraising platform for large Mainland Chinese companies. Mainland companies account for more than 30% of the 1100 traded companies on the HKSE, and represent 45% of total market capitalization.

In May 2006, IPO activity resumed in the Shanghai after a year-long IPO moratorium for corporate governance reforms. The headline-grabbing ICBC IPO gave the Chinese government a chance to show off its newly improved corporate governance standards in Shanghai. "To have a premier bank give the seal of approval to do a listing was very important to the Chinese government," says Choi.

The HKSE need not feel immediately threatened by the improved profile of the SSE, since as fundraising platforms, the two stock exchanges' target investors are so different, according to Philip Leung, Strategic Growth Markets leader, Ernst & Young China. While the Hong Kong exchange (H-shares) targets sophisticated international investors, the Shanghai Exchange (A-shares) caters primarily to PRC nationals.

Nonetheless, Shanghai's 2007 IPO proceeds are expected to surpass those of the HKSE by a narrow margin — boosted by a trend in dual listings, says Terence Ho, of Ernst & Young China. "A + H is the trend."

Thus, although HKSE currently dominates the market for large Chinese deals, Shanghai will undoubtably pose competition in the future. Eager to push further development of its domestic exchanges, the Chinese government is encouraging local companies to sell shares on the mainland, rather than in Hong Kong and New York. In the long run, more capital will probably be raised in Shanghai, and less funds will be coming out of Hong Kong.

Some Companies Still Seek Listings in US and Elsewhere

While many major mainland companies are listing on local exchanges, some of the most well-managed, venture capital-backed Chinese businesses still aspire to a US listing on NASDAQ. Currently, there are 41 mainland Chinese companies listed on NASDAQ. "Listing on the US exchanges is still a status symbol, a way of telling the world that you have arrived. However, for Chinese companies, the allure of going to the US market is largely limited to the TMT (technology, media, telecommunications) sector," says Choi. "Many Chinese companies believe that the highest valuations, deepest liquidity, best industry understanding, and greatest shareholder value are still to be found in the US," says Sutton. "Moreover, the US is also where most of their peers trade."

While large, often state-owned Chinese companies prefer to list in Hong Kong, smaller Chinese companies, especially the privately owned ones, frequently choose

to list in Singapore, Luxembourg, or London's small-cap exchange, AIM, where the listing requirements are not as strict. "With small private Chinese companies, there is a lot of discussion of the pros and cons of listing on various exchanges," says Choi. "They ask, 'Do we list on London's AIM now, or do we bite the bullet and spend the next six months making our company better and stronger, and try to meet US stock requirements and list in the US.?'"

Rule 144A Offers Access to US Institutional Capital

Over the last three years, Rule 144A transactions have become a rapidly accelerating trend in China. "Now, after ICBC, it has been proven that the HKSE can handle very large deals, particularly when a part of the shares is offered to institutional investors through a Rule 144A transaction," says Leung. Specifically, large, billion-dollar-plus Chinese companies (e.g., ICBC and BOC), file an IPO in Hong Kong and then, under Rule 144A, sell a tranche to institutional investors in the US, thereby avoiding the US regulatory environment.

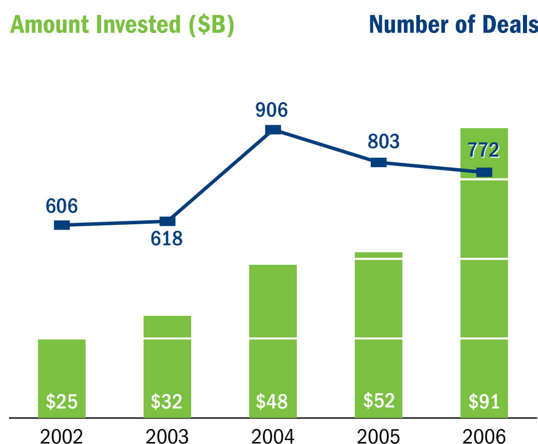
"China does more Rule 144A transactions than any other country in the world, apart from the US, Brazil, and India. The Rule 144A transaction sizes have become enormous," says Sutton. "While in 2001–2002, US$500 million was a big transaction, these days that's a fairly standard transaction, and many of the transactions are in the billions."

In 2007: More Large (But Not Jumbo-Sized) Companies Go Public

In 2007, the Chinese market continues to surge with numerous IPOs. Although most of the largest state-owned enterprises have already gone public in the past six years, Chinese IPO momentum continues with large listings, especially from the privatization of two major sectors: second-tier financial institutions and insurers. The pipelines of the rapidly maturing Chinese IPO markets feature a broader spectrum of issuers than in recent years, including natural resource companies, infrastructural, technology, healthcare, telecommunications, clean technology, and consumer retail sectors.

"The major risk factor in the Chinese IPO market is the Chinese economy — and whether the central government of China can manage the growth, "says Choi. However, in 2007, the Chinese economy appears to be staying on track with its 9% growth rate, with no signs of a slow-down. ■

Figure 1: Asia-Pacific IPO Activity by Year



Source: Dealogic, Thomson Financial, Ernst & Young

Figure 2: Asia-Pacific 2006 IPO Activity by Country Domicile

Domicile	Total Capital Raised (US $M)	Number of IPOs
Greater China	$56,616	175
Japan	12,798	185
India	7,233	78
South Korea	5,075	65
Australia	4,204	173
Thailand	2,173	19
Other	2,624	77
Total	$90,723	772

Paul M.Y. Chow

Chief Executive
Hong Kong Exchanges and Clearing Limited

Ernst & Young: ***Last year, we started to see the beginning of consolidation of exchanges. What impact do you think this trend is having on pre-listed companies?***

Paul Chow: I think every exchange adopts a different strategy. In Hong Kong we have yet to be convinced that mergers and acquisitions bring about synergies in areas such as business development, IT, human resources, and cost rationalization. Cross-border mergers and acquisitions are even more difficult to accomplish. The obvious obstacles to overcome are differences in culture, language, political environment, and different legal and regulatory regimes.

Our exchange is a central market operator. Unlike most companies, we are not a player in the market. It is, however, much easier to merge market players than to merge market operators.

Next, if we treat a merger or acquisition as an investment, then the question we have to ask ourselves is "Should we do this on behalf of our shareholders or should we return any excess cash to the shareholders so that they can make their own investment decisions?"

For the past 20 years we have not seen any hugely successful cross-border mergers and acquisitions between exchanges. Perhaps there may be one or two cases in Europe, but then Europe is different. Europe has taken 50 years to build its European Union. Different countries are operating under very similar or more uniform systems with one euro currency, so the environment is more conducive to mergers of the exchanges; whereas in places like Asia, a lot of things are different across countries: different currencies, rules and regulations, languages and so forth. It is difficult to create synergies for two exchanges with so many fundamental differences.

In addition, success of a consolidation depends on whether a critical mass can be created with sufficient liquidity to enable the trading of companies listed on the exchange. We do not believe that a company can be listed in multiple jurisdictions and still maintain sufficient liquidity in its home market, as well as other places where it is listed.

Another trend is that many market intermediaries are now more globalized in nature. So if anyone in Hong Kong would like to buy securities of a company, say in São Paulo, Johannesburg, Tokyo, or New York, it can be very easily done by just one phone call to the account representative of a global intermediary located in Hong Kong, and the transaction can be executed within the next 24 hours. Globalization of trading, essentially the execution and settlement of trades, rests in the hands of the global market intermediaries. This, in my own view, is different from what you have mentioned about the globalization of exchanges, which is more related to the convergence of international standards and best practices, including the level of governance standards, regulations, transaction costs, etc.

Ernst & Young: ***How would you describe the local versus foreign landscape of IPOs for Chinese companies?***

Paul Chow: I believe most companies will seek listing in the home market. You do not see a lot of American companies seeking listing outside of New York, or UK companies seeking listing outside of London. There are companies located in jurisdictions where the exchanges are not that international. These companies will tend to seek listing outside of their home countries, in the international marketplace. As home exchanges become more sophisticated and adopt standards and practices on a par with those of international exchanges, the merits of local companies seeking listing in the exchanges outside of the home market will gradually diminish. And because of the home market effect, it is much easier to create a critical mass of trading, which in turn attracts more investors.

What I just described has been evidenced in Mainland China since the 1990s as companies started to seek listing in Hong Kong, and New York. With the mainland exchanges operating closer to the international standards in terms of regulations, market infrastructure, risk management measures, and so forth, more Chinese companies are seeking listings in the mainland exchanges instead. Hong Kong is unique in the sense that it is part of China, but at the same time, under "one country, two systems," it is also part of the global securities market. Hong Kong has the advantage of acting as a bridge between overseas investors and the Mainland Chinese companies.

Similarly, many companies from Russia and Eastern European countries seek listings in London because exchanges in these countries need time to mature. In the future, when the exchanges in these countries operate more on a par with the international standards, possibly more companies in Russia and Eastern Europe will stay in their home jurisdictions. So I do not see this trend

Continued on page 30

Paul Chow, continued from page 29

as a surprise, it is just a natural progression.

Therefore, in the long run, most companies will tend to list in their home markets and exchanges will be under more pressure to improve the market quality and reduce the transaction costs, in order to compete with foreign exchanges in attracting inflow of investment from all around the world. Exchanges should not have any difficulties reducing transaction costs per-unit over a long period of time because trading volumes tend to increase over time. I believe most exchanges will converge to roughly the same cost level over a long period of time.

"A quality market with liquidity will attract issuers seeking to list. This creates larger market capitalization, higher trading volume, and in turn, more liquidity — a virtuous circle."

***Ernst & Young:* What do you think makes mature market investors comfortable in investing in those emerging market entities? How do they balance the risk/reward equation?**

Paul Chow: You have to always understand the risk involved and then factor in the required risk premium that will provide a return on most of the risk that you are willing to undertake. In the developed countries, investors are able to understand the environment better, know the risks involved and what return to expect. Information is more transparent as there are a lot of analysts who have been covering the developed countries and their companies for a long time. In emerging markets, some things may be new and not easily understood by the investors. There may also be the risk of unforeseeable capital control which is something not common in a developed market. These are examples of the risk an investor has to bear when investing in an emerging market.

Nevertheless, emerging markets are attractive because a lot of companies in these markets will expand their businesses and have substantial growth potential compared with companies in the developed markets. You will see more and more of these growth companies as the economies of the emerging markets improve, say in India, China, Brazil, Russia, or in the Eastern European countries. Over a period of time, these companies will be able to increase in size and sophistication. In addition, investors also have to evaluate the emerging market infrastructure, rules and regulations, and market practices which may not be as well-developed as those in countries like the US, the UK or other European countries. Investors need to weigh the company and market risks, and ask for a risk premium to justify their investment. Take a look at China — mainland companies will give you a better return, but at the same time the risk involved may be higher. So it's all about balancing the risk and return.

***Ernst & Young:* What's your view on how the Shanghai Stock Exchange will potentially challenge the Hong Kong exchange to become the primary exchange for Chinese IPOs?**

Paul Chow: Today Shanghai operates under a closed system. The capital account in China is closed and the renminbi is not freely convertible. Investors outside of China are not allowed to invest in the mainland, and vice versa. When the renminbi becomes freely convertible there will be more intense competition for investors' money among exchanges in Shanghai, Shenzhen, Hong Kong, and even other overseas countries,. Then it goes back to the quality of the market and transaction costs.

Having three exchanges in China is no different from what is observed in many other major markets. In the US, there is NASDAQ, the New York Stock Exchange, the American Stock Exchange, the Chicago Stock Exchange, the Chicago Mercantile Exchange, the International Securities Exchange, etc. In Japan, there is the Tokyo Stock Exchange and the Osaka Stock Exchange. The number of stock exchanges within a country depends on the size of the country and its economy. In China, surely it is not an issue to have more than one exchange. But the question is, which one will be like New York in the US, or Tokyo in Japan? Is it Shanghai or Hong Kong or Shenzhen? We have to wait and see. It depends on a lot of factors, in fact all the factors that I have mentioned earlier. At the end of the day, market quality will determine the position of an exchange.

Once the investors have no confidence in a market they will not channel their orders to the market and, without orders, there will not be any liquidity. Without liquidity, or depth of market, issuers will not seek listing. Why

Continued on the next page

Jocelyn Choi

Senior Vice President, Equity Capital Markets Asia
Lehman Brothers, Inc.

***Ernst & Young:* Based on the last 18 months, what are the key trends and takeaways?**

Jocelyn Choi: 2006 was a record year for Asian equity issuance. The market was characterized by extremely robust secondary markets which makes the primary market much more conducive to executing successful deals. It was not only a record year as far as the number of Chinese issuances, but it was also the first year where Asia (excluding Japan) exceeded the US as far as dollar volume coming out of the region. So it was certainly a landmark year in that respect. China had four of the five largest IPOs to come out of the region, including ICBC, the largest global IPO of all time.

The equitization of China will continue. SOEs will continue to privatize and we will continue to see IPOs from private entrepreneurial companies in high growth sectors—technology, media, consumer. The IPO pipeline is enormous, which isn't to say deal execution isn't without challenges. While the secular growth story of China is very compelling, investors are setting the quality bar higher than before. Investors are picking apart the particular equity story and making sure that the financial model makes sense.

***Ernst & Young:* What is the advice you usually give to a company in China seeking to go public?**

Jocelyn Choi: First, focus on building a proven track record of revenue and net income growth. Second, demonstrate business momentum. One-trick ponies will fail to impress investors. Third, clearly define the company's competitive differentiation. "Me-too" stories are not terribly interesting to investors. Fourth, build a fail-proof financial model that the company will absolutely be able to "beat and revise." Investors hate negative surprises.

***Ernst & Young:* Do you see a big difference between foreign and mainland investor appetites for China?**

Jocelyn Choi: Yes and no—for landmark transactions, for must-own deals, I don't think there's a difference in appetite between US, European and Asian investors. Mainland Chinese investors tend to be less valuation sensitive. ■

Paul Chow, continued from the previous page.

should they come? They will go elsewhere where liquidity resides. This is why Tokyo and New York are still the dominating exchanges in their respective countries.

A quality market with liquidity will attract issuers to seek listing. This creates larger market capitalization, higher trading volume and, in turn, more liquidity—a virtuous circle. A quality market is like a magnet attracting issuers and investors. But different people have different interpretations of what is meant by quality. Here in Hong Kong, we focus on five key aspects. First, we ensure that our rules and regulations are on a par with international standards and best practices. The rules and regulations include listing rules, company law, international accounting standards, corporate governance standards, information disclosure requirement, evaluation of business and taxation system, to name a few. Second, we focus on developing and maintaining a very robust market infrastructure to support substantial volume of trading, clearing and settlement, and information dissemination. Third, we maintain a rigorous and proven risk management mechanism so that we can withstand the fluctuation and volatility of the market. Fourth, we focus on keeping transaction costs down. Last but not least, the regulatory regime ensures that all the market intermediaries are subject to proper supervision, that they have the highest level of integrity to earn the trust of the investors, and that they provide a decent service for a reasonable fee.

The mere fact that Hong Kong is ranked number six among major world exchanges in terms of market capitalization demonstrates that Hong Kong has the above qualities. Hong Kong is only a city, but its market capitalization exceeds that of Australia, Germany and Canada.

At the same time, it is important that we do not become complacent, because the world changes very rapidly. We face competition from other exchanges and other marketplaces all over the world. There's always an incentive for us to compete because it is in competing that we strive for continuous improvement, financial innovation, and cost reduction. ■

Pan Gong Sheng

General Manager
Industrial and Commercial Bank of China (ICBC)

> ***"The success of the listing not only promoted the development of the mainland Chinese capital market but also enhanced the scale and positioning of the Hong Kong capital market."***

Ernst & Young: How do you think going public has served your company's business plan?

Pan Gong Sheng: First, going public helped to increase the bank's CAR (Capital Adequacy Ratio), significantly. After the IPO, the CAR of ICBC reached around 14% and the core CAR, 12%, setting a good capital base for the bank's future business expansion.

Second, after the IPO, the bank will make further improvements to its corporate governance standards strictly according to the requirements of domestic and overseas capital markets.

Third, the IPO has set the stage for ICBC to grow into a global leading financial institution. After the IPO, ICBC has stabilized its position as one of the world's three largest commercial banks in terms of total market capitalization, setting the stage for further boosting the bank's competitiveness and brand image in the international financial markets.

In general, I believe that going public helped ICBC lay a good foundation for the expansion of its business scope and operation space as well as its future development.

Ernst & Young: Why did you decide to go public on both the HKSE and Shanghai exchanges? Did you consider other exchanges?

Pan Gong Sheng: With regard to the choice of listing venue, ICBC conducted extensive research prior to the IPO. Choosing an appropriate listing venue is of great significance for the success of the IPO. Prior to the IPO, we had considered many factors such as liquidity, investor base, transaction volume, follow-up costs, post-IPO and legal issues during the IPO process. After considering these various factors, we made our decision to list simultaneously in Hong Kong and Mainland China. Usually HKSE is an important venue for mainland Chinese large enterprises to go public abroad. As China's largest commercial bank, ICBC took into account future development of China's economy and capital markets. Since the bank's major customer base is in Mainland China, and client relationships need to be developed, in line with the long-term strategy, we decided to go public in Mainland China. The first-ever simultaneous launch of A- and H-share IPOs has proved to be very successful in many aspects. For instance, the success of the listing not only promoted the development of the mainland Chinese capital market but also enhanced the scale and positioning of the Hong Kong capital market.

Ernst & Young: What has been the impact of being the largest IPO ever?

Pan Gong Sheng: The global investment community and global press spoke very highly of ICBC's IPO. ICBC's Hong Kong and Shanghai dual listing of A+H shares raised a total of US$22 billion, exceeding the previous world record of US$18.4 billion set by the Japanese company NTT DoCoMo in 1998, and became the largest IPO of all time, in terms of capital raised. It was the largest A-share and H-share IPO in history with the A-share tranche worth US$6 billion, and the H-share tranches amounting to US$16 billion. The successful IPO has significantly improved ICBC's international image and reputation. Now ICBC ranks among the top three global commercial banks in terms of total market capitalization. For China, the success of ICBC's IPO has significantly promoted and developed the Hong Kong and China mainland capital markets, leaving the world with a favorable impression. ICBC's IPO was eagerly sought after by investors from all over the world, which again proves the appropriateness of the Chinese government's decision to reform the state-owned commercial banks and the choice of path for the reform. The IPO has not only enhanced the competitiveness of China's state-owned commercial banks, but also improved their international image and status. Media and various groups of society considered ICBC's successful IPO as the milestone event for the successful reform of China's state-owned commercial banks.

Ernst & Young: What factors influenced the timing of your IPO?

Pan Gong Sheng: As you know, ICBC simultaneously launched A- and H-share listings on two separate capital markets, with significant differences such as fundamentals of listed companies and investor bases, making it difficult to choose the most suitable stock exchange in both capital markets. Therefore, ICBC developed a detailed listings timetable prior to the IPO, and closely watched the dynamics of domestic and overseas capital markets. Our great efforts in pre-IPO preparation resulted in a good investment atmosphere and overall recognition from domestic and overseas investors for ICBC. We made sufficient pre-IPO preparation and successfully grasped favorable opportunities in the capital market,

which facilitated the simultaneous launch of A- and H-share IPOs.

***Ernst & Young:* During the roadshow, what were your key messages to institutional investors? What was most important to them?**

Pan Gong Sheng: During the roadshow, we met many investors and demonstrated how a traditional Chinese state-owned commercial bank successfully transformed during the past seven to eight years.

First, ICBC is the largest commercial bank in China, with absolute market leadership, a strong distribution network, and a solid customer base. Its unparalleled business base in the Chinese market makes ICBC the best representative of the rapidly growing China economy.

Second, ICBC is the leader in the full-scale transformation and reconstruction of the Chinese financial industry. We have a management team with sophisticated strategic foresight and superior performance ability. During recent years, we have continuously progressed in strategic transformation, information technology, risk management, etc., and have built up strong first-mover advantage and core competency in the Chinese banking industry.

Third, we acquired sound financial performance through implementation of a sound growth policy during the past years. As the strategic transformation progressed we would, through our brand new commercial bank platform, fully exploit the growth of the Chinese market to bring sustainable and high returns to our shareholders.

Generally speaking, the message was about how the largest Chinese commercial bank reconstructed and transformed under the backdrop of the fast-growing Chinese economy. The roadshow won high recognition from investors.

