Floating on AIM

In the first of a two-part article David Tilston of OverNet Data explains how the company was floated on the Alternative Investment Market.

I joined OverNet Data in April this year as Finance Director and led it through its flotation process. Most treasurers with a broad financial experience would, in my opinion, be capable of handling such an exercise: the objective of this article is to provide some insight into the flotation process and the issues that can arise. While many of these are obvious, the real challenge is in staying on top of a large volume of matters which need resolving within a tight time frame.

In this article, I will first look at some of the key documents that will be required in the AIM flotation process, along with points to note regarding their production and content. Some of the judgmental issues and practicalities which may be faced are assessed later on in the article.

Key documents

Some of the key documents that will be required, along with the points to note regarding their production and content, are listed below.

Business plan and financial projections

This is the kick-off point. The management team must have a coherent and carefully thought through business plan on why the business can succeed and how it will, in time, generate profit and cashflow. This is the essential proposition for would-be investors. The business plan is the first document that the company's professional advisers will review as part of their initial due diligence and advice on whether a flotation of the company is possible.

Long form report

Assuming the advisers are positive on the flotation prospects, a firm of reporting accountants (often the auditors) will be commissioned to write a long form report addressed both to the directors and the company's financial adviser. The content of the report will be agreed in advance with the financial adviser so it addresses any specific matters they wish to understand in greater depth.

The long form report, potentially a lengthy document, will provide a thorough description of the company's activities, organisational structure and marketplace. It will analyse past financial performance and internal controls, and will examine the financial forecasts and their underlying assumptions in detail. Sensitivity on the key variables (for example, pricing levels and volume growth) will be stress-tested for market developments – ie, the impact of competition. The long form report will act as a thorough briefing document for the financial advisers to allow them to undertake their due diligence on the company ahead of flotation. Prior to flotation the directors are required to confirm the accuracy of the facts – but not the reporting accountant's opinions – contained in long form report.

Working capital board memorandum

In the flotation prospectus the directors will need to make a statement similar to that shown in *Figure 1*. The working capital board memorandum will be adopted by the board before flotation demonstrating that the company will have sufficient funds and providing evidence to support the statement. Although the period reported on is 12 months, it is commonplace for a longer period – 18 months, for example – to be considered.

The contents of the memorandum will largely consist of the financial projections contained within the long form report. Downside sensitivities (such as delays in product launches, customer take-up of new or innovative services and the loss of major customers) will be assessed to ensure the company's

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OverNet Data develops real-time interactive wireless data and mobile commerce solutions for WAP-enabled phones and next generation handheld devices such as smartphones and wireless personal digital assistants (PDAs). The company floated on AIM in July this year to raise capital to finance its marketing and software development strategy.

FIGURE 1

Board statement

In the opinion of the company, having made due and careful enquiry and having regard to the net proceeds of the placing, the working capital available to the company and the group will, from the time that the ordinary shares are admitted to AIM, be sufficient for its present requirements, that is at least for the 12 months following. ■

financial position is suitably robust to permit the flotation to proceed.

Financial procedures board memorandum

A financial procedures board memorandum, detailing the major internal management reporting and controls, will be prepared and adopted by the board at completion. This would include management responsibilities for sales and expenditure levels, controls over capital expenditure, management reporting and accountability, and key financial policies, such as currency hedging strategy.

Many of the contents of this document will already have been described in the long form report.

The purpose of this memorandum is to document that the directors have established procedures which provide a reasonable basis for them to make proper judgements as to the financial position of the company and group as this is required by the Stock Exchange as part of the admission application.

Prospectus

This is the key document produced by the company for investors. It will include detailed information on the company, its business, products and markets, along with any further information relevant to an investor making a decision. It will include an accountant's report on past published financial data. It will also contain much additional data on such matters as the company's share capital, directors' service contracts, the memorandum and articles of association, share option schemes and material contracts and so on.

