CLIFFORD CHANCE

Briefing note

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Market trends in cornerstone investment

Cornerstone investors

Cornerstone investors have become a regular feature of Asian IPOs over recent years. Cornerstone investors are usually sovereign wealth funds, institutional investors or, in the case of Hong Kong, local tycoons. They are important not only because they guarantee that a proportion of the offer will be sold but also because they stimulate investor demand and, for some investors, lend credibility to the company that is proposing to IPO. They are particularly important when investor confidence is at a low ebb and equity markets are volatile.

The cornerstone process

Cornerstone investors generally commit to invest a fixed amount in an IPO at any price within the IPO price range before the bookbuilding process. They do not normally receive a discount on the price that they pay for their shares. Potential cornerstone investors are generally contacted a few weeks before the roadshow and agree to become insiders and sign confidentiality agreements in exchange for receiving near final drafts or advanced copies of the preliminary prospectus. They will often also be given an opportunity to meet and talk with the IPO company's management. They will not be provided with any information beyond that which is to be contained in the prospectus and, ultimately, all of the IPO investors will receive the same information.

The allotment of shares to cornerstone investors will be guaranteed in the subscription agreement that they enter into. The only matter remaining to be determined after signing the subscription agreement is the final offer price used for the calculation of the number of shares the cornerstone investor is to receive.

Details of the cornerstone investors, including their names, business backgrounds, the amounts of their commitments, any board representation, any parent guarantee and the lock-up period are included in the prospectus.

In consideration for the preferential status that they are accorded in the IPO, cornerstone investors will often be asked to agree to a lock-up in respect of the shares (generally applicable for 6 months) so as to ensure an orderly market after the IPO. It also ensures that cornerstone investors cannot 'flip' the shares for a quick profit immediately after the IPO.

In Singapore, cornerstone investors will not normally be expected to provide a lock-up whereas, in Hong Kong, they will.

In Hong Kong, the listing rules provide that controlling shareholders (being persons who together control 30% or more of the shares of the issuer) must agree to a lock-up over their shares for the 6 months after listing and for the 6 month period commencing on the expiry of the earlier 6 months period if this would result in that person ceasing to be a controlling shareholder. As a matter of practice, however, the Stock Exchange of Hong Kong (the "SEHK") will generally also require cornerstone shares to be locked up for 6 months after listing even when the investor is not a controlling shareholder.

Key issues

- What are the pros and cons of cornerstone investment?
- Increasing presence of cornerstone investors in IPOs
- Increased risks for cornerstone investors in volatile securities markets.
- What can be done to encourage cornerstone investment?

Strategic and anchor investors

Cornerstone investors should be distinguished from strategic and anchor investors. A cornerstone investment is typically financially motivated rather than strategic. Strategic investors will generally invest earlier in the IPO company's history and will often have involvement in management and strategic decisions. An anchor investor will apply for shares in the IPO in the same way as any other institutional investor rather than pursuant to a separate subscription agreement and will not receive any preferential treatment. Anchor investors are generally not disclosed in the prospectus nor do they provide a lock-up.

In some jurisdictions the position of anchor investors is covered by regulation and may be different. For example, the Securities and Exchange Board of India ("**SEBI**") has introduced a requirement that Indian IPO issuers must have anchor investors with the intention that they will improve price discovery during the IPO process.

As a result of the SEBI regulations, anchor investors in India are much more like cornerstone investors. They will be offered IPO shares before the offer opens to the public, details of the anchor investors have to be made public before the issue opens and they will be locked up for 30 days after closing. In addition, they will be required to put up a margin of 25% of the amount of their application. The balance is to be paid within two days after the close of the issue. The anchor investors apply for shares in the Indian IPO along with other institutional investors but if the price that they have offered is less than the bookbuilt price, they will have to make up the difference. If their price is higher than the bookbuilt price, they will have to forego the amount of the excess.

Benefits and criticisms of the cornerstone process

The cornerstone process has been criticised for, amongst other things, not being good for the company after its IPO (liquidity suffers because of the number of shares which are locked up) and not being fair to investors (because cornerstone investors are given priority status).

However, much of the criticism of cornerstone investment stems from a time of strong IPO activity when post IPO share prices would generally rise. This led to a feeling that cornerstone investors were not really assuming any meaningful risk in exchange for the benefit of priority treatment in the IPO. Ironically, the involvement of cornerstone investors may have been a factor in stable or strong post IPO share price performance. The presence of cornerstone investors indicates solid demand at the beginning of the marketing period and provides confidence, particularly to retail investors who are likely to take comfort that the IPO company is vouched for by someone who is buying its shares, rather than by someone who is selling them. In addition, the lock-up of cornerstone investors will mean that fewer shares will be available for purchase post the IPO. This can result in an increase in demand for the IPO shares, which in turn means that the other institutional investors are likely to receive fewer shares than they applied for. In Hong Kong, an IPO is often required to include a retail tranche and if the retail tranche is over subscribed, shares will be clawed back from the institutional tranche. The cornerstone investors will generally not be affected by the clawback from the institutional tranche so that only the non-cornerstone institutional investors will lose out from any reallocation. These investors will generally seek to acquire some or all of the shortfall in their allocation through the acquisition of additional shares in the open market when trading commences, thus potentially strengthening the share price.