***Ernst & Young:* What was the most valuable step that you took to prepare ICBC to operate as a public company?**

Pan Gong Sheng: ICBC had been preparing for years prior to its IPO. For example, we created a corporate governance framework in accordance with international standards. In terms of internal organizational structure, we set up an independent internal audit system and appointed external independent directors to the Board. We improved our financial accounting system according to International Accounting Standards and New Financial Accounting Standards issued by the Ministry of Finance of China. We also improved our information disclosure system in order to enhance the transparency of ICBC as a public company. We can say that ICBC has achieved great progress in corporate governance standards.

***Ernst & Young:* What advice would you give to another CEO considering an IPO?**

Pan Gong Sheng: I would say that chance favors the prepared mind. ■

John Deng

Chairman and CEO
Vimicro Corporation

Vimicro is a China-based fabless semiconductor company, which listed on NASDAQ in 2005.

“A NASDAQ company carries a certain premium in the eyes of our clients, our employees, our shareholders, the Chinese government, and media.”

Ernst & Young: How did going public serve your company’s business plan?

John Deng: I feel that, through the IPO, the company has improved its global presence by leveraging brand equity and the credibility of a NASDAQ listing. We have greater financial resources and risk protection afforded by our internal corporate governance. And we have the opportunity to work with some first-tier brands, such as Samsung and Dell.

I think it is also important for employee morale. Since the IPO, people see the company as more prestigious, no longer a start-up; they feel more secure financially and in terms of their career. And project managers feel that there is more potential for the future, both in engineering and in management. They are looking forward to a stable, long-term career with the company.

Externally, our liquidity will help shareholders, including the company founders, investors, etc., to manage their investments better. There has also been very strong governmental support since the company became NASDAQ-listed. The government sees this an industry case study for the kind of technological development which used to be carried out only by state enterprises, state laboratories or universities. They believe this could be the business or development model for China’s future.

In short, I think the IPO has really helped the company: from the point of view of customer relationships, internal employment, shareholder investment, as well as social and governmental support.

Ernst & Young: Why did you decide to go public in the United States, and particularly on NASDAQ?

John Deng: We’d been thinking about launching the IPO in China, and had also been pursued by bankers and agents to launch in Hong Kong. In the end, we went for NASDAQ because I and my other co-founders from Silicon Valley were a lot more familiar with it than other exchanges. I also think a NASDAQ company carries a certain premium in the eyes of our clients, our employees, our shareholders, the Chinese government, and media.

This is how you really prove yourself as a global company. You have a platform that allows you to continue to globalize just like any other Silicon Valley company, and your technology launch is undergoing due diligence with auditors or lawyers, intellectual property, and corporate governance, in a market that is famous for restrictive controls.

The key issue is how to grow a business from China into a global powerhouse for the future. What globalization really means for technology companies is innovation. You can get money for any market expansion, but the essential difference is that you have a platform on which to globalize your technology innovation.

Ernst & Young: If it was today, would you still go to NASDAQ, or would it be a different decision process?

John Deng: I think we would go through the same process, even though we know that Sarbanes-Oxley always creates a lot of overhead for the company.

Ernst & Young: What are some of the challenges of operating a US-listed company from China?

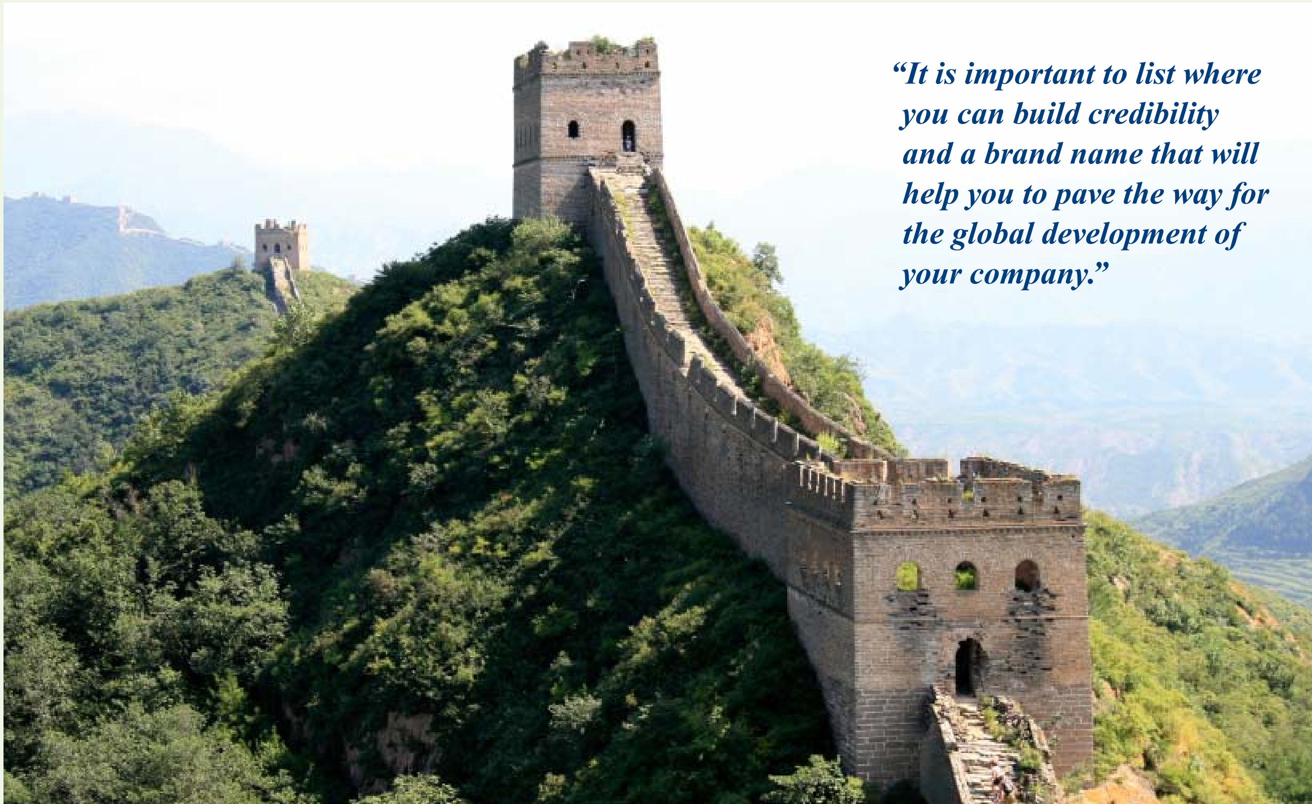
John Deng: It’s very challenging. You really need to spend a lot of time training employees to understand securities law and what they can and cannot do. Also, you need to establish a very strong enterprise resource planning and accounting system. Typically, People’s Republic of China (PRC) GAAP has different software, so when we’re listing on NASDAQ, we have to convert our PRC accounting system into US GAAP, which is even more of a challenge. I think the professionalism requirement for a NASDAQ public company is a lot more restrictive and more challenging.

Ernst & Young: What were some of the factors that influenced the timing of the IPO?

John Deng: In our case, we need more cash for revenue growth, so it was important for us to go public. After going public, you have a very strong financial resource to meet cash demand and develop the business.

Also once you’re listed, you’re one of the market leaders, and you may be able to acquire and merge with other companies. The company can reach maturity and it becomes easier to expand into adjacent technology markets. Doing that organically takes more time. By listing on NASDAQ, you have an additional monetary instrument to implement this approach. Overall, I think that’s critical.

Ernst & Young: What were the three most valuable steps that you took to



"It is important to list where you can build credibility and a brand name that will help you to pave the way for the global development of your company."

prepare the company to be a US-listed company?

John Deng: We restructured our board with more international, independent board members to make the board not only bigger but also more diversified and more independent. We also restructured our management team to equip it for the day-to-day operations of a public company. Lastly, we upgraded our accounting systems.

Ernst & Young: ***Was there a given time before the IPO that you felt the company was already behaving as a public company?***

John Deng: Yes. Actually, I think in the year before the IPO, we operated like a public company. Every quarter you have a forecast, and we have always tried to under-promise and over-deliver. We knew that investment bankers would expect the CEO and top management of the company to be able to operate like a public company, immediately after the IPO. So, we thought that the four quarters before the IPO would prepare us for post-IPO life, and we changed our approach a year before we really went public.

Ernst & Young: ***What advice would you give to other China-based CEOs that are considering taking their companies public in the US?***

John Deng: People really need to understand the challenges as well as the opportunity. In our case, Vimicro was the first listed semiconductor technology company, which is very different from Internet, service, manufacturing, or advertising companies. For us, accessing NASDAQ, which presents a global platform, allowed us to grow the business globally.

The decision on where to list is a strategic one. If you have a food company in China, with a domestic rather than export market, you should list in China with a brand name and shareholders who are also consumers of your product. I think for any technology company it is important to list where you can build credibility and a brand name that will help you to pave the way for the global development of your company. Therefore, I think any company and CEO needs to look into the nature of the business and consider the strategic benefits of listing in certain markets.

The other question is timing. Is the company trying to list too early or too late? Matching the timing of the IPO to the life cycle of the company is important for both the CEO and the company. CEOs must have good and experienced boards that can guide them through the decision-making of the IPO process as, in most cases, the CEOs have significant operational experience, but less in the process of going public, particularly in overseas markets. ■

India: Indian Exchanges Launch Billion-Dollar IPOs

KEY TRENDS:

- **The strength of India's economy, stock market, corporate profits, energy sector, and private equity fuel IPOs in 2006 and 2007.**
- **Indian exchanges hosted several billion-dollar IPOs in 2006, all prime examples of the rise in localization.**
- **Cross border activity and the role of foreign capital continue to grow.**
- **Enabling relatively easy access to global institutional capital, Qualified Institutional Placements (QIPs) gain immediate popularity.**
- **The private equity rush into India has lead to a potential for many IPO exits.**

India's rapid economic growth, robust corporate profitability, and a four-year bull run on Bombay's Stock Exchange (BSE), continue to fuel India's strong IPO markets. "Keen investor interest in India's strong growth story has been reflected in the attractive valuations and key price/earnings multiples garnered by Indian companies," says R. Balachander, IPO Leader, Strategic Growth Markets, Ernst & Young India. In 2006, India's markets launched 78 IPOs and raised US$7.23 billion. Currently, India's exchanges rank eighth in the world for numbers of IPOs and value in 2006.

Corporate Growth and Energy Sector Drive Indian IPOs

Despite a May 2006 market tumble that erased more than US$100 billion in value in the BSE and sparked concerns that the four-year Indian stock rally was over, Indian IPO activity quickly resumed its upward momentum. In 2006, India's IPO market has been fairly broad-based, although energy companies dominated with more than 50% share of funds raised. In 2006, India's largest IPO was petroleum refining company, Reliance Petroleum, which raised US$1.8 billion, followed by the oil production and exploration company, Cairn Energy, which raised US$1.3 billion. Real estate IPOs also generated stellar returns for investors.

Another major driver of India's greater number of larger deals has been the growth of Indian corporations and their need for additional capital for potential acquisitions. As some analysts say, corporate India is not only in expansionary mode, but also in acquisitive mode, which has raised their equity capital market needs. Thus, larger deal sizes in India are consistent with the growth in the economy and the need for capital.

Growth in Localization and Globalization

Localization of capital markets activity in India has been on the rise. In the last two years, local asset managers have been established, thereby reducing the dependence of the Indian markets on foreign institutions and creating greater stability. Retail investors are behind the rapid recent development of domestic asset management funds.

In the past 18 months, growing numbers of large Indian companies are going public on local Indian exchanges. Billion-dollar equity offerings recently completed in the domestic exchanges include the Reliance Petroleum and Cairn India IPOs. The localization trend may be viewed as a function of the growth in the local capital pools available for investment within India, and the increase in asset allocations to India by global asset managers.

At the same time, the role of foreign capital and cross-border activity by Indian companies continues to expand rapidly in India. Foreign institutional investors make up three-fourths of new funds flowing into the market, and therefore foreign capital is supporting much of India's growth. In recent years, international asset managers (e.g., Fidelity and Templeton) have set up shop in India and experienced strong growth.

The vast majority of Indian companies list only in India. However, growing numbers of Indian companies are listing abroad, primarily for higher valuations and visibility. The London, Singapore and Luxembourg exchanges are the primary external exchanges preferred by cross-border Indian issuers. (However, by law, Indian companies are

also required to list their shares on a domestic exchange before listing abroad.)

India's Latest Listing Trend: QIPs

With 9,000 listed companies, India has the largest number of both small and mid-cap public companies in the world, listed on a total of 23 exchanges. However, India's two primary exchanges are the Bombay Stock Exchange and National Stock Exchange. Until mid-2006, many companies did a local Indian listing, and then a Global Depositary Receipt (GDR). However in May 2006, Qualified Institutional Placements (QIP) were introduced, which are similar to Rule 144A placements. "QIPs are a very big hit in India now," says Balachander. "It's a two-way opportunity—for India to gain access to available capital without having to list abroad and for foreign investors to invest in India companies." A QIP enables access to the global institutional market through institutional placements of equity shares, without a formal non-Indian listing. According to analysts, QIPs are more efficient, cost- and time-effective, and investor- and issuer-friendly than the GDR.

Private Equity Invasion in India

Private equity in India has reached record levels, with more than $7 billion invested in 2006. Top global private equity funds such as Carlyle, Blackstone, Texas Pacific and Warburg Pincus, as well as local funds, have been key drivers of the strength of Indian IPO markets. Kohlberg Kravis Roberts entered India with the country's largest leveraged buy-out to date, the acquisition of Flextronics Software Systems for US$900 million, and more buyouts are expected in the future. Financial sponsors have been able to raise large pools of permanent capital. Some of the funds being raised are dedicated specifically to India. Analysts say the challenge is finding large and attractive investment opportunities. Moreover, the competition for assets in India among financial sponsors, hedge funds and institutions has increased prices and reduced return profiles.

In 2007: IPOs Continue to Surge

In 2007 Indian IPOs continue to surge in numbers. Says Balachander, "Last year we saw about 78 IPOs. In 2007, I won't be surprised if the number of IPOs doubles. We are clearly looking at a hundred plus IPOs." Balachander anticipates continued strength in the energy and real estate sector. India's largest land developer, DLF, could be the largest Indian IPO, which is expected to raise about US$2 billion in June. ■

Justin Haik

Executive Director, Global Capital Markets
Morgan Stanley & Co. International plc

> ***"Localization is the key theme in India and that extends throughout the region. There has been an increase in the number of billion-dollar equity offerings completed in the domestic market."***

***Ernst & Young:* What do you perceive as the key trends in IPO activity in India over the past twelve months?**

Justin Haik: Localization is the key theme and that extends throughout the region. There has been an increase in the number of billion-dollar equity offerings completed in the domestic market. Examples include the US$1.8 billion IPO of Reliance Petroleum and US$1.9 billion IPO for Cairn India. The buyers include retail, domestic, and international institutional investors.

***Ernst & Young:* Where do you think all this liquidity is coming from?**

Justin Haik: This is a result of two things. One is the growth in the local institutional and retail pools of capital available for investment within India. The second is that global asset managers are increasing their asset allocation to Asia, given the strong growth and relatively attractive valuations.

***Ernst & Young:* Could you comment on the tremendous increase in private equity in India?**

Justin Haik: As an asset class, private equity is experiencing enormous growth and India is benefiting from that. Financial sponsors have been able to raise large pools of permanent capital and need to invest. Some of the funds being raised are dedicated to the Asia-Pacific region and some of them specifically to India. The challenge is finding large and attractive investment opportunities. In Asia, competition among financial sponsors, hedge funds, and institutions for assets has increased prices and thereby reduced their return profile.

***Ernst & Young:* In India how are corporate governance standards relative to other developing economies?**

Justin Haik: Generally speaking in India, like other countries in Asia, many publicly traded companies are majority-owned by families. Problems can arise due to conflicts between the interests of the family and those of minority shareholders. It gets even more complicated when the controlling shareholder owns similar or related assets held outside the listed company.

***Ernst & Young:* To what extent was the global reaction to the drop in the Shanghai Exchange an overreaction?**

Justin Haik: The 9% drop in the Shanghai A-share Index on 27 February 2007 was a catalyst for the correction elsewhere. The sharp adjustment focused investor's attention on the risks in their own markets and forced them to price risk more accurately. For example, US investors appear not to have priced the impact of the slowdown in their domestic real estate market correctly, nor the potential impact on subprime lenders. It took something like a drop in China to focus people's attention and realize that these are real risks.

***Ernst & Young:* Do you think the correction showed that what happens in China can have global effects?**

Justin Haik: You need to remember that the China A-share market is a closed market. With high savings rates and a lack of investment alternatives, Chinese investors have been very focused on buying stocks. This tide of money has contributed to the Shanghai A-share market doubling in value in 2006. Then in February 2007, market speculation about further interest rates hikes in China and the potential introduction of a capital gains tax on equities contributed to a retail-led sell-off. Despite Shanghai and Shenzhen having a market capitalization in excess of US$1.5 trillion, foreign investors account for only 10% of that through the Qualified Foreign Institutional Investor (QFII) scheme. When Shanghai fell 9%, the rest of the world had to pay attention. People started asking themselves, "What risks exist here in my own market, what haven't we thought about?" and that's when people start to say, "Maybe I should reduce my risk profile."

Ernst & Young: ***Are people going to be more cautious? Would this have an impact on the IPO market?***

Justin Haik: Investors are likely to be more cautious about their investments and reduce their ownership in stocks and markets they know the least about. That said, economic growth in emerging markets remains well above the levels of the US and therefore will continue to attract portfolio investment. The outlook for companies looking to list remains positive.

Ernst & Young: ***Do you see any major impact of future possible mergers between exchanges?***

Justin Haik: From an Asian issuers perspective, it was once thought that to do a multi-billion dollar IPO, a company had to undertake a dual listing in order to tap the largest pools of capital. This has changed as a result of several factors. Institutional investors have committed more capital to Asia and relocated investment professionals into cities like Hong Kong and Singapore. Moreover, the perceived benefits of a US listing, for instance, may be outweighed by the litigation risks and ongoing compliance costs. Issuers like the Bank of China, China Construction Bank and ICBC proved that it is not necessary to have a US listing to attract international investors. ■

"Economic growth in emerging markets remains well above the levels of the US and therefore will continue to attract portfolio investment."

Europe: Russian Growth Story Drives European Markets

KEY TRENDS:

- **Europe's IPO markets rose to an all-time high in 2006, and remain high-flyers in 2007, bolstered by beefy deals, cross-border listings in London, and private equity.**
- **As the region's high-growth story, Russia drives European IPO activity.**
- **London has become the top listings destination for cross-border issuers seeking relatively quick and easy capital.**
- **Europe's junior exchanges, including London's AIM, the Euronext's Alternext, and Deutsche Borse's Entry Standard, are thriving with small-cap activity.**
- **The ballooning growth in European private equity is leading to more IPO exits, and sizeable public-to-private transactions.**

Europe's steady economic expansion, attractive stock prices relative to US peers, low interest rates, and vigorous secondary stock markets galvanized its IPO markets in 2006 and 2007. For the second year in a row, Europe's exchanges attracted the most cross-border listings, especially Russian companies listing in London. Another key source of capital in Europe has been the large private equity firms seeking to exit their investments through IPOs. As a region, Europe attained the largest dollar value worldwide, US$93.9 billion, via 528 deals in 2006 (See Figure 1, page 43).

Europe's IPO Value Soars With Large Deals

Hefty transactions characterized the European IPO market in 2006 with its average deal size of US$177.8 million. European deals made up over half of the world's IPOs worth over US$1 billion. Twenty-two European listings raised more than US$1 billion each. The largest European listing (globally, the third largest) was Russian state-owned oil company Rosneft, worth US$10.7 billion in a dual listing in London and Moscow, while the second largest European IPO was France's investment bank Natixis, worth US$5.3 billion on the Euronext.

European Emerging Markets: It's All About Russia

"It's all about Russia," says Henrik Gobel, Managing Director and Head of of Equity Syndicate Desk at Morgan Stanley. "IPOs from Russia are the driving force behind European issuances, just like IPOs from China drive the Far East. You have got to look outside the core economies, to the emerging markets, for high economic growth." With its crowded IPO pipeline, Russian and Eastern European companies gave the European IPO market a boost with 70 deals in 2006.