As part of the marketing process to investors, a 'pathfinder' prospectus may be issued. This is essentially the prospectus in draft form with such items as the final amount to be raised and the issue price excluded. It is vital that the pathfinder is complete in all material respects (apart from share issue details) to avoid having to go back to prospective investors pre-float to disclose additional material facts which will appear in the finalised prospectus issued on the day of the flotation.

Investor presentation slide pack

The management team will normally use a slide presentation to explain their business and prospects to potential shareholders. This will aim to get over the company's attractions as an investment in a concise way. Institutional presentations will normally take up to one hour including questions, so it is important to get the investment proposition across quickly and clearly.

Broker's research note

Although not a document produced by the company, the broker's research note plays an important part in the investor marketing process. This note can contrast the status and competitive position of the company with its peer group and give some comparative information on relative valuations and prospects.

NOMAD/NOMBRO agreement

This agreement reflects the arrangements between the company and its nominated adviser and nominated broker (who may be the same party for smaller companies). This agreement lays out the services the adviser will provide, the company's undertakings on how the two parties will work together to ensure that relevant Stock Exchange requirements are met.

Placing agreement

This agreement deals with the nuts and bolts of the placing (assuming entry into AIM is by a placing) and the relevant fee arrangements. It is signed personally by each of the directors, including non-executives.

Of particular importance is the extensive and detailed warranties required by the financial adviser and contained in the document. This covers:

- accuracy of information included within the prospectus;
- that forecasts in the prospectus have been prepared on a reasonable basis;
- that all information investors could reasonably be required has been disclosed;
- that working capital is adequate;
- that any accounting information has been appropriately prepared on a 'true and fair' basis;
- that there have been no material changes recently to the business; and
- many more matters as stipulated by the Stock Exchange regulations.

The warranties ensure that the directors minds are focused on the accuracy of the information disclosed in the prospectus.

FIGURE 2

Verification notes

Please confirm and provide evidence that Dataquest expects UK mobile data revenue to grow from £196.7m in 1999 to £5.1bn in 2004, representing a compound annual growth rate for the period 2000-2004 of 64.8% – Confirmed. Please see page 4 of Dataquest report.

Please confirm that application service provision is the delivery of software from a remote location over a communication network via a subscription-based outsourcing contract – Confirmed. Please see presentation from the Gartner Group entitled ASP – moving beyond the early adopters which confirms this statement. ■

Verification notes

The liabilities of directors are potentially significant and verification notes are an important means of limiting the risks involved by detailed checking of all statements and facts in the prospectus.

There is a requirement under The Public Offers of Securities Regulations 1995 (POS Regulations) that a prospectus should contain all such information as investors and their professional advisers would reasonably require, and reasonably expect to find there, for the purposes of making an informed assessment of the assets and liabilities, financial position, profits and losses and prospects of the company and the rights attached to the shares in question.

If a person relies on a prospectus and buys the shares offered and suffers a loss as a result of any untrue, misleading or omitted statement, then the persons responsible will be liable to pay compensation.

The verification notes are prepared to record the steps that have been taken to verify the facts, and the basis for the statements of opinion, intention and expectation, contained in the prospectus.

This acts as a (time-consuming) quality control check on the contents of the prospectus to minimise the above risks (see *Figure 2* for examples).

Other documents

There are also a wide range of other documents to be completed, such as revised plc standard memorandum and articles of association, directors' service agreements, share option/incentive plans, lock-in arrangements for existing shareholders and so on.

Judgement and practicalities

We faced a large number of issues to assess and manage as a result of the flotation process, and in many cases there was not a clear right or wrong approach. Loosely, the issues can be grouped into three broad categories:

- the business plan, market conditions and uncertainty;
- managing the overall process; and
- investor issues.

THE BUSINESS PLAN, MARKET CONDITIONS AND UNCERTAINTY

● Business plans and financial requirements
OverNet Data approached the market during a period of fluctuating sentiment around technology stocks. In March the techMARK index reached a high, following a very sharp run up from late 1999. During the early summer investor interest in this sector waned, then stabilised.