Much of the present volatility in the global securities markets, stems from a lack of investor confidence. Cornerstone investors can be an important source of confidence for investors. As a result, there have recently been transactions with very large cornerstone participations.

The Glencore IPO, in which Clifford Chance acted for the underwriting syndicate, was not only the first time a cornerstone process had been undertaken in a European IPO but was also one of the largest cornerstone investor commitments ever undertaken. Twelve cornerstone investors (which included a mix of sovereign wealth funds from Asia and the Middle East as well as asset managers, hedge funds and private banks) committed to subscribe for US$3.1 billion worth of shares. Their subscriptions accounted for a third of the IPO and provided the transaction with significant momentum in the bookbuilding process enabling the book to be covered on the first day.

Huadian Fuxin Energy Corp. recently raised US$319 million in its Hong Kong IPO. It secured more than 60% of that in cornerstone investments from six investors. In the recent Malaysian IPO of the plantation company, Felda Global Ventures Holdings Bhd, 10 cornerstone investors covered US$1 billion of the US$3 billion which the company was seeking to raise.

These are significant proportions of the total amount of the IPO and show the particular importance that is now being attached to an IPO being on a solid footing before it is marketed to other investors.

What can be done to encourage cornerstone investment?

In the present market conditions the presence of cornerstone investors can make the difference between an IPO being possible or not. It is likely that cornerstone investment will continue to be used in Asia, but for increasingly large proportions of the transaction, and that it will be used on transactions in markets outside Asia. However, the volatile securities markets have also increased the risks for cornerstone investors and something will need to be done to encourage their participation given the increased risks that they will assume.

1. **More detailed information to be received earlier?**

   Cornerstone investors will not commit funds on the basis of little or partially absorbed information. They will need to be made insiders earlier in the process (at least several weeks before the first roadshow) and, having signed confidentiality agreements, provided with earlier drafts of the prospectus and earlier opportunities to ask questions. This process needs to be carefully managed. Prospective cornerstone investors should only receive information that will be included in the prospectus. The only preference of cornerstone investors over other investors in terms of the information that they receive should be that they receive it earlier and that they have a chance to raise questions about it.

   Another possibility is for an issuer to approach potential pre-IPO or cornerstone investors several months before its IPO to ensure their participation in the IPO process. This will involve management presentations and roadshows as well as the delivery of early drafts of the prospectus once the IPO process begins. As a practical matter, this could be significant additional burden for a company that may not even have is full post IPO management team in place at that time and careful thought will need to be given as to how the company will deal with this.

2. **Lock-ups and discounts?**

   Inevitably, cornerstone investors will ask about dispensing with the lock-up and receiving a discount on the subscription price. These are much more difficult issues and the arrangements used will depend on the circumstances of each transaction. Some jurisdictions will offer more flexibility than others. For example, in Singapore, whether or not the cornerstone investors provide a lock-up will depend on negotiations between the cornerstone investors, the IPO company and the underwriters and the usual practice is that a lock-up is not required. In Hong Kong, the terms of the proposed cornerstone investment must be disclosed to the SEHK prior to listing and the SEHK has a track record of requiring cornerstone investors to provide a lock-up. There are good reasons for a cornerstone lock-up. The lock-up will provide confidence in the stability of the post transaction share price because fewer shares are available for sale and because it shows cornerstone confidence in the company. It is also important because it is something that the cornerstone investor obviously gives in exchange for preferential treatment over other investors in the offer. However, flexibility in the requirement of a lock-up in respect of all or part of the cornerstone investment would be a justified recognition that circumstances have changed. Given the volatile securities markets, cornerstone investors are now assuming real risk when they commit to invest whilst the value of their participation to the success of the transaction has also significantly increased. All lock-ups are subject to carve outs and exceptions and there is generally scope for these to be negotiated.

   Discounts could be structured in various ways - for example, a straight forward reduction in the subscription price, an issue of bonus shares or a return of cash. However, discounts are a significant departure from the usual cornerstone scenario where a pre-IPO placing is conclusively completed at the IPO price (so long as that price falls within a contractually agreed range) before the roadshow commences. A discount arrangement for a cornerstone investor (however structured) is likely to cause marketing issues in relation to the transaction and to raise regulatory concerns about whether all investors are being treated equally. In some jurisdictions this could mean the rejection of the listing application. In Hong Kong it is likely that a discount would be held to be contrary to the requirements that the issue and marketing of the shares are conducted in a fair and orderly manner and that all holders of shares are treated fairly and evenly. Also, if the offer is subject to US securities laws, there will be a risk that any investor purchasing shares in the offer at a discount will be considered to be an 'underwriter' and, therefore, subject to potential underwriter liability in the US for material misstatements in or omissions in disclosure when the investors seek to sell the shares. There may be arguments to rebut this presumption in the case of a cornerstone investor and disclosure in the offer document about the cornerstone process may reduce the risk, but there will always be an element of risk if a discount is provided.

Conclusion

Despite these difficulties, we expect to see more discussions around these issues as the likelihood of cornerstone participation in IPOs increases. Flexibility in the arrangements made to encourage cornerstone investment is likely to play a significant part in encouraging IPO activity over the next year.

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