"Investors in Europe are looking for growth, and most growth is coming from the emerging markets of Europe, which are Russia, and Central and Eastern Europe, because those economies are at a younger stage of development," says Richard Cormack, Head of New Markets, Equity Capital Markets at Goldman Sachs. "Investors buy into the BRICs theory of life where some of these emerging economies are going to be very significant developed economies in a few decades. People know they are buying in a market that is emerging, and they're buying into the growth story of that market."

"The majority of companies who come to London from emerging markets list Global Depositary Receipts (GDRs),"says Tracy Pierce, Head of Global Business Development at the London Stock Exchange. Pierce notes that the GDR is targeted at specialist, professional investors who are well aware of the potential risks and rewards associated with investing in emerging market stocks.

"A source for increasing market liquidity from Europe is the combination of the IFRS, global regulatory cooperation and the euro, as a shared currency outside the US,—together, they create a common language," says Jackson Day, Global Director of Capital Markets at Ernst & Young.

London: The New Cross-Border Listings Destination

In 2006, cross-border listings into Europe swelled in numbers, as London became the most popular global capital markets hub for cross-border IPOs (both LSE and AIM). London raised US$24 billion in 2006, a massive increase of 85% from US$13 billion in 2005. The majority of overseas companies listing in London came from Russia and raised a record US$15.4 billion through eight deals, on the London Stock Exchange. According to Pierce, 107 international companies from 26 countries joined the LSE in 2006.

Why are foreign companies flocking to London? Deep liquidity, a wide range of institutional investors, simple listing requirements, broad analyst coverage, cheaper underwriting fees than the US, superior valuations, a reputation for openness to international companies, unparalleled access to international capital, and geographical proximity to Russia, Eastern Europe, and the Middle East—these are among London's chief selling points, according to David Wilkinson, IPO Leader at Ernst & Young UK. "Undoubtedly a desire to move outside of the Sarbanes-Oxley corporate governance provisions is part of the mix. But just as important," Wilkinson says, "is the fact that a wide range of companies, including small and mid-cap, can attract institutional investment in London."

"Most companies prefer London's exchanges over other European exchanges," says Gobel, "with the exception of

"The equity shift that has taken place in the European investor base, over the past decade has been enormous. We are now a fully fluid hedge fund community and all the big US mutual funds have offices here."

Benelux or French companies, and those that don't meet London's listing requirements. London becomes the natural home, simply because that is where the world goes round when it comes to capital markets."

Most European Companies Raise Funds at Home

Although the US exchanges still harbor the deepest liquidity, European exchanges no longer suffer in comparison to the US. Indeed, in 2006 fundraising, European exchanges raised about 33% of the world total, while US exchanges raised 17%. "The equity shift that has taken place in the European investor base, over the past decade has been enormous. We are now a fully fluid hedge fund community

"The vast majority of European IPOs have a Rule 144A tranche to access US capital."

and all the big US mutual funds have offices here," notes Gobel.

Indeed, about 90% of European companies choose domestic exchanges for their primary listing. "It may be partly language, culture, a bit of nationalism, and an expectation that they will get a better reception in their own local markets," says Wilkinson.

"European companies mistakenly think there's a real choice in where to list," says Julie Teigland, Central European Strategic Growth Markets Leader at Ernst & Young. "Typically, a company will wish to add a second listing only if the local exchange is considered unattractive by international investors, too small, or the company has a compelling business case abroad."

Since the European exchanges such as LSE and Euronext share similar access to international investors, there is no compelling reason for European companies to do a cross-border listing in another European exchange. "Even if you are listed in France, you can reach UK investors too," says Any Antola, Continental Western Europe Area IPO Leader, Ernst & Young France.

"Venture-backed market leaders used to consider listing on US exchanges," says Wilkinson, "but today if you are a Swiss biotechnology company or a German technology company, your first thought might not be a list on NASDAQ. It might be to list either on Euronext or the London Stock Exchange as your global market, to appeal to growth investors. That's a big change."

NYSE Euronext: First Transatlantic Exchange

In April 2007, NYSE Euronext, the product of NYSE's US$14.3 billion merger with Paris-based Euronext, is the first transatlantic exchange. Linking the NYSE with stock exchanges in Paris, London, Brussels, Amsterdam, and Lisbon, and run by Euronext NV, The new exchange brings together 4000 listed companies worth US$28.5 trillion in market value.

Such a transatlantic merger could offer a host of other advantages, including greater economies of scale, higher volumes, lower fees, deeper liquidity, cheaper trading, and speedier, more-efficient capital movements.

Serious competition for the new exchange could arise from a new pan-European trading platform dubbed Project Turquoise, which was set up by seven of Europe's biggest investment banks, and set to launch at the end of 2007. The new European Union's "Markets in Financial Instruments Directive," (MiFID) is the investment banking response to the high tariffs of Europe's exchanges eating into their equity trading margins.

Will there be further consolidation among the European exchanges? "The principal exchanges of significance in Europe are in London, Germany, and Paris," says James Klein, from the Capital Markets Group, Ernst & Young Russia. "There really doesn't need to be 18 regulators of 18 exchanges in Europe. Unless those two or three large European exchanges can really come to grips with their differences, they're always going to be fair game for somebody on the prowl like a NYSE, which is essentially acting as a consolidator."

AIM and Copycat Junior Markets Thrive

Driving UK IPO activity is London's small-cap exchange, Alternative Investment Market (AIM), the world's leading exchange in terms of numbers of deals, with 11% of the total number of IPOs in 2006. However AIM represents just 34% of European deal numbers and 8% of total European funds raised. Created in 1995 to provide young businesses with access to public markets at earlier stage of their growth, AIM attracts many local and foreign listings, in some instances acting as a substitute for late-stage venture capital financing. "Investors want good stories, and corporations need access to capital—AIM provides that," says Gobel. More than one-third of the companies that joined AIM in 2006, a record total of 69 IPOs, were based overseas.

The impact of AIM's success has been realized by other junior exchanges in Europe. The new junior market for the Deutsche Borse, the Entry Standard, and the junior market of Euronext, Alternext, have been surprisingly active, particularly with IPOs of emerging technology companies.

"The junior markets provide smaller companies with an avenue to the public markets they would otherwise not have," says Christoph Stanger, Co-Head of European Equity Capital Markets at Goldman Sachs, "so these markets are good from an economic perspective. However, from a volume perspective, relative to the big markets, the junior markets are not that significant."

Figure 1: Europe, Middle East and Africa
IPO Activity by Year

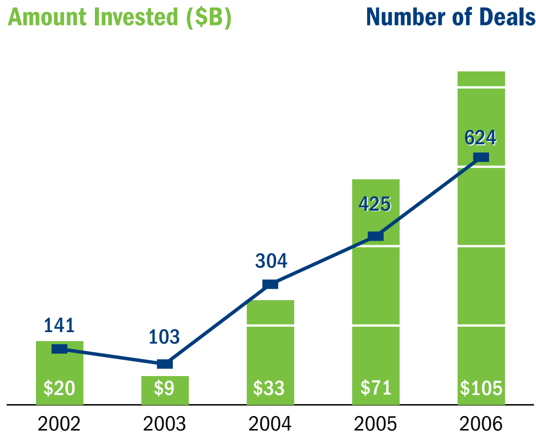


Figure 2: Europe, Middle East and Africa 2006
IPO Activity by Country Domicile

Domicile	Total Capital Raised (US $M)	Number of IPOs
Russian Federation	$18,008	21
United Kingdom	17,188	151
France	12,985	75
Germany	8,257	63
Italy	6,054	23
Netherlands	4,150	13
Saudi Arabia	4,022	12
Spain	3,823	10
Other	30,598	256
Total	**$105,085**	**624**

Source: Dealogic, Thomson Financial, Ernst & Young

UK, Germany, and France: Bullish IPO Activity

"Most investors in Europe are not country-specific," says Gobel. "They don't look at whether they would rather own a UK versus a German company. They look at one big European market and the European index." Nonetheless, since 2003, the three largest European markets – UK, Germany, and France – have enjoyed a four-year stock market rally.

The UK's IPO market has been robust, heavily weighted with jumbo listings in 2006. The UK's 151 deals were the fifth highest number of IPOs in the world in 2006 and raised US$17.2 billion. In 2006, the UK's largest IPO was the insurance company Standard Life Assurance, worth US$4.4 billion in London.

Germany's capital markets continue to revitalize and raised US$8.3 billion, through 63 IPOs in 2006, says Teigland. "A backlog of premium companies with a drive to potential exits, and renewed optimism about the German stock market itself, are driving IPO activity." In 2006, Germany's largest IPO in 2006 was consumer staples company Symrise AG which raised US$1.8 billion on Deutsche Borse.

In France, greater investor confidence in the Paris stock exchange is also driving up the IPO activity, according to Antola. In 2006, France launched 75 IPOs and raised US$13 billion. In recent years, France has been busily privatizing its major state-owned assets, including France Telecom and Gaz de France. In 2006, France's largest IPO was investment bank Natixis, worth US$5.3 billion on the Euronext.

One of the emerging IPO industries in Europe has been the clean technology sector. European investors have demonstrated keener interest in clean energy technologies than their American counterparts. After the numerous successful clean technology IPOs of 2005, the European markets saw 40 clean technology businesses from the US, the UK, Canada, and Australia, go public on London's AIM in 2006.

Bigger Private Equity Buyouts Lead to More IPO Exits

In 2006, across Europe, M&A volumes climbed to an all-time high at US$3.6 trillion, fueled by cheap debt, well-heeled private equity firms, and cash-rich CEOs seeking global expansion. In 2006, the European private equity markets had a strong year, with US$21.1 billion worth of deals – and many exits via the public markets. The biggest private equity backed IPO of Europe of the year was oil refiner Petroplus Holdings offering, which raised US$50 billion in Zurich.

In Europe, private equity investors and "activist investors" (i.e., hedge funds or groups who take big stakes in companies and influence company management) are a growing phenomenon with a huge impact, especially on corporate governance issues, says Wieseneck. "LBO activity took off earlier in the decade in the US, but has really caught up in Europe. It's a real positive that Europe is now seeing the same type of aggressive market players as

the US market. It's making the European market more like the US market, where the free movement of capital allows the available cash to go to those opportunities where capital is most needed. It's very healthy."

Private Equity Scoops Up Large Companies

"In 2006, the value of European public companies scooped up by private equity reached record levels," says Gobel. "That's a function of fund sizes that are so large, they have to go after really big opportunities. And big opportunities are, by definition, seasoned companies rather than relatively early-stage companies."

The process of de-equitization, or public-to-private transactions, will typify the European capital landscape. De-equitization flourishes in the current market environment where the cost of capital remains low—when financing is much cheaper than the likely return on equity.

Although de-equitization is a global trend, including in the US, the UK markets have been hardest hit. The British equity market has shrunk by 4%, which is more than double the US and four times that of Europe, according to a Citigroup study.[1] Despite the booming public markets, in London, more equities were retired than newly issued, as the City suffered a net withdrawal of US$27 billion in public-to-private transactions.

1 Citigroup Global Markets, Equity Research, *European Portfolio Strategist*, 8 March 2007.

Most Large IPOs Include Rule 144A Placement

In 2006, 15 of the top 20 IPOs domiciled in Europe included a Rule 144A offering. "The number of Rule 144A filings will increase, while dual listings will tend to remain stagnant," says Teigland. "That's because European companies often shy away from the stringent US rules, and high costs of a US listing. "

While the US exchanges still have the deepest liquidity, very few European companies bother with a dual US listing. Instead the vast majority of European IPOs have a Rule 144A tranche, to access the US institutional capital, says Gobel. "If you do a local listing with a Rule 144A, you access a vast amount of American funds. The incremental extra you might get by a full US listing is so little."

In 2007: Europe's Public Markets Remain High Flyers

Anticipated global M&A activity by fast-growing companies from the emerging markets will continue to fuel the European capital markets as those companies seek capital for their growth plans. Experts say the European IPO market will also be bolstered by private equity firms seeking to exit their investment through IPOs rather than by sale to corporate/financial buyers. "In 2007, expect a lot of issuance activity from European private equity funds. Since there has been a lot of M&A activity, the private equity firms need to find a way out, and the IPO is still the preferred exit route," says Gobel.

In the UK, Germany and France, the first quarter of 2007 saw a packed pipeline of strong companies still keen to go public. "There is still a pool of good-quality companies waiting to come to market. These are companies with strong management teams, and good profitability and growth prospects," says Wilkinson. ■

Christoph Stanger

Global Managing Director
Goldman Sachs International

***Ernst & Young:* When you look back on the global/European IPO landscape, what were the key trends?**

Christoph Stanger: In 2006, globally, there was a total equity volume of approximately US$670 billion, compared with about US$491 billion in 2004. Europe accounted for 39%, Asia 32%, and the US 29% of the total equity volume.

There's been quite a distinct change in Europe, in terms of the significance and mix of LBOs (leveraged buy-outs), IPOs, or rights issues. In 2004 we had US$149 billion in issue volume in Europe—48% LBOs, 23% IPOs, 17% rights issues and 12% marketed offerings. In 2006, the volume was US$260 billion—43% IPOs, 29% LBOs, 21% rights issues, and 7% marketed offerings. So the message that we're taking from that is with the bull market now in its fourth year, the mix of what's coming to market is changing from issuance by existing companies to new equity.

In the IPO market, large transactions predominate. The top 25 deals raised, globally, almost 50% of all equity issued. There is a trend towards very large transactions, including ICBC and Rosneft.

In terms of regional activity, there's also a trend towards new markets. In 2006, in terms of global IPO volume, 18% came out of China and 8% came out of Russia (whereas 4% came out of Germany). There's a shift towards new markets capturing a big share as the growth rates in the underlying economies are high, and the market

Continued on page 48

Henrik Gobel

Managing Director and Head of Equity Syndicate Desk
Morgan Stanley & Co. International plc

***Ernst & Young:* What key trends have you seen in the last 18 months?**

Henrik Gobel: I think the number one trend is how emerging markets now drive Europe, just as they do in Asia. These markets continue to be the key driver of issuance. The Russian market in particular has grown and is rapidly developing. The second largest trend is how privatization is becoming less of an issue. Governments have exited most of their holdings and protectionism has, to some extent, been creeping back into Europe, which means we haven't seen the big sell-downs that occurred in previous years. Thirdly, as private equity firms churn their assets a little faster, they will play a larger role in issuance—not only financing issuance, but IPOs in particular, where they will put back some of the companies they've been buying.

Looking at Europe, the German/Austrian/Swiss region saw large issuances, particularly because real estate really took off in 2006 and raised very large sums of capital. When compared to the market capitalization of the sector for example, it is quite extraordinary how much capital can be raised and we expect that to continue. Elsewhere in Europe, activity levels are also strong. France, Italy, the UK, and Germany will see strong activity with many IPOs, but the really big IPOs are in emerging markets and real estate. Obviously there's permanent capital, which is a theme as well, like KKR and Marshall Wace, but it has not carried through to a really large degree. We are seeing some hedge funds, private equity, and asset managers going out and raising funds rather than getting money direct from investors, and we expect some of them to list their management companies in 2007.

In summary, the pipeline is as good as it was in 2006, probably even better. We've had a decent start and we need equity markets to do well, but I think it's clear that the issuance pipeline is as healthy. M&A will be a real swing factor on issuance, but on the IPO front we have more mandates today than we did 12 months ago.

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***Ernst & Young:* What's the impact on pre-listed companies from the NYSE Euronext merger and any future consolidation of exchanges?**

Henrik Gobel: Capital is global today. There is prestige for issuers in what exchange they list on, but London is as prestigious as the NYSE. For an issuer it doesn't really make a lot of difference in terms of raising the money required. Some of the best IPO markets are also some of the smaller exchanges around Europe. The vast bulk of capital can invest pretty much in any market anywhere in the world. London clearly has become the place to list, possibly because the investment banking community is based there and it just makes sense to do business in London. The regulatory regime is favorable to new issuers and it is in the same time zone as Eastern Europe, the driver of much of the new issuance. If the LSE were owned by a US exchange and if that were to create more regulatory uncertainty, the listings could migrate to Euronext. If, however, there was no regulatory uncertainty, London would still be the listing place of choice for international issuers. When we speak to investors today, they will not say, "I like investing on Euronext, I don't like investing in London" or "I prefer to invest in Frankfurt"—they will go where the good stories are. Money follows good stories, and today London is where many of the new exciting stories are coming to. Listing on Euronext is probably easier than listing on London, but it does not have the history of international listings. You wouldn't list an emerging market stock on Euronext today because you'd be isolated, away from all the other emerging markets stocks, so you'd come to London.

"As private equity firms churn their assets a little faster, they will play a larger role in issuance—IPOs in particular."

As trading increases, a need to drive down costs will fuel potential further exchange consolidation. The cost of trading is too high and the consolidation of exchanges is all about lowering the cost of facilitating trading. If the exchanges don't get together and reduce costs themselves, then the banks, and indeed the investors, will find ways to do it.

***Ernst & Young:* What is the outlook for AIM?**

Henrik Gobel: The AIM outlook is good—it enables companies with shorter track records to access the capital markets. I know there's been a lot of talk about how AIM underperforms, but that's because investors have been de-risking and the nature of that market is that there will be problems. And remember, a vast proportion of AIM listings are very small capital raisings. When we go to investors with a new offering, the last thing they ask is: "Is it full LSE or AIM?" They ask if this is a company they want to invest in or not, and then perhaps later they may ask if it is AIM. Clearly there is a part of the UK fund market that can't invest more than a certain percentage of their funds on AIM, simply because they're indexed to the broad markets or have other limitations on investment profile. However, investors around the world, hedge funds, and others involved in capital markets don't ask whether it's AIM or the LSE. They ask "Is this a business I want to hold or not?" They all understand the risk factors of investing on AIM, such as less regulatory overview, reporting requirements, and financial history. I think the fact that almost as much money was raised on AIM as on NASDAQ over the last couple of years is not a coincidence, and that AIM will continue to be a large, growing market. Investors want to access the good stories and corporates need access to easy capital—AIM provides both. Are there going to be blow-ups along the way? Absolutely. Should you therefore increase the overview? Probably not. While you should make sure you have a good regulatory framework, the people buying and selling these companies are qualified investors. If retail offerings were involved, I'd be a lot more concerned, but they're not.

***Ernst & Young:* What's the impact of private equity?**

Henrik Gobel: Judging by the amount of M&A done by the private equity funds, the private equity firms need to get out of those assets. The IPO route is still the usual exit route and given that they are very active and have, raised enormous amounts of money over the last 24 months, and invested a lot of it. The companies they have bought need to come back to the market at some point, so expect a lot of issuances from private equity funds.

***Ernst & Young:* What are European investors looking for now, and where do they look?**

Henrik Gobel: Currently we are stuck in a European economy that is growing but not dramatically. People are looking for high growth, which today usually means emerging markets. If the stock markets mirror economic growth, at least to some extent, then for real growth you have got to look outside the core economies. Investors continue to seek potential for efficient balance sheets, dividend yield, and buy-backs. Companies where the management can't find high-growth opportunities, will return the money to the investors. People don't want to see companies hoarding cash when they don't have any growth opportunities. European investors are looking for three criteria; growth, capital efficiency, and shareholder friendly management. I don't see that changing.

***Ernst & Young:* What advice would you give to companies considering an IPO?**

Henrik Gobel: More than ever before, a company must make sure it carries out its IPO with credible people who have credible banking teams in the relevant sectors. Make sure you partner with banks which have a very capable industry banking team. They can give advice and position your equity story and will work with you to make sure the whole setup behind the scenes is the right one before you go to the public markets. ■

Tracy Pierce

Head of Global Business Development
London Stock Exchange plc

***Ernst & Young:* When you look back at the IPO landscape in the last 12-18 months, were there any key trends, that stood out for you?**

Tracy Pierce: The most striking development was that 2006 was a record-breaking year for money raised by both UK and international companies on our markets — and was significantly up on the previous year. In 2006, 367 IPOs joined our markets and raised over £29 billion, ahead of both the Hong Kong and New York Stock Exchanges and double the amount of money raised on NASDAQ.

The number and diversity of international IPOs was also a major feature, with 107 international companies from 26 countries joining our markets during the year, including the debut of Lotte Shopping in February, which became the second Korean company to dual-list in London and Seoul, and raised £1.6 billion; Napo Pharmaceutical's IPO in July, which was the first US company to take a primary listing on our Main Market; and MCB Bank, which issued Global Depositary Receipts on the Professional Securities Market in October and became the first Pakistani company to join our markets.

***Ernst & Young:* A small percentage of high-profile companies choose to list abroad. How do you compete for those deals?**

Tracy Pierce: For most companies the prime driver for a listing is their need to raise capital. In London, we offer companies access to an international, professional investor base and Europe's deepest pool of liquidity. Over £8.3 trillion of institutional funds are managed in London, including 75% of European hedge funds and 50% of Europe's institutional equity capital.

To keep our competitive edge, we work closely with regulators to ensure that we apply high standards but also maintain a balance of regulation that is appropriate for both companies and investors. We believe that the UK has done extremely well in maintaining this balance through our principles-based regulation and our "comply or explain" model of corporate governance.

The cost of an IPO is also important for companies and London is highly competitive in this regard. A study published this year showed that the cost of capital at both the IPO stage and beyond is lower in London than in any other major European or US financial center. For example, IPO underwriting fees in the UK are typically 3% to 4 % of funding proceeds, compared with 6.5% to 7% in the US.

Technology is another factor — electronic trading is now a huge driver of liquidity, and we invest in our technology to ensure that it keeps ahead of demand. In fact, we will complete a major overhaul of our trading systems this year with the introduction of our new TradElect system.

These are the main reasons why London is continuing to attract companies from literally all over the world.

As for developments in the next couple of years, we think that the Americas are particularly interesting. Historically, companies from Latin America have looked towards the US capital markets, but they are now taking an increasing interest in London. For example, Hochschild Mining plc was the first company from Peru to take a primary listing on our Main Market. We are also seeing increasing success in the US, with an additional 24 companies joining AIM in the year.

***Ernst & Young:* What makes mature market investors comfortable investing in emerging market entities? How do they balance the risk/reward equation?**

Tracy Pierce: Obviously how investors choose to weight emerging market stocks in their own portfolios is a matter for them to decide. They will form their own views based on the company fundamentals, and the country and sector in which those companies operate. However, the process of listing in London has an important part to play in providing investor confidence, because it ensures that investors have the information they require to make a judgement about whether or not to invest.

Wherever a company is from and whether it lists on our Main Market or joins AIM, the London regulatory model requires high standards of disclosure and transparency at the time of an IPO and on an ongoing basis.

If investors want to invest in most of our international stocks, they have to make a positive decision to do so. Admission to our markets does not mean automatic inclusion in the UK's FTSE index series that so many investors track.

The majority of companies who come to London from emerging markets such as Central and Eastern Europe, Asia, and the Middle East, list Global

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"The cost of capital at both the IPO stage and beyond is lower in London than in any other major European or US financial center. "

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capitalization, as a percentage of GDP, is relatively small. There's a need to catch up, and we've seen that in a pretty distinct way, in 2006.

Clearly there is discussion among stock exchanges to merge. But I think companies will continue to choose their primary place of listing in the markets where they operate, assuming that it has a reasonable stock exchange. Then, in some instances, they may want to add a second listing.

"With the bull market now in its fourth year, the mix of what's coming to market is changing from issuance by existing companies to new equity."

The globalization of stock exchanges is more a question of where do companies maintain secondary listings? If you look back, some of the big houses used to be listed on five, six, seven, eight or ten stock exchanges around the globe. What you'll find is that multi-listings, over time, will go down as stock exchanges become unified.

***Ernst & Young:* Will the NYSE Euronext merger have a material impact on where companies list?**

Christoph Stanger: No, I don't think so. If companies choose to list outside of their domestic markets, where do they go? There are two places in the world that tend to attract a lot of foreign listings — London and New York. New York has disadvantaged itself quite a bit through very strict regulation. Most people will point to the Sarbanes-Oxley discussion and the ongoing maintenance requirements once you're listed. A lot of issuers shy away from that.

The alternative, (i.e., London) is quite attractive. There is very little disadvantage as the European markets are very, very liquid. This year, the new issue volume in Europe actually was higher than the new issue volume in the United States. The theory that one had (in the past) is "I have to go to New York if I do something really big because I may not be able to sell it in my domestic market." That's not the case anymore.

People are asking, "Which place gives me a better regulatory environment?" London is getting the upper hand. We see this in a pronounced way with respect to the emerging market issuance out of Europe and Russia. Years back, you would have said Russian companies will look to NASDAQ, and to NYSE. There are very few today that would do that. Most of them will, by definition, go to London as a place listing, although for Asia that is still slightly different.

***Ernst & Young:* With so many different alternative paths to financing, what do you usually advise a CFO?**

Christoph Stanger: It will depend on the circumstances. In 90% of all cases, the advice will be, go public in the market where you operate. If you're a German company, you list in Frankfurt. If you're a UK company, you list in the UK. If you're a French company, you list in France. With that, you access all of the European capital or all of the capital that is outside of the United States.

Then, in most instances, given that we're in a global capital market, we would also give big US institutions access to your stock. So go to the US and do it on the basis of Rule 144A, which means you can get the institutional market in the US. That will be 90% of all situations. Then, there may be a few instances where you say, instead of just doing the Rule 144A, go and list in the US fully, for other reasons.

***Ernst & Young:* What's your take on Rule 144A deals, and why do companies pursue a full US listing, when it seems easier to take the Rule 144A route?**

Christoph Stanger: Basically, Rule 144A is a US rule that determines to whom you're allowed to sell your stock. A Rule 144A transaction is an institutional tranche of a foreign IPO targeted to onshore US institutions. It is not a new thing. It's been around for many, many years. A lot more people are choosing Rule 144A instead of a full listing in the US because Rule 144A is much less complicated.

There are still benefits to a US listing that one can't completely ignore. If you're truly a global company, you're active in the US market, you want to access the US debt markets, and you want to issue other instruments, then you need to be registered there. If you want to do M&A in the United States and you are buying companies with your stock, you need to be listed in the United States. However, for companies that are just looking at fundraising rather than strategic options, they will be quite skeptical of needing to access the US market in listed form. They can also gain access to the US market, for instance, through the Rule 144A route.

***Ernst & Young:* What's your view of the various alternative capital-raising vehicles in the capital markets now?**

Christoph Stanger: The massive inflow into private equity, and the cheapness of available debt, means that in many situations, in particular in the more established markets, when sponsors or owners think about exit, they will weigh an IPO versus an M&A transaction. The M&A transaction could be the form of selling it strategically but also selling it to private equity. They will look at the valuation merits of one route versus the other.

Most of the private equity community that owns assets, before they decide what to do, will look at both options. In many cases, they will decide on one, but in a lot of cases, they just run

those tracks in parallel. So they say "We're going to go public," but at the same time, they will see whether there is another sponsor or somebody else coming along who offers a value that's superior to what they can get in the public markets. That trend is here, and that trend will continue to be around.

When you look at the overall IPO volumes, they're clearly on an upward trend. The public market is definitely highly competitive. Given that the private equity community will have been such a massive purchaser of assets, the other upcoming trend is that private equity will also be a big sponsor for IPOs in the future. Assets may actually do a turn before they get recycled in the capital markets. As private equity grows, the IPO volume, overall, will grow. Because at the end of the day, it'll have to come out of private equity hands, and it'll have to go into the public hands.

What you will see most likely as a trend is public to private transactions. Companies are being scooped up by private equity. That's a function of the fund sizes that are so large that they have to go after really big opportunities. Big opportunities, by definition, are seasoned companies rather than relatively early stage companies. Again, you'd expect those companies to come back out again in the public market two or three years later. ■

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Depositary Receipts (GDRs). This particular type of security is targeted at specialist, professional investors that are aware of the potential risks and rewards associated with investing in developing market stocks. GDRs are not eligible for inclusion in the UK FTSE indices, and usually cannot be bought by private investors.

However, there are examples where companies based in emerging markets want to reach the widest investor audience. In those cases, they can follow the route taken for example by the Kazakh IPO Kazakhmys, and complete a primary listing, where companies have to meet UK super-equivalent standards and are expected to apply the UK code of corporate governance.

Ernst & Young: What were the important developments in emerging market exchanges that have enabled them to host mega IPOs?

Tracy Pierce: The large amounts of capital raised in Hong Kong last year were significant, but predominantly as a result of mainland Chinese privatizations in the banking sector and so not necessarily indicative of a longer-term trend.

In other capital markets, such as Russia and Kazakhstan, we are seeing increasing numbers of dual listings in London and the domestic markets.

Ernst & Young: As we enter 2007, what are your Exchange's strategic priorities?

Tracy Pierce: In terms of the Exchange's priorities as a whole, 2007 is a very significant year as we see the introduction of MiFID across Europe.

Perhaps less hyped, though equally important, will be the roll-out of our new TradElect platform later this year. This system will deliver unprecedented levels of performance, reliability and scalability, marking the end of a four-year investment programme by the Exchange, and provide the basis for the continuation of the significant growth in liquidity that we have seen in recent years.

Ernst & Young: In the last 12 months we have seen some consolidation activity among stock exchanges. What do you think of this trend?

Tracy Pierce: Part of the reason for increased activity is that capital market participants are interested in global trading solutions — the challenge for exchanges is how it can be provided.

Consolidation is one way to achieve this, but co-operation between exchanges is also an effective method. This is one of the reasons why we recently signed a Letter of Intent with the Tokyo Stock Exchange, with the aim of jointly enhancing our international presence and bringing benefits for issuers, investors, and member firms.

Ernst & Young: What is your outlook for Eastern Europe?

Tracy Pierce: In capital markets such as Russia and Kazakhstan, we are seeing increasing numbers of dual listings in London and the domestic markets. For example, Rosneft was the largest Russian company to list in 2006, raising a record US$10.7 billion in July.

The diversification of London-listed Russian companies beyond the traditional natural resources sector is increasing. This includes the recent listings of companies such as Sitronics, one of the largest hi-tech companies in Eastern Europe, and Sistema Hals, one of Russia's largest property developers.

Kazakhstan is also an increasingly important market for the Exchange. The quality of companies joining in the year was impressive, representing the leading economic sectors such as banking (Halyk Bank), gas (KazMunaiGas), and property (Chagala).

The pipeline of companies from the region planning to list in London remains strong and there is growing interest in trading Russian and CIS securities. In 2006, the value of Russian and CIS securities traded on the International Order Book (IOB) increased to US$179.8 billion — and in the first three months of 2007 has already exceeded US$47 billion. ■

"(On the LSE) the number and diversity of international IPOs was a major feature, with 107 international companies from 26 countries joining our markets during the year."

Middle East: Demand for Middle East IPOs Far Exceeds Supply

KEY TRENDS:

- **After three years of record growth, most Middle East markets endured erratic performance in 2006, but seem to be steadier in 2007.**
- **Factors leading to Middle East volatility include excess liquidity, irrational retail speculation and lack of market depth.**
- **The Middle East IPO pipeline is expected to expand, with large-scale privatizations and infrastructural projects in the works.**

After three years of rising oil prices, record growth, and a booming IPO market, the Middle East economies suffered sharp market volatility in 2006. Most regional exchanges were down for the year, except for Oman, Bahrain, Kuwait and Egypt. The Saudi exchange lost more than half of its value. Dubai's exchange was the world's worst performing stock market in 2006, as it plummeted by two-thirds in value since its peak in the previous year. Nevertheless, Middle East secondary market instability has not seriously dampened investor appetite for IPOs. The Middle East IPO markets raised US $10.8 billion through 87 deals in 2006. The region's top IPO was Qatar's Al Rayyan Bank offering, which raised US$1.1 billion.

A Big Bubble Bound to Burst

"In 2005, the Saudi market was one of the highest performing exchanges in the world. We had more than a tenfold increase in the value of the Middle East markets between 2000 and 2005. It was a big bubble that was bound to burst," says Omar Bitar, Ernst & Young Managing Partner of Advisory Services in the Middle East. "Eighty percent of that growth happened during 2005 and the first two months of 2006, so this was abnormal. P/E levels were unrealistic, especially in almost all non-performing companies without clear potentials. The markets were clearly overvalued. There was just so much liquidity and hype."

What's behind Middle East market unpredictability? Most market watchers blame excess liquidity, lack of regional market depth, irrational speculation by unsophisticated retail investors, lack of transparency and market immaturity. In recent years, trading on the stock market has become a popular pastime in many Gulf countries, with a large percentage of the population investing in the market until its downturn. After the May 2006 market tumble, many retail investors recorded devastating losses.

Bitar believes Middle East markets are still in the early development stages. "For instance, the Saudi market, which is probably 60% of the focus, is basically very raw. It's only two years old. The Saudi financial authorities have not been able to apply international standards to its performance in such a short period of time, given the volume in these markets and the liquidity level available. Investors were not investing on a logical basis."

Highly Liquid, Oversubscribed IPO Markets

In the last three years, the strong surge in oil revenues left Gulf markets flooded with cash. Although highly liquid, Middle East markets offer a limited number of investment opportunities. Currently, only about 1,600 companies are listed on all 14 Arab bourses. Thus, Middle East markets remain highly vulnerable to volatility, since demand for new IPOs continues to far exceed supply, and most IPOs remain highly oversubscribed. "Middle East companies who had recent IPOs were three to five times oversubscribed, despite a much weakened market position," says Bitar. "Such factors have led to IPO price bubbles and irrational speculation by ill-advised retail investors."

With few exceptions, companies in the Middle East do not seek to list beyond national boundaries. "Middle East companies are more likely to have a more successful IPO here in the Gulf than they would in a foreign market, " says Bitar. "A main driver for Gulf IPOs is the high liquidity of the market and the strong desire for IPOs. Historically, investors made hefty gains from investing in IPOs. Therefore key decision makers in pre-listed

"Middle East companies are more likely to have a more successful IPO here in the Gulf than they would in a foreign market."

companies still consider this market as a leading one for IPO activities."

Private equity firms have been very popular among Middle East investors. Multibillion-dollar buyout funds have been buying private companies and taking them public. "Over half of these private equity firms, "says Bitar, "have been created as a result of the immense liquidity from the 9/11 effect. After 9/11 many Middle East businessman stopped sending their money to the US. Many of these private equity funds are created by very wealthy businessmen who want to create a local vehicle where they can invest their money."

In 2007: Expansion in IPO Market Expected

With many IPOs waiting in the pipelines, Bitar expects the Middle East IPO market to continue growing in the next couple of years. Says Bitar, " Middle East IPO growth is driven by high market liquidity, government privatization activities, continued economic prosperity, and the massive government budget surplus created primarily by increased oil prices, the main source of the government's revenue. "

The Middle East's new strategy of opening state-dominated sectors to private sector investment will most likely lead to large-scale IPOs in the next couple of years, says Bitar. Massive infrastructural projects for air transport and airport services, construction, highways, ports, water desalination and oil refineries are expected. Says Bitar, "The only hurdle that could stand in the way and cause a sudden halt to this activity would be political turmoil or a sudden major reduction in oil prices." ■

CIS/RUSSIA: 'The Year of IPOs in Russia'

KEY TRENDS:

- **Russian IPO markets flourish in 2006 and 2007, particularly in the commodities and financial services sectors.**
- **Larger Russian companies seek credibility and deeper liquidity by listing in London.**
- **Russian companies face uncertainty ahead with 2008 presidential elections, commodity prices, and corporate governance issues.**
- **A GDR in London combined with a US Rule 144A offering is the most popular form of listing.**
- **As the private equity market remains undeveloped, IPOs are by far the most popular Russian exit strategy, with the best valuations.**
- **Kazakhstan launches large IPOs in resources and banking sectors with several major banks expected to go public in 2007.**

In response to the liveliness of the new issuance market, Russian President Vladimir Putin dubbed 2006 "the year of IPOs in Russia." Russian-domiciled companies raised US$18 billion through 21 deals in 2006.The year's largest Russian IPO, state-owned oil and gas giant, Rosneft, dual-listed in Moscow and London, and raised US$10.6 billion. The past seven years in Russia have been a period of relative stability and economic growth. Investor confidence has been lifted by Russia's consumer boom, incoming investments, petrodollars, high commodities prices and demand, lower inflation, and surging real estate and stock market. Against this market backdrop, the Russian IPO market has rapidly developed. Although this market is still smaller than that of industrialized countries, IPOs of Russian companies now make up 8% of global volume by dollars. Perhaps the most striking trend of the 18 months has been the large influx of Russian companies seeking credibility and capital in the public markets of London.

Large Russian Companies Flock to London

Since a Russian company going public is required to list 30% of its offering on the domestic Russian exchanges, the big question is whether it will list abroad as well. Any company with more than US$5 billion in market capitalization needs more market capacity than Moscow can provide, so larger companies will dual-list: locally in Moscow, coupled with a cross-border listing. In the past two years, the preferred market has clearly been London—through a Global Depositary Receipt (GDR) listing. Of the 21 Russian-domiciled IPOs in 2006, 7 were listed only in Moscow, while the other 14 were listed on the LSE (eight deals), AIM (five deals), and NASDAQ (one deal). The inflow of Russian companies seeking to go public in London began in 2005 when consumer services company Sistema dual-listed in Moscow and London and raised US$1.5 billion.

"A London listing boosts credibility and offers a much deeper capital pool, with lower transactions costs than the US," says James Klein of the Capital Markets Group, Ernst & Young, Russia. "It's very simple, you can list there much more quickly than you can in the US, it costs less, the regulatory regime is extremely light, there's a huge amount of capital, and it's closer."

"London is tempting to Russian issuers," says Henrik Gobel, Managing Director and Head of the Equity Syndicate Desk at Morgan Stanley, "because it's closer from a time zone perspective, it has a listing environment supportive of international companies, it's a home for many emerging market investors and large funds who invest in Russia. It has as much liquidity as the US, and a more flexible regulatory regime."

At the same time, more international investors have begun to set up branch offices in Moscow to enable local capital fundraising, especially with smaller deals, notes Anton Cherny, Managing Director, Head of Equity Capital Markets, Renaissance Capital. "Regardless of where a company lists, in London or in Moscow, 80% of the buyers will be the same, mostly the large international

names, and all are set up to buy shares both locally and internationally. There are only a handful of international names that still require London listings to buy Russian shares," says Cherny. However, Klein says most investors would still rather deal through London, as the Russian exchanges still lag far behind London for execution, costs, and transparency.

"Perhaps the most striking trend is the large influx of Russian companies going public in London."

Major Risk Factors: Elections, Commodities, Corporate Governance

The Russian market provides a backlog of companies with global aspirations seeking to list on international capital markets, says Richard Cormack, Head of New Markets, Equity Capital Markets, Goldman Sachs. "Investors in Russia are industry-driven first, and then geographically-driven," says Paul Murphy, Transaction Support Leader, Ernst & Young, Russia. Murphy believes the Russian companies have a strong foothold in certain basic industries such as energy, steel, and mining. "Investors recognize the fundamental strength of those industries and issuers in Russia, and they're willing to pay for it."

Nonetheless, some analysts believe that investor appetite for Russian IPOs could be waning, in the face of uncertainty ahead. "Investors in Russia are becoming choosier and more demanding on price, risk, and transparency," says Murphy.

Russians elect a new parliament in December 2007, and choose a successor to President Putin in March 2008. Some market watchers speculate that such political uncertainty could be spurring companies to get their IPOs out of the way in 2007, and instability may follow in 2008. However, Cherny says the prevailing Russian market sentiment is that Putin's successor will most likely maintain a similar political and economic policy.

Another major risk factor for Russian investors is the possibility of a sharp correction in the price of oil. Says Cormack, "An oil price drop could also lead to a sharp fall in the Russian equity market, since approximately three-quarters of the Russian index is in commodities, much of it, oil-related."

Finally, since Russian corporate governance standards tend to be shaky, it continues to be a major issue for investors in Russia, says Klein. "Recent research indicates

that Russian companies are leaving as much as 20% of their valuations on the table because of perceived corporate governance issues."

Most Common Listing Form: London GDR and Rule 144A

Currently, the GDR in London, together with the Rule 144A offering in the US is the most common form of listing. A GDR is a dollar-denominated certificate of ownership of underlying shares which trades on an international exchange, typically London. Rule 144A is an exception to the registration requirements of the US securities laws, and allows investors to sell the GDR to qualified institutional buyers in the US.

According to Cherny, companies take the GDR route because it's easier than a full UK listing, with less compliance and preparation work, and no penalty or discount. Cherny believes that there's no difference in the amount of capital raised, since the majority of investors into Russia are specialized professional investors who can evaluate the company properly. "The GDR offers the broadest access to investors, particularly those focused on investing in the Russian market and in emerging markets," says Cherny.

Private Equity Remains Undeveloped

The flurry of global M&A activity has pressured Russian companies, especially the larger ones, to grow, expand, and raise capital, particularly through an IPO. "For the Russian companies that aren't absorbed by those inbound investors, their valuation is pushed up, giving them the opportunity to go to the capital markets if they're big enough," says Klein. "Far and away the biggest activity is an IPO—an actual public sale—although we have seen some private placement activity where, instead of filing an IPO, they've maybe placed some shares privately with investors."

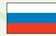
"Currently, Russia's private equity industry is under development—it's not the traditional private equity industry seen in the West, and there are no leveraged buyouts," says Cherny. "But there are quite a few local and international players who are happy to take private risk, and buy into unlisted assets." Cherny considers the Russian universe of private investors to be wider than in the West. These private investors are not traditional LBO shops, but include hedge funds, venture capitalists, asset managers with private equity "arms," and in particular, oligarch industrialists and their vehicles who have private equity concentrated in their hands. Says Cherny, "Investors want to invest on a pre-IPO basis in sectors with quick exits, and sectors with track records."

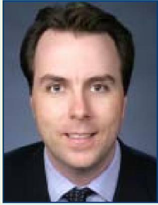
Large Kazakh IPOs in Resources and Banking

"People are looking to buy into growth in emerging markets. With much of eastern Europe being absorbed into the EU and maturing, they are now looking further east, they are looking to Russia, and beyond, to Kazakhstan," says Cormack. As the largest central Asian economy, mineral-rich Kazakhstan's booming economy has been driven by its natural resources: oil, gas, and mining. Kazakhstan's strong economic framework and resource reserves have attracted foreign investment, and now more Kazakh companies are seeking to tap global capital markets. Murphy observes that, although the Kazakh IPO market so far has been limited to two sectors: (natural resources and financials), all IPOs have priced very successfully. In 2006, a Kazakh upstream national oil and gas company, KazMunaiGaz, raised US$2.3 billion in the largest ever Kazakh IPO. The IPO of Kazakhstan's second-largest bank, Halyk Bank, raised about US$1 billion in 2007. "It's the beginning of a series of large Kazakh banks positioning themselves to go public in 2007," says Klein.

In 2007: Momentum Continues with Greater Diversity

In the first half of 2007, a significant proportion of large Russian IPOs worth over US $500 million continued to dual-list in London and Moscow. Most notably, in May 2007, Russia's giant state-owned bank, Vneshtorgbank (VTB), listed in both Moscow and London with a deal size of around US$8 billion. "You'll see continued strength through the issuances out of Russia with the potential for some large privatization offerings as well as some large corporate IPOs," says Cormack. "This year we expect to see activity from a broader cross-section of sectors as opposed to what has been a fairly heavily skewed pipeline towards commodities." ■





Richard Cormack

Head of New Markets, Equity Capital Markets
Goldman Sachs International

Ernst & Young: ***What makes developed market investors comfortable investing in the emerging markets?***

Richard Cormack: Investors are looking for growth, particularly if you're looking within the European region. A lot of that growth is going to come from the emerging markets of Europe, i.e., Russia and Central/Eastern Europe, because those economies are at a younger stage of development. People are investing in these markets because they see attractive growth opportunities. They buy into the BRICs (Brazil, Russia, India and China) theory of life where some of these emerging economies are going to be very significant developed economies in a few decades. People know they are buying into a market that is emerging, and they're buying into the growth story of that market.

Investment is all about risk and reward. Yes, there may be some greater risk in investing in emerging markets, and there may be greater volatility in investing in emerging markets. (We saw that in May/June of last year.) But the rewards have also been higher. So investors are prepared for that trade-off.

Emerging markets have also outperformed developed markets, adding to investor confidence. For the last three or four years, Russia has been one of the best performing markets globally. If you look at markets as a whole, emerging markets as an asset class were up something like 30% or 40% in 2006, as opposed to global markets, which were up mid to high teens in percentage terms. There have been stock-specific stories within that, as there is in any market. But the returns and the growth have certainly been strong within the emerging market asset class.

Ernst & Young: ***What's your IPO outlook for Russia in 2007?***

Richard Cormack: We expect to continue to see high levels of activity out of Russia. The Russian market was very active in 2006 and accounted for about 8% of global volume (it accounted for only 3% in 2004 and 1% in 2003 of much lower aggregate volumes). You'll see continued strength through the issuances out of Russia with the potential for some large privatization offerings as well as some large corporate IPOs. This year we expect to see activity from a broader cross-section of sectors as opposed to what has been a fairly heavily skewed pipeline towards commodities.

Ernst & Young: ***What's behind the wave of Russian IPOs since 2005 after a decade of inactivity?***

Richard Cormack: Number one, the market has performed very strongly. So you have an issuing environment that has been very supportive to companies. You have a strong secondary market and investor enthusiasm driven by the strength of that secondary market. Number two, on the back of strength in the commodity area, there are a lot of companies in Russia that have more global aspirations, so they want to list on the capital markets to gain a foothold as they look further west for potential strategic activity.

Ernst & Young: ***What do you think are the major Russian risk factors?***

Richard Cormack: The Russian market is largely going to be driven by the commodity price environment. If you see a sharp correction downwards in the price of oil, you would expect to see the Russian equity market fall, not least because Gazprom is a very significant part of the index. Approximately three quarters of the Russian index is commodity-related — much of it is oil-related. So that is clearly a macro risk to the market in general. There is also some concern about volatility in the lead-up to the presidential elections next year.

In terms of the company-specific risks, maybe there's a page or two more for a Russian IPO than there is for a French or German IPO. But every company has its risk factors and every industry has its risk factors.

"There may be greater volatility in investing in emerging markets. But the rewards have also been higher."

Ernst & Young: ***Many Russian companies are listing abroad, especially in London. How do they decide which exchange to list on?***

Richard Cormack: Any Russian incorporated company has to list in Russia. It's a regulatory requirement. The question then is whether they list internationally as well. If they do, the market of default is London through a GDR listing. We've talked already about some of the relative pros and cons of London versus the US. Frankly, London is attractive to Russian issuers because it's more proximate from a time zone perspective and it has a listing environment that is supportive for international companies. It also is the home of a lot of emerging market investors and global emerging market funds. It's a natural place to come.

Ernst & Young: ***Just how underdeveloped are the Russian regulatory***

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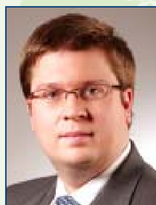


Anton Cherny

Managing Director, Head of Equity Capital Markets
Renaissance Capital

Ernst & Young: What have been the key trends in the Russian IPO market in the past year?

Anton Cherny: We have seen a number of trends so far. The opening of the IPO market started with IPOs that took place in late 2004, early 2005. The first one was Mechel IPO on the New York Stock Exchange; then the Efes Breweries IPO, which is technically speaking a Turkish company but which has a large majority of operations in Russia; and the third was the IPO of Sistema which was the first US$1.5 billion large offering of a Russian company on the London Stock Exchange.

Since then the number and volume of deals has increased exponentially, and now we routinely have deal volume between US$5 billion and US$20 billion coming out of Russia every year. US$1billion plus deals became commonplace. For example, in 2006, there was the US$1 billion IPO of Comstar on the London Stock Exchange early in the year. Then there was the US$10 billion IPO of Rosneft, also on the London Stock Exchange. There was also the US$1 billion IPO of TMK in November.

The trend we see today is that the deals are becoming much larger. This year there were three quite substantial transactions of between US$500 million and US$1 billion for Sitronics, Polymetal, and Integra. We expect that by the end of the year there will be many more large transactions.

The second trend is that, while in the past, activity was centered around three sectors, namely metals and mining, oil and gas, and telecoms, now the sectors and the variety of the companies coming through the market is much more diverse. Activity in the financial institutions sector is one obvious trend. A large transaction is expected out of state owned bank, Vnestorgbank which will be a multi-billion dollar offering, and there are a couple of other capital increases happening in the banking sector. There may be one or two insurance deals as well.

The other sectors that are becoming more and more prominent are the consumer sector and the retail sector. The IPO of Pyaterochka, the Russian retail chain, in 2005 on the London Stock Exchange marked the beginning of this trend. There were quite a few deals out of the consumer sector too — for example, Magnit and Veropharm — and we expect the sector to be increasingly represented in the Russian IPO universe by the end of this year.

A lot of issuance also is expected out of the utilities sector. It started late last year with the IPO of OGK5, and we expect at least three or four deals to be priced this year out of this sector. The fourth sector is real estate, which was active last year and will be even more so in 2007. It's a booming sector in Russia, so it obviously requires a lot of capital.

The third trend is that now capital markets are becoming more mature and there are more and more stocks already listed in the market, there will be more follow-on issuance activity by the companies that are already listed. This clearly doesn't qualify for an IPO from a technical point of view, but it definitely is an important trend in the Russian capital market. So the companies that have recently listed on the London Stock Exchange or the New York Stock Exchange, for example, will be coming back to the market to raise more capital.

Ernst & Young: What's driving these larger deals?

Anton Cherny: First of all it's a question of supply and demand. What drives the supply is the appetite for capital. Primarily, in the utilities sector there is a huge requirement for capital to modernize the infrastructure of the assets. The same is true for the financial sector, which is growing exponentially and where there are mandatory requirements in terms of debt-to-equity ratios established by the Central Bank. To fund this growth, the banks need to raise more and more capital. As far as other sectors are concerned, such as metals and mining, international consolidation drives the capital raising. In real estate, there is a need to develop new projects, business centers, residential communities, which are all capital-intensive projects. So that drives the supply.

On the demand side, as Russian capital markets are becoming more and more developed, global funds are allocating more capital to Russia as part of the general migration of capital from the developed markets to developing markets, particularly the "BRICs" — Brazil, Russia, India and China. On the other hand, the Russian domestic market has been developed exponentially, and more and more petrodollars are being recycled back into the economy. So that drives the demand. All these factors on the one hand require the companies to do larger deals because of the need for capital and, on the other hand, the bigger deals are becoming more and more feasible because of the capacity of the market.

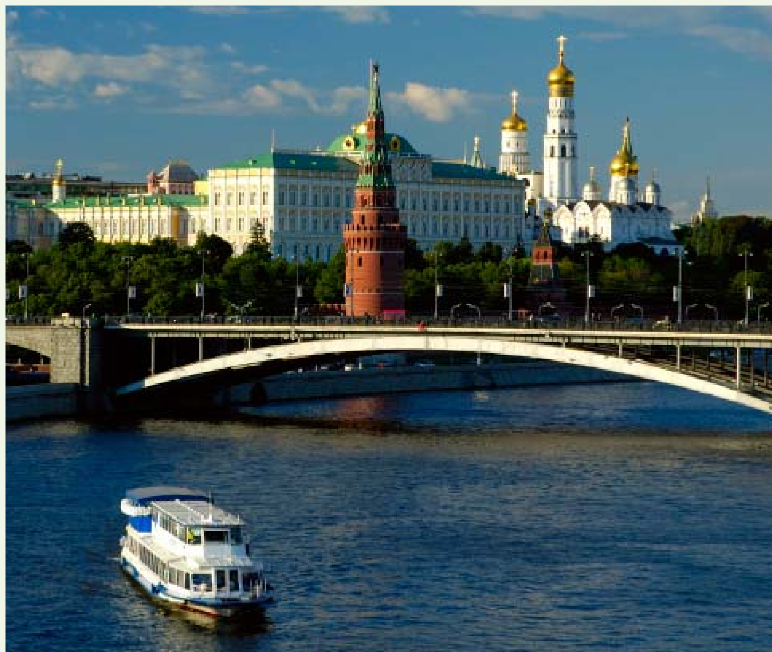
***Ernst & Young:* What is the significance of a local Moscow listing versus a London listing?**

Anton Cherny: On the one hand, the stock market regulator in Russia encourages companies to list locally in order to develop Russian equity markets. What happens normally in any other market, such as Italy, Germany, France, is that companies are doing IPOs in their local market. This is quite natural. The strategic goal of the regulator is to develop the same kind of infrastructure in Russia so that the Russian companies can raise money locally.

When you are talking about the US$1 billion-plus deals, or maybe US$500 million-plus deals, you clearly need more market capacity, which the local market cannot provide at the moment. That's why the bigger deals are going into London. As far as the smaller deals are concerned, more and more of them are raising capital locally. For example, if you look at the Rosneft deal, only US$4 billion of the US$10 billion was raised internationally, whereas the remaining US$6 billion was raised domestically. In another example, there was an offering of Open Investments, a large real estate developer in Russia, in September 2006. It was an offering of almost US$900 million and there was no London listing. What is important is that a lot of international investors now recognize this trend; they are fully set up locally and are able to buy local shares listed in Russia. There are only a handful of international names, particularly in the US, that still require London or New York listings to buy Russian shares. And more importantly, more and more international investors are opening offices in Moscow.

***Ernst & Young:* What is the impact of the Russian exchanges being relatively small, with limited capital raising capabilities?**

Anton Cherny: Let's just separate the two issues. One issue is: who buys the IPO? Is it Russian investors or international investors? Regardless of where you list, in London or in Moscow, 80% of the buyers will be the same: large international names, all set up to buy shares both locally and internationally. So it is not the stock exchange that provides the investors or capital. It is investors who are being proactively targeted by the issuers through the roadshow. Effectively it is the investment bank that brings the issuer to investors, not the stock exchange. The stock exchange is their medium — investors need the stock to be listed and that is what the stock exchange is providing.



"The number and volume of deals has increased exponentially, and now we routinely have deal volume between US$5 billion and US$20 billion coming out of Russia every year."

***Ernst & Young:* What will happen to dual listings in London as the Russian stock exchanges mature?**

Anton Cherny: For the larger transactions worth US$0.5 billion plus, London will still remain the primary destination. I don't expect much capital-raising by Russian companies on NYSE or NASDAQ. There will be more and more offerings on the local stock exchanges — this is a fact of life.

***Ernst & Young:* What are the major reasons behind the surge in Russian IPOs in recent years?**

Anton Cherny: 2004 and 2005 were the first years where companies were recovering from the crisis that hit Russia in 1998–1999. It was the fifth consecutive year of growth where companies reached a critical mass, allowing them to tap the capital markets, It also had something to do with some of the stock exchange requirements; because for example; the London Stock Exchange requires three years of audited financials. So if the company started international audits back in 2001–2002, the earliest they were able to do their offerings was in 2004–2005. This was the second reason for the surge. The third was the increase in supply and a huge migration of capital from the developed economies into the developing economies. After the slump in Western Europe and the US in 2001–2003, stocks were depreciating in value for three years in a row. At the same time, developing markets, including Russia, were growing quite fast, so capital started migrating. All these three factors combined to create

Continued on page 58

Anton Cherny, continued from page 57

a surge in the issuance back in 2004–2005.

The amount of capital allocated to the emerging markets in the global context is still quite substantial. Russia's share of the new capital inflows into emerging markets is still very, very high. There are more and more companies that are ready to list, so I don't expect any slow down of issuance activity in the next year to 18 months, unless we hit some global problems in the financial markets.

***Ernst & Young:* What is your view on Kazakhstan's IPO market?**

Anton Cherny: Kazakhstan's IPO market has been marked by two very successful recent deals, two bank offerings that went very well—Kazkommertsbank and Halyk Bank. They were very, very successful, priced at the top of the range in some cases, and their ranges have since increased. There was also the very successful offering of Kazakhmys, a mining company, which also priced at the top of the range and traded up significantly after the IPO.

In general, the IPO market in Kazakhstan is narrower than it is in Russia today. So far it has been limited to two sectors: natural resources and financials. However, the Kazakhstan deals tend to be a little bit larger than the average size of a Russian deal, and they've been all priced very successfully. ■

Richard Cormack, continued from page 55

environment and capital markets from an international perspective?

Richard Cormack: The regulatory environment and the capital markets framework are developing. From the Russian standpoint, the Russian Parliament is in the process of, (if not having already approved) legislation for RDRs (Russian Depositary Receipts), which would allow offshore companies to list in Russia. That will have an impact, particularly in offshore incorporated companies, operating within Russia. Now they will have a route to list in the Russian market. In terms of Russian incorporated companies, you're seeing more companies only list in Russia as opposed to feeling the need to do a dual listing, highlighting a deepening of the market and the fact that investors are increasingly comfortable investing in Russia.

***Ernst & Young:* What's your macroeconomic outlook for Russia in the next 12 to 24 months?**

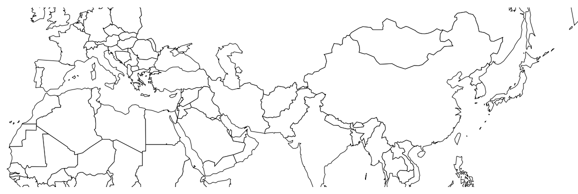
Richard Cormack: We continue to have a positive outlook on the economy with similar kind of growth as last year, in the 6% to 7% range. Global liquidity conditions remain strong. There's always potential for some volatility caused by internal or external factors over a 12- or 24-month period. Overall, the macro picture is still pretty robust. Frankly, it can be still be pretty robust at oil prices lower than these current levels.

***Ernst & Young:* What's your perspective on the CIS/central Asian markets?**

Richard Cormack: We saw some activity out of Kazakhstan in the back half of last year. There is likely to be some continued issuance. We saw the two bank IPOs towards the end of last year. Other transactions could come out of that sector in Kazakhstan as well. Investors will continue to look at those markets. They're looking to add growth to their portfolio. With the EU having expanded to its current borders and incorporating more of the Eastern European markets, they're actually increasingly developed in nature. So as investors look for more growth, they look further east, to Russia, and beyond Russia. Kazakhstan, and Ukraine will probably be the two largest markets of the central Asian states.

***Ernst & Young:* Do you have any advice for companies thinking about going public in Russia?**

Richard Cormack: The capital markets are very much open but investors are becoming more selective. It's important to position and structure yourself appropriately, and to put the right governance principles in place. Such advice though could equally be given to an issuer in Russia or in the UK. ■



Australia: High Commodities Prices Fuel Australian Resources Boom

As Australian stock markets rise for the fourth year in a row, Australia's stable economy, record corporate profits and booming resources sector have led to an extraordinarily active IPO market. In 2006, Australia launched 173 IPOs, raising US$4.2 billion, with many listings in the resources and energy sector. The largest Australian IPO of 2006 was explosives maker Dyno Nobel worth US$800 million.

KEY TRENDS:

- **Rising commodity prices and demand from Asia fuel thriving resources and energy sectors.**
- **A recent surge in private equity will lead to many IPO exits in next 12–24 months.**

High Commodity Prices and Demand Fuel IPOs

"For the last two years, the greatest impact on the Australian economy has been commodity prices and the demand from China and India for mineral resources," says Patrick Winter, Strategic Growth Markets Leader, Ernst & Young Australia. Winter expects Chinese demand for Australia's raw materials for steel and aluminium production to accelerate. "Reports are that the demand out of China for these resources has only just begun."

In 2006, 58% of Australia's IPOs came from the resources sector, whose returns have been extraordinarily high. Underscoring the strength of commodity prices, 8 out of 10 best-performing IPOs in Australia were resource companies. "Keen investor interest in resources companies have been driven by commodity pricing and demand. As a result, many resources companies floated in 2005 and 2006," says Winter.

The Quest for Additional Equity

"Since much Australian revenue is earned abroad, some companies find they need to list outside Australia to get the additional equity they need," says Winter. "We're a country of 20 million people with a limited amount of equity depth. It's nothing like the equity depth in the European, US or Asian marketplaces. In Australia, more of our companies must think globally, as much of our customer base is now global." In Winter's view, the purpose of many Australian offshore listings is to gain capital and credibility in a region or country where they are doing business.

Other key recent sources for additional liquidity include growing levels of pension fund flows, private equity, and M&A activity. "Australia's private equity boom began about two years ago," says Winter. "The Australian private equity market is quite immature compared with the US and the UK. We haven't had the big wave of private equity-backed IPOs come to market yet." Winter expects many private equity exits in the next 12–24 months—most probably IPOs or, to a lesser extent, secondary buyouts from another private equity firm. "From now on we'll have a constant, steady pipeline of IPO potentials as we see private equity investors exiting their investing companies, especially in 2008 and beyond."

In 2007: An Even Stronger IPO Market Anticipated

In 2007, the Australian IPO market looks even stronger than last year, says Winter. In the Australian pipeline is the IPO of world's largest drilling services provider, Boart Longyear, (US$1.9 billion) and proposed privatization of health insurance company Medibank Private (US$1.5 billion). ■

United States: Private Equity and Venture Capital Back Over Half of IPOs

KEY TRENDS:

- **Robust US markets garner the highest number of IPOs in 2006 and maintain momentum with a pipeline of high-quality deals in 2007.**
- **Most global companies list at home, rather than in the US, as local markets grow more liquid and better regulated.**
- **A full US listing is still the benchmark standard, with the deepest liquidity, premium valuations, and many strategic advantages.**
- **Many capital raising options exist in the US, including private equity, M&A, Rule 144A offerings, and SPACS.**
- **Private equity and venture capital firms emerge as key players in the US public markets.**

In the past 18 months, the vitality of the US stock market has whet investor appetite for risk, and spurred US-domiciled IPO numbers to record heights. Although some market watchers blame US regulations for the rise in non-US cross-border issuances, globalization of capital may be the primary force behind the trend as it has lead to stronger, more liquid, competitive markets worldwide. For a truly global company, a US listing is still seen as the "gold standard" with access to the deepest pool of capital, a valuation premium, and strategic advantages. A key driver behind over half of all US-domiciled IPOs have been private equity and venture capital firms.

US Launches Record Number of IPOs

US IPOs had a record year in 2006. The US launched the world's highest number of IPOs 187 deals, and raised US$34.1 billion, the second largest amount of capital raised (See Figure 2, page 63). The US market's fourth quarter was the busiest since 1999, raising US$12.4 billion, in 72 IPOs. The largest US IPO in 2006 was MasterCard, raising US$2.6 billion. Ranked ninth in value globally, MasterCard was the only US company and offering to rank among the global top 10 IPOs for the year.

"In the past two years, we've seen a vibrant, three-legged IPO market—we're seeing not only IPOs from subsidiaries carved out of large public companies, but also sponsor-backed companies, and growth companies, " says Larry Wieseneck, Head of Global Finance at Lehman Brothers. "The diversity of deals is a sign of a healthy market."

One-third of all US-domiciled IPOs were venture-backed, underscoring the key role of the US venture capital industry in sourcing companies seeking to go public. In addition, private equity has played a key role in fueling the capital markets in the US. In 2006, 34% of IPO proceeds and 27% of IPOs were private equity-backed buy-outs.

More Cross-Border IPOs List Outside US

Over the past decade, global capital market horizons have broadened, with significant listings occurring on local exchanges and thus outside the US. "We're not seeing nearly the same amount of non-US issuers listing in the US. Global issuers coming to market are choosing to stay in their local markets or list in London, more frequently than they have in the past," says Wieseneck. In 2006, about 90% of issuers across the globe chose to list on their domestic exchanges.

Many market watchers note that the traditional status of the US as the single pre-eminent global capital markets leader may be diminishing. However, the evolution of the US role may be largely attributed to growth in the global equity markets, and increased liquidity available outside the US. Such a convergence of global market changes has greatly heightened the willingness and the ability of large foreign issuers to execute large equity deals on non-US exchanges. "For many years, the US had the advantage of being the only truly liquid market with openness, proper disclosure, and straightforward accounting rules, which led to the US being by far the best market for companies seeking the best price for their issues," says Wieseneck. "However, when you combine the highly litigious nature of the US market—which has been there for years—and the changes in the marketplace brought on by Sarbanes-Oxley, it feels from a foreign issuer's standpoint that the

long arm of litigation risk is always there if they list their company in the US."

"The US is no longer as attractive for international issuers," says Henrik Gobel, Managing Director and Head of Equity Syndicate Desk, Morgan Stanley. "First, you don't automatically get a higher valuation by listing in the US. Second, you access only marginally more US investors, but the vast amount of US investors can participate in London anyway, so why bother? Third, why put yourself on a harsh regulatory regime, if you don't need to? Fourth, if you do a listing with a Rule 144A offering in the US, you can gain access to the vast amount of American funds."

Global Companies List on Home Exchanges

However, many experts believe that the growth in non-US listings may be due primarily to better-regulated and more liquid overseas markets, rather than a response to US regulations. Globalization of capital has enhanced regional economic growth, cross-border trading, liquidity, and the stringency of local regulatory frameworks including corporate governance—all of which heightens the ability of local exchanges to support large IPOs. "Given the record performance of the US capital markets this year and the burgeoning pipeline, it is difficult to conclude that Sarbanes-Oxley has had a negative impact," says Maria Pinelli, Americas' Director, Strategic Growth Markets, Ernst & Young.

"One-third of all US-domiciled IPOs were venture-backed, underscoring the key role of the US venture capital industry in sourcing companies seeking to go public."

Furthermore, in 2006, when 9 out of 10 companies went public in their home market, they were merely following a time-honored tradition of listing on their domestic exchanges. "It's a historic but perhaps unrecognized fact that in most markets, at least 90% of companies list on a domestic exchange," says Pinelli. In the past several years, the number of cross-border listings has risen. Nonetheless, in 2006, only 173 IPOs were cross-border

"Growth in non-US listings may be due primarily to better-regulated and more liquid overseas markets, rather than a response to US regulations."

deals, representing 10% of total IPOs and 15% of total capital raised. In other words, cross border deals are still a relatively small proportion of total IPOs.

Intensified rivalry from foreign exchanges such as LSE and HKSE may have also added to the impression that the US market may be losing its financial grip. "London has a very aggressive marketing team," says Pinelli. "Their message is: 'Avoid the US. Come to us. We're not as costly, we're less regulated, and we're not as litigious.'" After a robust year with listings of state owned enterprises, the Hong Kong exchange has also proved itself a worthy competitor, especially now that mainland companies are no longer finding it necessary to list on foreign exchanges to access deep liquidity.

With over 50 exchanges worldwide, international companies have many listing options. "If we look at the 10% of companies that do leave home to list, most don't go far—they tend to list regionally, on an exchange close to their corporate home market," says Pinelli. She notes that some of these IPOs have deal sizes much smaller than the average US IPO, and would fail to attract US research analyst attention. "Although a small percentage of non-US companies may be avoiding the US, the American exchanges appear to be attracting their fair share of deals."

Currently, a revision of Sarbanes-Oxley's Section 404 to ease the burden for compliance for smaller companies is underway. This revision would make the US market more competitive with London's AIM market. "It'll be interesting to see if the US can react quickly enough to the regulatory environment to skim off some of the losses, and make high-growth smaller companies feel like it's logical to list again," says Cully Davis, Director of Equity Capital Markets at Credit Suisse.

US Exchanges Still Set Market Standard

For many of the top foreign companies, US exchanges are still seen as "the gold standard" of the global markets. With a US-standard corporate governance model in place, companies can expect around a 30% valuation premium on their equity. "What companies want out of the NASDAQ listing comes down to valuation. It's access to capital, putting their company on a global platform, showing their customers, peer groups, that they can list in the US," says Charlotte Crosswell, Head of NASDAQ International. According to David Wilkinson, IPO Leader, Ernst & Young UK, "If you can list in the US, you've met the most stringent standards of corporate governance in the world."

Nowadays, global businesses list in the US for strategic purposes, not just for access to liquidity. "There are still benefits to a US listing that one can't completely ignore," says Christoph Stanger, Co-Head of European Equity Capital Markets at Goldman Sachs. Stanger notes that a global company needs to be registered in the US, if it is active in the US market, seeks to do M&A deals and buy companies with its stock in the US, and seeks access to the US debt markets and the issuance of other instruments.

"A listing in the US still provides the deepest pool of capital, US branding and acquisition currency which only a US-listed security can provide. Also, US-based employees can be compensated with US dollars and US-listed stock," says Richard Cormack, Head of New Markets, Equity Capital Markets, Goldman Sachs International.

Rule 144A Deals Become Popular Alternatives

For foreign companies seeking speedier and easier access to the US capital markets, Rule 144A private placement transactions have emerged as an increasingly popular alternative to a full US listing. Typically, foreign companies make a local equity offering, and then access US-qualified institutional buyers through a Rule 144A transaction. Davis feels that Rule 144A deals help companies to avoid the "cost, pain, and suffering" involved in meeting requirements for US registration, and in the long wait for the Securities & Exchange Commission (SEC) to declare their registration statements to be effective. Davis also notes that all of the foreign companies that he has taken public lately had the opportunity to list in the US, but chose to pursue a Rule 144A transaction instead.

So why would any overseas company bother with a full US listing when it can conduct a local IPO plus a Rule 144A deal? Stanger believes that in most instances, foreign issuers choose not to undertake a full listing in the US, as Rule 144A will allow them to access a large part of the target investor base. Full listings tend to be driven by other considerations, like being in a position to use shares as a currency for acquisitions in the US, or to compensate US-based employees with stock options.

"The Rule 144A transactions are just one more indication that the US capital market system is actually probably one of the most sophisticated in the world," says Pinelli, "because of its structure and its ability to carry out both public, very transparent transactions and those that are more private, less transparent."

Private Equity Emerges as a Key Player

The US capital markets are still the most mature and sophisticated in the world, offering a wide range of capital raising options including venture capital, private equity, debt, Rule 144A offerings, and SPACs. Ever since the IPO market began to pick up in 2004, private equity firms have been major players in the US public markets, especially the super-sized deals. In the past 12–18 months US private equity has rapidly expanded both in the large amounts of capital invested and in the number of private equity-backed companies that went public.

In Davis's view, "The biggest driver of activity, going into 2007, is the speed and scope with which a lot of the private equity shops will pursue exits in the public markets." In 2006, private equity was behind 6 of the 10 biggest deals in the US in terms of funds raised, with industrial company, Spirit AeroSystems the largest of all US private equity-backed IPO deals.

Private equity-backed companies look to the US IPO markets as major sources of liquidity and capital growth. Eventually, all private equity funds will seek an exit out of their investments, either through a sale or a new issuance. Since private equity firms have been such avid asset purchasers, they will also be big sponsors for IPOs in the future.

While an IPO offers prestige and liquid currency, private equity can be an effective, less expensive way to raise capital. However, the IPO is the most likely exit route for very large companies, since it's easier to find many buyers of just one small piece of a company (as in an IPO), than to seek one buyer willing to pay billions for the entire company. "For larger deals, IPOs are probably the only exits," says Gregory Ledford, Managing Director, Carlyle Group.

Yet another striking trend is de-equitization or public-to-private transactions where private equity investors buy out already listed companies. "Private equity now in the US is so large that many companies, even very large ones, now are potentially a target to be taken private from their current public status," says Donald Straszheim, Vice Chairman of Roth Capital Partners.

Figure 1: North American IPO Activity by Year

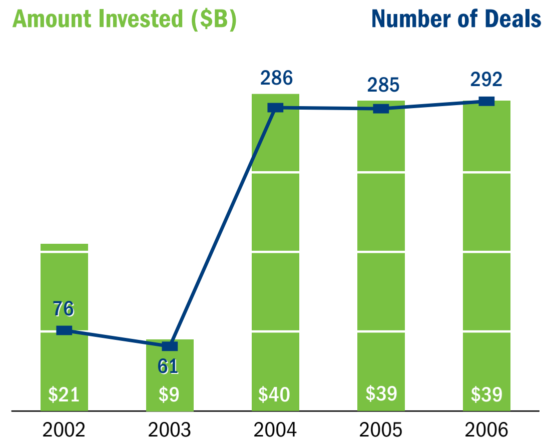


Figure 2: North America 2006 IPO Activity by Country Domicile

Domicile	Total Capital Raised (US $M)	Number of IPOs
United States	$34,113	187
Canada	4,431	105
Total	**$38,544**	**292**

Source: Dealogic, Thomson Financial, Ernst & Young

"While an IPO offers prestige and liquid currency, private equity can be an effective, less expensive way to raise capital. However, the IPO is the most likely exit route for very large companies. "

What leads a public company to go private? "Where a management team doesn't feel they are being rewarded appropriately," says Ledford, "and where management teams feel they can produce better performance by spreading equity more broadly among the upper tiers of management, creating more of an employee-owned situation." Notes Ledford, "Driving the unprecedented levels of private equity activity is the combination of a tremendous supply of capital to buy companies (both debt and

"With an M&A, companies are getting immediate cash for 100% ownership, immediate exits, and they don't have to deal with a lot of the regulatory challenges."

equity) and the increasing interest and willingness of companies to entertain going private."

M&A Viewed as Attractive Alternative to IPO

"Although many new companies come to the US market, we also see a lot of companies go to M&A activity, taken private, or delisted," says Crosswell. "Our numbers stay pretty well flat year on year, with the amount of new companies that we get effectively balancing out the companies that have left NASDAQ for one of those reasons."

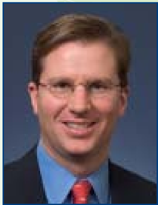
It would have been an even more active IPO market in the US, if not for the unprecedented amount of M&A activity. "Many companies that would have pursued an IPO are being gobbled up by acquirers whose currency is trading at all-time highs," says Davis. "Although going public may offer more favorable multiples, it takes much longer to conduct an IPO than a merger. With an M&A, companies are getting immediate cash for 100% ownership, immediate exits, and they don't have to deal with a lot of the regulatory challenges."

In 2007: A Robust IPO Pipeline of High-Quality, Diverse Deals

In 2007, US-domiciled IPOs continue to be robust, maintaining 2006 momentum, with a varied cross-section of sectors. With the healthy US markets, investor appetite for solid growth stories continues to be keen. "Any good company that has a strong operating and financial performance, even if not in the most active sectors, would find a receptive IPO market," says Pinelli.

In 2006 and in the first quarter of 2007, although no single sector has dominated, growth-oriented stocks in health care, and technology have been the most active, accounting for the majority of IPOs. "It's the very same technology companies—the ones every assumed just disappeared after the 2001 capital markets crash—that are registering to go public now, about six years from the initial financing to an IPO," says Pinelli. Although energy was the third-most-active sector in 2006, the sector is undergoing enormous changes, particularly with the growth of interest in the alternative energy space.

Although there's a backlog of deals filed with the SEC, it's not the "irrational IPO exuberance" of the Internet bubble years. Says Davis, "It's harder now for US companies to go public than in 1999-2000, because there's a higher quality hurdle. US investors are becoming pickier and seeking diversification. IPO activity is broad sector-wise, as well as being very issuer-specific. In the various sectors for which investors are bullish, the level of interest is dependent on the strong financial and operating performance of companies." ■



Cully Davis

Director, Equity Capital Markets
Credit Suisse Securities (USA) LLC

Ernst & Young: ***What's your view on the US IPO landscape in 2006?***

Cully Davis: I would characterize 2006 as being reasonably light in terms of the total number of deals, and deal volume as well, for the year globally—with a few exceptions of some very large mega deals coming out of Asia. Certainly in the US, deal activity was less than expected, somewhat driven by a tough environment in the summer. During the last quarter of the year a lot happened across a lot of sectors though, and that was really driven by a strong market, some pent-up demand, resulting from the lack of activity we saw through the summer, and just a favorable financing environment generally.

Ernst & Young: ***What were the reasons for the level of IPO activity in the US?***

Cully Davis: I think there are a few things. Firstly, the M&A environment has been incredibly active and we've seen a lot of companies that would otherwise pursue an IPO being gobbled up by acquirers who feel like their stock is trading at all-time highs, so they have an attractive currency. So I think part of it has to do with the fact that a vibrant M&A environment and companies trading at very full multiples has created a very interesting alternative to going public, because they're getting all cash, they're getting immediate exits and they don't have to deal with a lot of the regulatory challenges particularly here in the US.

Ernst & Young: ***What's the impact of stock exchange consolidation such as NYSE Euronext?***

Cully Davis: Certainly we pay attention to it. I don't know that it will materially change my perception of how companies will ultimately trade once I take them public, so I am not concerned or necessarily interested from a market-efficiency standpoint. From just a competitive standpoint, a lot of the US exchanges are seeing their business potentially slow down as a result of the US regulatory environment. So I can certainly understand there are competitive desires to maintain ownership and a role within the faster growing markets, which right now appear to be some of the non-US exchanges that benefit from a more liberal regulatory environment. Those markets are catering to the higher-growth, earlier-stage companies, that we used to take public in the US. The US exchanges are paying attention to those markets as an avenue to continue their own growth trajectories.

Ernst & Young: ***About 35% of IPO deals appear to be backed by private equity players. What should we expect in the next 12 months?***

Cully Davis: The biggest driver of activity in 2007 is the speed and scope at which a lot of the private equity and financial sponsor shops will pursue exits in the public markets, and how the larger public companies decide to finance their ongoing M&A strategies. Yes, the private equity funds have gone through a phase recently of raising large amounts of money, so they all are sitting on or have been putting to work a lot of these dollars. And the natural outgrowth of that is obviously a much more active M&A environment which we've already seen. And then the most logical exit for a lot of these investments ultimately is the public markets. The recent success of the private equity shops in raising money is getting translated into a very active M&A market and is already, or will very soon be, translated into a very active equity market as they all contemplate their exits.

Ernst & Young: ***What are the ultimate monetization plans for these private equity firms?***

Cully Davis: The most logical strategies obviously involve merger activity, either continuing to buy assets and building larger businesses, or folding these discrete assets into other public or private entities. This strategy is attractive if you're a private equity investor because it often provides immediate liquidity if you sell your assets to some other public entity for cash. IPOs don't provide that instant gratification as you often have to endure the registration process in order to potentially sell some shares in the IPO. Often you can't sell much or anything at all in the IPO so you have to endure an extended lock-up period and further market risk before you can sell more shares. But the public markets will continue to be a logical exit for a lot of these private equity shops. The multiples in an IPO context generally are pretty favorable relative to M&A opportunities. These private equity shops will have to weigh the arbitrage and potential multiples, with the likely delay in exiting through the public markets, against an M&A process.

Ernst & Young: ***What's making US investors comfortable with investing in the emerging markets?***

Cully Davis: Every fund has a little bit of a different perspective. Some funds will take the approach that they'll invest a certain percentage of

Continued on page 70

Charlotte Crosswell

Head of NASDAQ International
NASDAQ

> ***"There has been a shift in our business, with an increasing number of companies coming from the emerging markets."***

***Ernst & Young:* What's behind the growth in competition and consolidation between world stock exchanges that we're seeing now?**

Charlotte Crosswell: I actually don't think there is greater competition. A lot of it has been exaggerated in the media. The main exchanges that are winning overseas listings — NASDAQ, New York Stock Exchange, the Hong Kong Stock Exchange to a certain extent and the London Stock Exchange — those exchanges have always been out there in the market promoting their services to overseas companies. Hong Kong has traditionally been the preferred market of choice for Chinese companies in addition to a dual listing in the US. However, now some Chinese companies are only listing in Hong Kong, due to the growth in Asian economies. The media have translated this to the US being out of vogue. I just don't think this is the case because we're still seeing a huge demand for overseas listings in the US.

Over the last 10 years a lot of people have talked about consolidation in the sector, but there are still a lot of countries that are keen to keep their local exchanges themselves. It's not just about the exchanges; it's about the back office, the clearing and settlement, the regulation. There are a lot of factors to be considered when merging exchanges.

***Ernst & Young:* What are the key criteria for pre-listed companies when deciding where to list and what are the benefits of a US listing in particular?**

Charlotte Crosswell: What a company usually looks for in a listing is access to capital, putting the company on a global platform, and showing its customers and peer groups that it can list in the US. At the end of the day it comes down to a valuation.

In the US the high financial corporate governance and listing standards give investors confidence, especially with companies listing from the emerging markets. Investors will pay the premium for companies that go through that strict regulation.

The good thing about going through a US listing is that for investors, knowing that companies have been through the SEC, Sarbanes-Oxley, and the strict corporate governance guidelines we have on NASDAQ, have some degree of comfort in that company by the time they get to market.

What is less common these days is companies looking for a "trophy listing" in the US. Companies listing in the US today are more likely to list because they have a specific need or reason to list in the US.

***Ernst & Young:* How is growing liquidity in the local markets worldwide influencing the natural trend for companies to list at home, as opposed to overseas?**

Charlotte Crosswell: What's happened over the years is local markets have obviously become more developed — that's already happened in Europe anyway. So we continue to see new development of local markets, particularly in the emerging markets. While companies might stay on their home market, home might not be where the better valuations are, where their peers are listed, where their customers are, where the majority of their revenues are. So even though there is more growth in the local markets, there remains an appetite to go overseas.

It very much comes down to the strength of the local market. It tends to be more by country rather than sector or type of company.

***Ernst & Young:* What are the key trends for IPOs in NASDAQ's business?**

Charlotte Crosswell: We're expanding on our listings business development outside the US, as we did last year. The growth coming out of China is absolutely key. A lot of exchanges are competing for that business because they know that Chinese companies are wanting to list overseas. Chinese companies need to list overseas to get higher valuations and more credibility in the global market. China is still our fastest growing market. We still see a steady stream of activity out of Israel and we are expecting a fairly strong year out of Israel this year. In India there have been fewer US listings, primarily because the local exchanges, the Bombay Stock Exchange and the National Stock Exchange have continued to develop. Therefore a lot of companies have listed solely in India and foreign investors are increasingly investing directly there. Russia has a well-trodden path for listing in London, although last year NASDAQ listed CTC Media, the largest foreign IPO to come from Russia. Korea, Taiwan, and Australia have a good pipeline of companies looking at a US listing, but China still is very much leading the growth for us.

So there has been a shift in our business, with an increasing number of companies coming from the emerging markets. These companies

often wait until they are larger in size before they list because investors expect them to have a track record, to maybe have profitability, to have good revenues. A few years ago we had a lot more companies listing from the more developed markets because that was where investor demand lay.

Ernst & Young: ***What would you say are the current major misconceptions about US listings these days?***

Charlotte Crosswell: There is talk out there from companies that they don't want to consider a US listing because of Sarbanes-Oxley. I think some of that is misperception. Again, it's being played out a huge amount in the media and we have seen some companies therefore think twice about listing in the US. Wherever you are going to list, there have to be high standards of corporate governance and high standards of regulation unless you go to a second tier market, which has less regulation.

We have talked to a lot of companies that have gone through the US listing who actually do not find Sarbanes-Oxley too much of a burden. In fact some companies like Sarbanes-Oxley because they believe it encourages them to have strict processes and controls. We had 23 IPOs last year from outside the US and that number has remained steady now for the last three years. There are still companies that have a lot of appetite for US listings and are willing to go through the extra costs and time involved in Sarbanes-Oxley to get some clients.

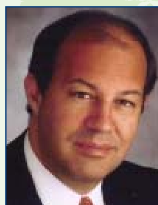
At NASDAQ, the emerging markets are driving our listings business because those are companies that benefit from a higher valuation and therefore believe they should be listed in the US, regardless of the hype around Sarbanes-Oxley.

The revision of Section 404 of Sarbanes-Oxley is something we are monitoring carefully. It is very important to companies from outside the US. Some changes can be made without taking away the high standards of corporate governance. Any relief that can be given to small- to mid-cap companies in the US market is going to be very well received.

Ernst & Young: ***What's the impact of the growth in M&A and private equity on NASDAQ's business?***

Charlotte Crosswell: Obviously there is a lot of M&A activity. Although we consistently get a lot of new companies coming to market, we also see companies either de-list or, more commonly, undergo M&A activity or taken private. Our numbers for international listings are currently pretty well flat year on year, with the amount of new companies that we get effectively balancing out the companies that have left NASDAQ for one of the alternative financing reasons you mention.

There is a lot of private equity activity. Over the last few years this has really grown, and we're going to see a lot of those private equity companies wanting exits at some point. So what we will likely see is many of those companies coming back to market at some point in the next two or three years. ■



Scott P. George

Managing Director
Morgan Joseph & Co., Inc.

***Ernst & Young:* So, what is a SPAC?**

Scott George: First of all, a SPAC is a Special Purpose Acquisition Company, which also is sometimes referred to as a "blank check company." A SPAC is, by definition, a newly formed entity that has no operations, and minimal assets and liabilities. The SPAC is created for the primary purpose of raising public equity capital that can then be used to finance the acquisition of a yet-unidentified business in a specific industry or country. The management of the SPAC is allowed only two years to find and close its first acquisition, but management has very strong financial incentives to complete a deal within that timeframe.

Since August 2003, 99 SPACs have been taken public, raising over US$7.6 billion in acquisition capital. An additional 44 SPACs seeking to raise almost US$4 billion already have filed their IPOs with the Securities Exchange Commission (SEC) and are awaiting the opportunity to price their offerings. Factoring in the ability of these SPACs to expand their capital bases by issuing more debt or equity securities, it is reasonable to think that they could drive total acquisition volume of over US$25 billion during the next two years. Given that level of funding capacity, one cannot help but be impressed by the power of this new and rapidly evolving market. Furthermore, all of the statistics I just gave relate only to the SPACs that are being marketed in the US securities markets. There are several other SPACs that have been brought to the market in Europe on AIM.

***Ernst & Young:* How does a SPAC work?**

Scott George: The way a SPAC works is that a successful business executive, or perhaps a small group, creates a brand-new entity that will then go and search for an acquisition. They then develop an investment thesis, select an investment bank to serve as underwriter and file a registration for an IPO with the SEC. In that registration statement, the company summarizes the credentials of the founding management team, describes the type of business they will seek to acquire and presents the structural characteristics of the offering. Among the most important of those structural characteristics are (1) the amount of money the management will commit to the undertaking and the ownership in the company they will possess; (2) the number of common shares and warrants that will be included in each of the units being offered in the IPO; (3) the portion of the offering proceeds that will immediately be deposited into an escrow account for the benefit of the shareholders; and (4) a description of the shareholders' voting rights and ability to convert their shares into their pro-rata share of the escrow account in the event the company either fails to consummate a transaction or closes a deal deemed undesirable by any individual shareholders. For example, a typical structure for a US$100 million SPAC would involve management being given a 20% promoted interest in the company and then being required to invest an additional US$3 million—US$5 million of their own money in the form of warrants, earning them an additional stake if an acquisition is completed. Most SPACs are structured as unit offerings with each unit sold including one share of common stock and either one or two warrants to purchase common stock. In recent deals, at least 95% of the IPO proceeds are deposited into the escrow account and held until an acquisition is approved by shareholders and then completed. One other important feature of all SPACs is that the initial acquisition they make must have a transaction value equal to at least 80% of the net IPO proceeds raised, but could be much higher than that if the company chooses to either issue more equity or incur debt.

***Ernst & Young:* What types of acquisitions are being completed by these SPACs?**

Scott George: As I mentioned earlier, each SPAC registration statement must lay out the investment strategy that will be pursued by the management team. Most of the time, the strategy is focused on opportunities in a particular industry—typically one that is closely related to the backgrounds of the management team. For example, the co-founder of Apple Computer did a SPAC focused on technology, the former CEO of Blockbuster Entertainment did one focused on consumer retailing, and the former CEO of Stone Container Corporation formed one focused on the paper-packaging sector. Some of the SPACs do not have a particular industry focus but have specified a country as the target of their investment strategy. For example, there have been more than a dozen SPACs focused on China as well as some on India, Israel, and Greece. A small number of SPACs have not specified any particular industry or geographical focus but rather pursued a specialized

strategy such as approaching private equity firms to identify portfolio companies that might be good acquisition candidates for them. Many of the SPAC acquisitions look a lot like buyouts of large successful operating companies and others, typically the small SPACs, pursue transactions that are structured more like conventional reverse mergers, thereby providing a small private company with the opportunity to go public cost-effectively by merging themselves into a clean-shell company. In the case of most SPACs, the company is renamed after the target once the acquisition is completed.

***Ernst & Young:* What would be the principal attraction for a private company to do a reverse merger into a SPAC, rather than just doing their own IPO?**

Scott George: There could be several reasons. First, selling a private company to a SPAC for shares in the SPAC can be a more cost-effective method of achieving public company status. The company would avoid the time and cost requirements of an extensive road show and it also would avoid the 7% underwriting spread that is customarily charged in an IPO. Perhaps the most important advantage of a reverse merger into a SPAC versus a traditional IPO is that, in the case of the SPAC, the IPO has already occurred, thereby eliminating the risk of the IPO window shutting in the middle of the offering process. Offsetting these advantages is the fact that a SPAC must still seek and obtain shareholder approval in order to complete the acquisition, and that process requires several months of time and considerable effort from a documentation and marketing perspective.

Remember, effectively what we're doing is, once a SPAC buys a company — they're almost always going to be buying a private company — that company really becomes the SPAC. Normally, the SPAC would then change the name of the SPAC to the name of the target and they would then take that private company public, with none of the costs of going public, because the costs had already been incurred. So the private company can take itself public much faster than it would through an IPO. It doesn't have to worry about the IPO window staying open because the company is already public and it's much less expensive. And the company already has sponsorship from Wall Street, because there are already firms that are making a market in the SPAC shares and are lined up, ready to provide research coverage, once the SPAC acquires the business. So it's a very attractive vehicle for some companies. Some of your clients may be looking to go public, but are really worried that the IPO window might close for six months, which often happens. In this case, that wouldn't be a concern at all.

***Ernst & Young:* Are there any obvious differences between what a SPAC would be looking for versus what a private equity firm would find attractive?**

Scott George: Many companies could be very attractive to both a SPAC and a traditional private equity firm but I think there are likely to be some differences as well. Many private equity firms are very focused on taking public companies private. Going private transactions would seem to be a much less attractive route for a SPAC, given the need in those situations to get shareholder approval from both sides of the transaction. Also, companies that are already public will not realize many of the benefits private companies would see by being acquired by a public shell. Another potential difference relates to the growth potential and capital requirements of the target business. A private equity firm might be most attracted to businesses that are very steady cash generators, even if they may not exhibit strong growth characteristics. A SPAC, on the other hand, would not be discouraged by an ongoing need for increased capital, but would highly value a company that has very strong growth potential. The larger private equity firms in the country are increasingly targeting large multi-billion dollar companies for their investments. On the other hand, SPACs generally target companies that are considered small to mid-size companies. ■

> ***"In a SPAC, the IPO has already occurred, thereby eliminating the risk of the IPO window shutting in the middle of the offering process."***

Cully Davis, continued from page 65

their assets within that fund in what's defined as emerging markets. Other funds have decided that they actually want to box out that kind of investment altogether and so they'll have dedicated funds solely for the purpose of investing in some of the emerging markets. They'll have fund managers in their portfolio whose only job is to analyse those markets and invest those funds. I think it's fair to say that there has been an increased amount of attention being paid to those types of opportunities.

We've done several Rule 144A emerging market transactions that follow this trend, Submarino being a good recent example. Submarino is a technology company we took public that is listed in Brazil. We spent a lot of time introducing them to the more traditional US technology investors here in the US. We've had great success engaging those investors and getting them to look at Submarino as a technology investment, not as an emerging market or Brazilian investment. You'll find that, whether or not a fund really has an emerging markets mandate or a separate fund allocated to emerging markets, if you can engage your portfolio manager and they really feel that the opportunity you're presenting them with is a logical extension of their overall fund objectives, they will find a way to invest.

***Ernst & Young:* Many companies are using Rule 144A as a way to access US capital — what's your perspective?**

Cully Davis: We've actually been involved with a lot of Rule 144A transactions lately. Most, if not all, of the companies that we took public certainly had the opportunity to do a US-registered, US-listed deal. Most of them chose not to, however, due in part to concerns over the burden of the regulatory environment here in the US. The faster speed at which they could get to market in a Rule 144A context also motivated many of these decisions. A Rule 144A decision used to have more to do with the quality of the company or the IPO readiness from just a business model perspective. There are more Rule 144A transactions being executed simply to avoid the cost and the pain and suffering of US registration. And it's not just limited to Rule 144A transactions either — we're seeing other markets, like the AIM market in London, that are benefiting from that same attitude.

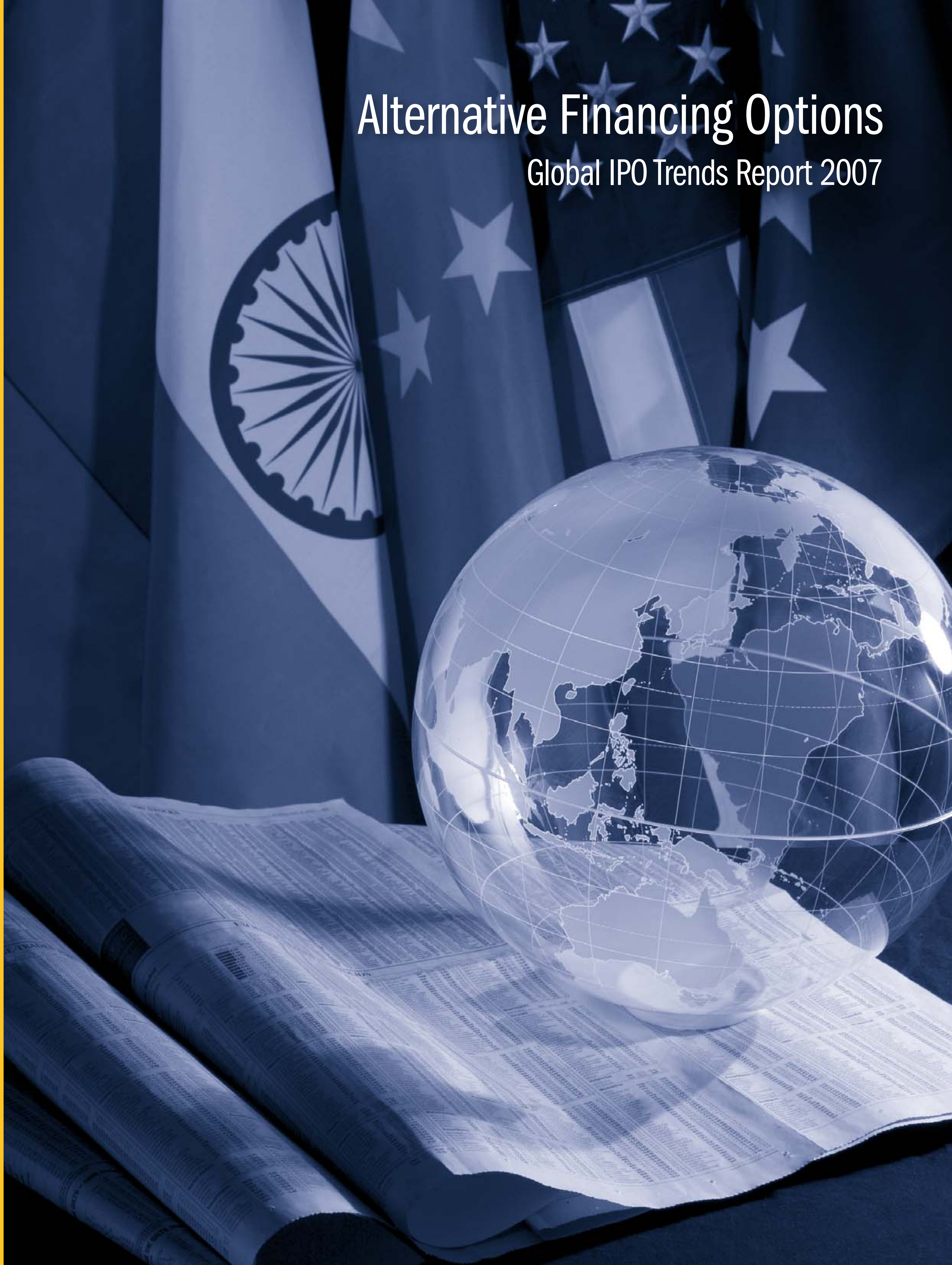
***Ernst & Young:* How do you advise a CFO on the alternative financing paths that they could take?**

Cully Davis: There are a series of questions you have to ask to give the right advice. You might not always understand the objective of the company. Why are they going public? Are they looking to get a currency for M&A? Are they looking to help some insiders, venture capital firms, or private equity investors monetize their positions? Are they looking to establish credibility in the market so they can compete more effectively with a big competitor? The answers to all those questions will begin to form my opinion as to where they should list, what they should do, and how fast they should do it.

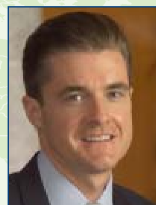
You always have to ask the internal questions too, such as how ready are they for the quarterly conference calls with analysts, and the ongoing interaction with investors to make sure they can achieve what the market is expecting them to, and still manage their business for the long term. Going public provides many opportunities for a company but it also introduces many challenges and conflicts that make striking an appropriate balance hard to achieve. ■

Alternative Financing Options

Global IPO Trends Report 2007



Gregory S. Ledford,
Managing Director
The Carlyle Group, LLC



Christopher H. Turner
Managing Director,
Capital Markets, Warburg Pincus

PERSPECTIVE ON PRIVATE EQUITY

"In regard to IPOs, timing is everything… For the larger deals, IPOs are probably the only exits, so the timing is going to be contingent on the market's acceptance of the transactions."

Ernst & Young: When you look back at the last 12 to 18 months in the global capital markets, are there any major takeaways or lessons learned from your perspective as private equity investors, as well as your portfolio?

Greg Ledford: Certainly the size of transactions. We closed Hertz in December of 2005 and at the time it was the second largest leveraged buyout (LBO) ever done—I am not even sure it's on the top 10 list anymore. So, with the amount of equity available from the private equity groups, and ability to raise debt with fewer covenants, much larger deals are able to get done now than even two years ago. In regard to IPOs, timing is everything. The markets open and close at different times and they have been pretty vibrant over the last six months. For the larger deals, IPOs are probably the only exits, so the timing is going to be contingent on the market's acceptance of the transactions. And I do believe we will see returns come down for the private equity firms on these larger deals simply because of how long it will take to exit. Time is your enemy, perhaps not in multiples of cash, but certainly in terms of IRR. I think there will be some pressure on private equity because it will take years to fully exit and finally get the full sales.

Chris Turner: I would echo Greg's comments. I think on the buy-side, it has been hard over the last three years to over-estimate the terms that are attainable in the credit markets with the right management team and the right credit story. There is so much liquidity and demand for financial assets on the part of credit investors that we have been able to push terms, as Greg alluded to, to levels that were not even imaginable pre-2003. One lesson that we have learned is to push "the art of the possible."

On the sell-side the lesson learned is "timing is everything." The cycles for ebbs and flows in specific sectors have compressed. Holding periods among buy-side portfolio managers in the public equity markets are shorter than ever. Allocation decisions are more important in terms of whom you sell your stock to, and you need to have management teams ready to be public, which is a higher bar than during the pre-Sarbanes-Oxley era.

Ernst & Young: What is your outlook for PE-backed IPOs in the next 12 to 18 months?

Chris Turner: Recently, as private equity IPOs go, so goes the IPO market. By that I mean, for the last couple of years private equity-backed IPOs have raised the majority of IPO capital—something like half of the dollars raised. Thus, private equity-backed IPOs are not simply a subset of the market, they actually are a large part of the market, and some would argue, have led the IPO market.

While it's impossible to predict more than six months ahead, we do think it is a good time to sell equity stories right now. There is immense liquidity in credit; likewise in equity. We currently have a very favorable perspective on the global markets.

A trend that I think is worth mentioning is how receptive the markets outside the US are. We have about half a dozen IPOs on deck for the first half of 2007 and we are finding that there is much more receptivity outside the US for IPOs. The depth of liquidity, the infrastructure for settlement and closing, and the sophistication of investors all over the world have made non-US venues for listing much more competitive. It's no longer a question of NASDAQ or a "big board" listing. We now have alternatives all over the world and I think you will see an increasing trend of much more localization of IPO offerings. There will be many more companies going public in their local markets, which I think is a good thing for the world economy, and hopefully for these developing markets as well.

Greg Ledford: From the private equity standpoint the supply of "product" to go public is just growing daily. I agree that you cannot predict the markets, but I also don't see anything on the horizon right now that would say that it is not going to continue. Nothing grows to the sun, but with the supply of product ready-to-go, and private equity-backed IPOs generally outperforming non-private equity IPOs, as shown in a recent Harvard Business School study, we're fairly confident that the markets will stay open. With regards to Hertz, our most high-profile IPO from 2006, I think the smart money knew that we had a good story there. And we still own 72% of the business. My group and I spend probably 50% of our time working on Hertz, working with management, and monitoring and supporting them to create value there. The "smart money" understands this and will continue to support private equity-backed IPOs.

Chris Turner: For many of the large-cap private equity firms, taking a

company public does not mean that we've exited or that we've relinquished our investment in the company. It is sometimes not even close to the midpoint of our investment period. Rather, it's just another step in the long evolution of investing in a company and exiting a company. Often, there is very little, if any, stock sold by the sponsor in an IPO. That's an important thing to keep in mind.

Greg Ledford: One more thing to add here. For all of these transactions, there is going to be a six-month lock-up period. It's tough to fully exit in two-and-a half to three years, even if the company's performing well and market conditions are great; unless you can break some of the lock-ups at different times, it's tough to exit any quicker.

***Ernst & Young:* Do you see any specific hot industries or sectors in terms of IPOs these days?**

Chris Turner: No. I think that the market is looking for the same thing it has always looked for, which is an identifiable strategy for growing earnings, and a management team that articulates a vision for the business and growing market share. We have seen hot, hot IPOs for companies in "boring" industries like renting cars, selling clothes, selling hamburgers, making tiny little aircraft components (and I'm referring to great IPO stories like Hertz, Burger King, and TransDigm), and you have also seen a host of technology IPOs. In fact, in the last half of 2006 we saw a bit of an increase in the market's willingness to fund cash burn through the equity market, which we hadn't seen since the pre-Internet bust. That's a small fraction of the market, though. For the most part, I think the sector is less important than the story being told by the management team and the credibility they have.

***Ernst & Young:* Large PE-backed acquisitions could likely lead to an IPO exit. What exit options do you have if the IPO market is not accommodating during your planned IPO time?**

Greg Ledford: Recapitalizations — if companies are performing well and the markets are not open, you will see more dividends and recaps.

Chris Turner: The other alternative is that you just wait — this is one of the greatest features of the private equity model. Our holdings are generally opaque and illiquid, and for that, we hope to offer our investors a premium to public liquid markets. If the market is not receptive to our company at a point in time, we have the flexibility to wait until it is. We can do that because we have fairly patient capital and no quarterly earnings pressure. It's not as if our stock price is going to go down and we are going to be threatened by a hostile player. These are private companies; they can continue to operate, they can continue to improve behind the private curtain, and when the markets are receptive, we'll come out.

Greg Ledford: There are always chances for us to exit some of these companies through a strategic sale depending on the industry, consolidation, etc. In most situations, if it was available to us, strategic sale would actually be our top option because there is certainty and you can get your cash much quicker.

***Ernst & Young:* What are your criteria for selecting the right exchange for your portfolio companies?**

Chris Turner: Earlier I talked about the different venues that we have looked at to take our portfolio companies public and it's no surprize what the criteria are. We look for valuation — we want to go public where we are going to get the right valuation and liquidity. We look to go public where we know there is a reasonable assurance that over the next four to five years, as we "leg out" of an investment, the liquidity will be there in that market. I also think that we see a trend of more companies going public in their home markets, whether that's Hong Kong or Scandinavia, Europe, or the US. Ultimately, the key criteria are valuation and liquidity.

***Ernst & Young:* Having the right IPO readiness process is a critical success factor for any successful IPO. Are there any unique issues for private equity-backed companies as they get ready to start the IPO process?**

Greg Ledford: I don't think the issues for private equity-backed companies are any different than any other company preparing to go public. Any company looking to go public should ask the question: Are you ready for the "prime time" — for the scrutiny, for Sarbanes-Oxley? Can you articulate the story, can you work with the analysts, can you articulate your growth model, is the team ready to go on the roadshow, and are they ready to be sales people and tell the story of the company? Thus, I wouldn't think that the criteria would be any different for private equity-backed companies versus non private equity-backed companies. The one benefit for the private equity-backed company is that they may have a few extra coaches.

Chris Turner: In taking our companies public, one of our primary concerns is management. Are they ready to sell the story and are they ready to be a public company management team? This is a different context from being a private company management team, especially in terms of reporting, communications, and public relations. We have companies in our portfolio that were previously public and getting those companies ready to be public again will be no problem, because they have already been there. Most likely, they could teach us a few things! With other companies that are venture-backed and have never been public, we try to do a fairly comprehensive job of getting management ready to be public, in terms of working with Wall Street, working with research analysts, attending appropriate conferences, and things like that.

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Private Equity Perspective, continued from page 73

So getting management ready for being public is something we spend time on.

The other thing that you need to do in those situations where our management team hasn't been public before is understand what their liquidity objectives are, in terms of selling their shares. That is an important issue with respect to the public investors and to us, having management invested for a while and having a significant portion of their net worth tied to the fortunes of the company.

"One of the best things about working with private equity is its ability to align with the interests of management and create value."

The last issue, that I think is somewhat unique to private equity-backed public companies, is overhang, and how you manage the market sensitivity to the fact that at some point the private equity firm will be exiting the company completely. I think that that's a relatively understood issue and as long as you demonstrate that you intend to exit in an orderly way, and in a fairly well-communicated way, I don't think it impairs valuation.

Ernst & Young: ***We have seen an increased trend of taking public companies private again. What are the top reasons? What is the impact on your ability to recruit and retain high-level CEOs for these companies? What is your primary focus after taking the company private? What will be the preferred exit route?***

Greg Ledford: There are a few reasons. First, companies feel underloved and under-valued — Wall Street doesn't understand them, they are trading at a discount to their peers. Second, there is tremendous pressure to meet quarterly numbers with the knowledge that the value of the company will be penalized if the quarterly numbers are missed. Third, and this is to a far lesser extent, Sarbanes-Oxley and all other regulatory issues can be cumbersome.

Chris Turner: Exactly. We have seen situations where a management team doesn't feel they are being rewarded appropriately. Or, situations where management teams feel that they can produce better performance by spreading equity more broadly among the top, and even second or third tiers of management, creating more of an employee-owned situation. The combination, I think, of the tremendous supply of capital to buy companies (both debt and equity), and the increasing interest and willingness on the part of companies to entertain private equity and going private transactions, has created an environment where you see a greater proportion of public-to-private transactions than we've had in a while.

Greg Ledford: There are also private companies that, from a size perspective, are below our radar screen, but they went public. They were sold on the attributes of being public, they got out there and they're now stranded in the capital markets. There's not enough float, they don't have access to capital markets — they probably should never have been public in the first place. These companies present very good opportunities for us to take private again. In regard to the impact on recruiting, for all the reasons we've stated before, many CEOs we speak to would rather be CEOs of private companies — where they can restructure or transform the company over a longer term without being punished.

Chris Turner: In the vast majority of cases, we are not actually recruiting a new CEO, we are investing with the existing CEO. Going private is often as much an initiative of the CEO and the management team as it is of ours, and we have not had an issue retaining top management talent. A lot of times, we've had calls from management teams either immediately or years after a private transaction, and they're saying "I love this, let's stay private."

Greg Ledford: Our primary focus after taking a company private is earnings growth. Whether we're going from public-to-private or buying a private company, our focus is to work with management. We mentioned earlier — one of the best things about working with private equity is the ability for private equity to align with the interests of management and create value. That's where we really want to focus — value creation, earnings growth, and then, having the right capital structure and debt pay-down.

On the other end of the spectrum, the exit route after taking a company from public to private really depends on the size of the company, and if there would be strategic interest in the purchase price. If you take a mid-cap company, you could do a strategic sale or secondary sale to another private equity. As for these mega deals, I pretty much assume that it will be back out to the public, as there is really no alternative for the big deals.

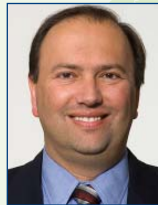
Ernst & Young: ***Is there a role for private equity in the venture-backed space?***

Greg Ledford: My personal opinion is that it's a completely different game. There might be a VC-backed company that has grown up and has the earnings — consistent earnings — and it's not just looking for growth or not churning off any cash. We look for cash flow and without cash flow it's pretty tough for us to get interested in any company, whether it is VC-backed or public.

Chris Turner: We have a little bit of a different perspective here. Warburg's history actually started in venture capital, and so we still have a very active venture capital effort. In fact, two of our biggest recent IPOs were started as venture capital investments. These companies were start-ups that grew in scale and size to the point where they were multi-billion dollar public enterprise valued companies. As Greg says, it is a very different investing model than LBO investing or late stage investing, but we do see good returns from our venture investments. ■

Jackson Day

Global Director, Capital Markets
Ernst & Young Global



Michael Bentley

Director, Central European Area Global Capital Markets
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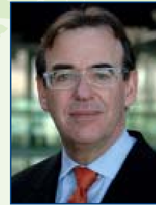

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PERSPECTIVE ON RULE 144A OFFERINGS

THE SEC ADOPTED RULE 144A as a safe harbor exemption from SEC registration requirements (pursuant to the US Securities Act of 1933) for resales of certain restricted securities to qualified institutional buyers (QIBs) by persons other than issuers. Specifically, it applies to securities of domestic and foreign issuers that are not listed on a US securities exchange. Rule 144A was designed to improve liquidity and efficiency of private placement market by offering more freedom to institutional investors to trade restricted securities, and to encourage foreign companies to sell securities in the US capital markets. As it allows institutional buyers to trade restricted securities among themselves, Rule 144A has greatly amplified the liquidity of these securities.

***Ernst & Young:* What are the factors driving the demand for Rule 144A offerings?**

Michael Bentley: Historically public companies used Rule 144As to issue primarily debt and preferred stock securities. However, two factors are driving an increase in Rule 144A transactions: the significant increase in private equity deals, and the number of equity private placements or equity Rule 144A offerings.

Recently we've seen a large amount of capital in the market. Private equity will be used in buyouts, and then those private equity firms seek to fund the transactions through issuing debt, equity securities and primarily debt securities. In my experience many of those transactions include a Rule 144A transaction. This approach wouldn't necessarily be in lieu of a US public listing, because the private equity funds are not looking to immediately take their buyout public, but that may be their exit strategy. Ultimately they're buying companies they view as undervalued and developing those businesses over time. Although the long-term strategy may be to take the company public, they seek to fund an initial buyout through raising debt, which typically involves Rule 144A transactions. Some fairly significant private equity transactions in Europe have followed that format.

The second driver is the increase in the number of equity private placements or equity Rule 144A offerings. Historically, public companies issued debt or preferred stock securities, but now we're seeing Rule 144A offerings as an equity vehicle, in particular for foreign companies, because it allows them to access the US equity market without all the effort of a registered public offering. Seven of the top 10 global IPOs in 2006 included a Rule 144A offering and of the top 20 global IPOs in 2006, 6 were from my area, Central and Eastern Europe, and all but 1 of these included a Rule 144A offering.

Jackson Day: The global securities markets around the world continue to strengthen, providing more liquidity into newer jurisdictions. For example, we're seeing more and more liquidity around the world, particularly in Hong Kong and London. Companies are raising equity in domestic markets or in markets nearer their homes, and tapping into other larger markets through other means. For example they often tap the US market via Rule 144A. They can utilize the Rule 144A market to invest in the US and benefit from the increased money available from qualified investors such as pension funds and mutual funds, all of which qualify for investments through this type of vehicle.

***Ernst & Young:* What are the Rule 144A investors' main exit strategies?**

Jackson Day: Although the traditional Rule 144A exit strategy was to refinance in the public market, the rapid increase in the Rule 144A market has rendered the exit strategy unclear. Some believe that ultimately these transactions have to be resolved in the public market. I am not convinced. There is so much liquidity in the Rule 144A market now that investors can actually refinance thru other private transactions.

"Many large companies are tapping more into the Rule 144A market, which illustrates the depth and liquidity in the private market."

Ernst & Young: Why do companies listed outside of the US seek to offer securities through Rule 144As?

Michael Bentley: The US market is still one of the largest capital markets in the world, with enormous liquidity and a wide range of investors, so companies still want to be able to access it, despite the increased regulatory requirements. Rule 144A offers them one way to do that without having to comply with all the requirements of a US public company.

Despite increased liquidity in domestic markets, I have no indication that Rule 144A activity is going to drop off. All the indication is that the transactions that we currently have going on in Central Europe will increase. There's still a belief that valuations are higher in the US.

Ernst & Young: What were the key trends in relation to Rule 144A offerings in the last 12–18 months?

Michael Bentley: We saw increased transactions and more IPOs that included Rule 144A offerings. In 2006 the third largest global IPO, Rosneft, which was Russia's largest and included a Rule 144A offering, as did the largest Swiss IPO in five years and the largest IPO in Germany in 2006. The top IPO in every major country in Central Europe included a Rule 144A tranche.

Ernst & Young: What are your expectations for Rule 144A activity in the next 12–18 months?

Jackson Day: Obtaining local listings and tapping into the US market via Rule 144A is a strategy that I expect will continue to be utilized in the future. Whether or not we see more activity next year will largely depend on the world economy. If the world economy softens and business slows, so will the need for money and Rule 144As.

Michael Lynch-Bell: We are seeing no decrease in large emerging market offerings particularly in the mining, chemical and oil & gas sectors. These will almost always include a Rule 144A offering which ensures that the two largest investor pools in the US and the UK are offered the opportunity to invest.

Ernst & Young: Who are the current major investors in Rule 144A offerings?

Jackson Day: Only qualified investors, such as those in the pension funds, hedge funds and mutual funds, can invest. These types of investments are not available for individual investors. Large cap individual stock has, to a some extent, fallen by the wayside. Now people invest through mutual funds to reduce their risk.

Ernst & Young: What types of companies tend to pursue Rule 144As?

Jackson Day: In general, the smaller companies in their earliest stage of growth tend to go to a domestic listing and then would be coupled with the Rule 144A. At the same time, though, many large companies are tapping more into the Rule 144A market, which demonstrates the depth and liquidity in the private market.

Ernst & Young: Is the Rule 144A displacing other capital raising vehicles?

Michael Bentley: I do not think it is displacing the IPO market. It serves as a complimentary step to the global IPO market. Many companies are doing an IPO in their local or another foreign market and the route to access the US investors as part of the global offering is through a Rule 144A offering.

Jackson Day: It is not a displacement but rather an alternative. The Rule 144A is just another way to make an investment and, because there are so many of them, they have kind of created a market among themselves.

Ernst & Young: What are the drawbacks of the Rule 144A offering?

Michael Lynch-Bell: Because of the requirement for financial information to be less than 135 days old this adds a time constraint to the process whereas for many markets financial information can be up to six months old. This requires a state of readiness which some emerging companies find hard to achieve.

In addition, there is a conflict between some disclosures required for non US markets which cannot be made in an offering document going into the US. As a result there is often a need for two different offering memoranda for the same issue which adds an element of extra cost. ■

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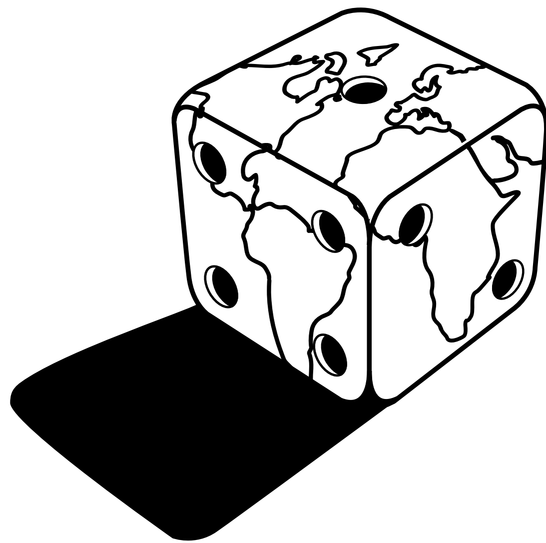

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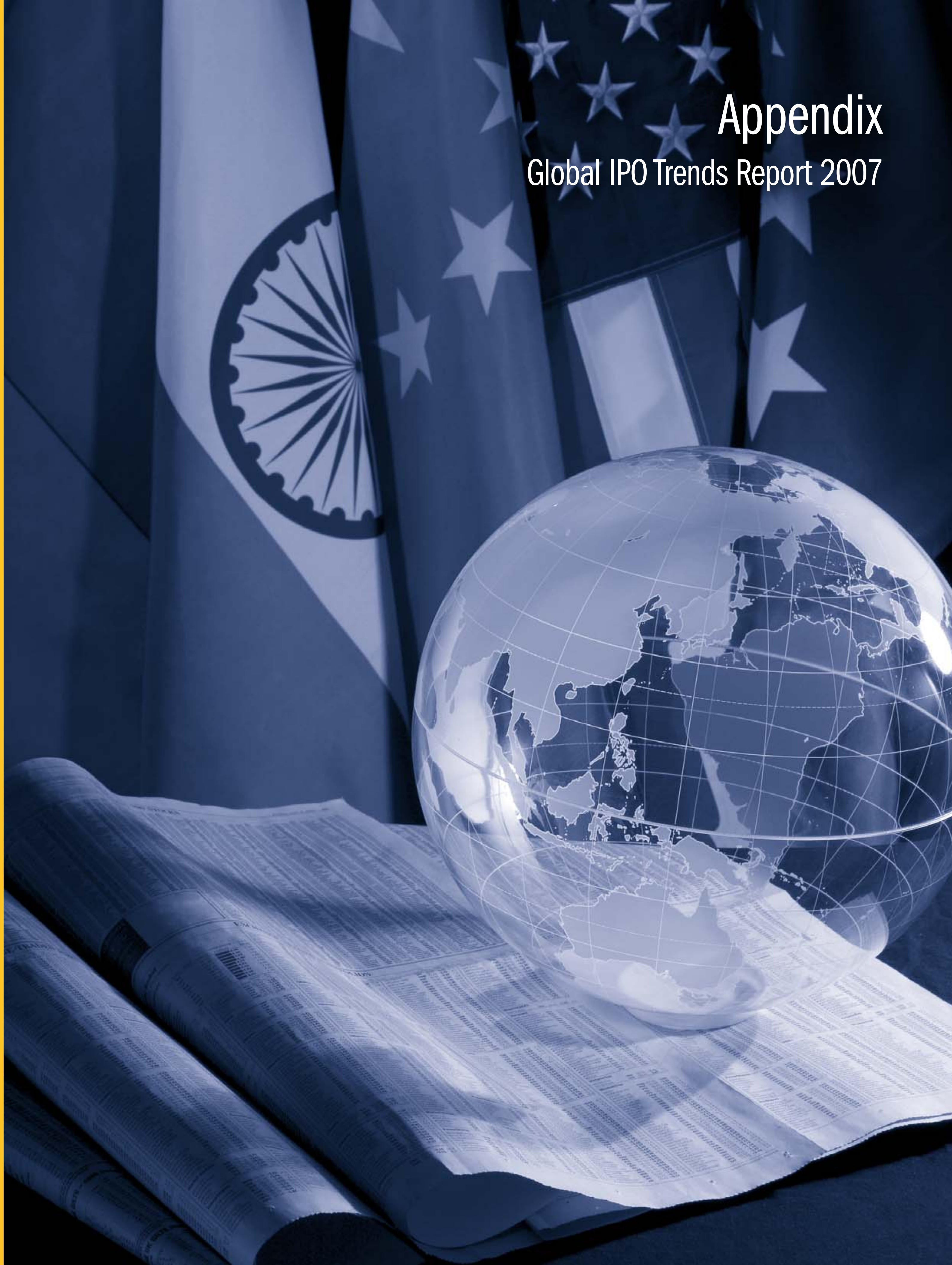
Appendix
Global IPO Trends Report 2007



Definitions

- IPO Definition: In this report, only IPOs of operating companies are considered. An IPO is defined as: *A company's first offering of equity to the public.*
- Comment: Only those IPOs for which the data providers Dealogic, Thomson Financial, and Ernst & Young have data regarding the issue date (the day the offer is priced and allocations are subsequently made), trading date (the date on which the security first trades), and proceeds (funds raised including any over allotment sold) are included. Postponed IPOs or those which have not yet priced are therefore excluded.
- In an attempt to exclude non-operating company IPOs such as trusts or funds, companies with the following SIC codes are excluded:
  - 6091: Financial companies that conduct trust, fiduciary, and custody activities.
  - 6371: Asset management companies such as health and welfare funds, pension funds and their third-party administration, as well as other financial vehicles.
  - 6722: Companies that are open-end investment funds.
  - 6726: Companies that are other financial vehicles.
  - 6732: Companies that are grant-making foundations.
  - 6733: Asset management companies that deal with trusts, estates and agency accounts.
  - 6798: Companies that are REITs.
- All charts are created based on the domicile nation of the issuers except for the chart titled "Global IPO Activity by Exchange (2006)" on page 6, which depicts market activity by exchanges as a percentage of global deals and capital raised.

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