Against this backdrop we were uncertain whether market conditions would permit a successful flotation prior to the summer break. Consequently, we developed a range of business plans and financial models dependent on the amount of share capital raised. The more capital available, the more rapidly the firm could afford to build up its operations. As always, a sensible balance between risk and reward was needed.

A key factor in the modelling was the rate of growth in sales which could prudently be expected. OverNet Data was only just beginning to generate sales revenue, but the macro-economic forecasts by external commentators suggested medium-term growth for our markets of about 100% per annum. The sales projections were the significant factor in determining when the company would move from loss to profit, and also the amount of funding that would be required to safely sustain the firm prior to profitability being achieved.

● Valuation
A further question for debate was how the company should be valued, given its early stage of development. Given the lack of a historical track record of growing profitability, other indicators needed to be used. In our case a valuation multiple based on projected turnover relative to a peer group proved most useful. There was naturally the usual debate on pricing between the directors, who were concerned that shares would be issued too cheaply, and the brokers, who wanted to ensure continuing investor interest post-flotation – and avoiding a subsequent collapse in the share price.

FIGURE 3

Limited trading
The subsidiary was incorporated in March 1999 and the group is at a very early stage in its business. There is therefore limited information on which to base an evaluation of the company's future prospects.

Market for company's products and services
The commercial feasibility of the company's business proposition is dependent on growth in the wireless technology sector, the mobile data and WAP markets, as well as acceptance of the company's services and products by network operators and end users. The market may not develop as the company expects, nor may the company's technology be accepted at the levels required to sustain the company on an ongoing basis. ■

● Amount raised
In the final event OverNet Data's share placing was comfortably oversubscribed. The last decision to be made was how much extra to raise in order to give the company additional financial flexibility. We initially sought to raise £2m before costs, but eventually took £3.5m – while still leaving unsatisfied demand for our shares in the market.

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● Risk factors
A final point on uncertainty and risk. Prospectuses will contain a list of risk factors that investors should consider before deciding to invest in the company. This section is important to the directors in limiting their personal liability, as it is a means of ensuring that investors have a full understanding of the potential risks (as well as rewards) from investing in the company (see *Figure 3* for examples). Our list of risk factors ran to over two pages in the prospectus, and it is not unknown for such lists to be significantly longer, particularly in US documents.

THE FLOTATION PROCESS

● Dealing with advisers
The company is inevitably highly reliant on its professional advisers. They will have completed flotations and share placings on a regular basis, and will be in close touch with market sentiment.

This does not necessarily mean that their advice should be taken without question, however. All companies have their own individual characteristics or needs, and often specific items can be accommodated. There is often no absolutely correct answer – more usually there is an acceptable range of outcomes and it is up to the company and its advisers to determine the most appropriate trade-off.

● Project management and the board
A key point in the process is to ensure that the whole board is committed to meeting the requirements of the flotation on a timely basis. They have to take it seriously from the outset, and strong project management disciplines are a prerequisite. These disciplines are normally provided by the financial adviser.

Very early on in the process OverNet Data's board received a briefing from its lawyers explaining potential legal liabilities of individual directors and how these would be mitigated by the verification and due diligence exercise. This clearly captured their attention and

FIGURE 4

The tax benefits of AIM

EIS relief is available to an individual investing in unquoted ordinary shares of a qualifying trading company which has gross assets of less than £15m, provided the investment is held for a minimum of three years. For these purposes a company listed on AIM is unquoted.

Individuals can invest up to £150,000 each tax year and qualify for income tax relief at 20% on the investment made: if the shares are held for the full three-year period and EIS relief is not otherwise withdrawn, any capital gain on sale is exempt from CGT. In addition, capital gains can be rolled over against the investment.

Whereas EIS relief is available for individuals investing in specific shares, investments in Venture Capital Trusts (which invest in a portfolio of firms eligible for EIS relief and are exempt from tax on capital gains they make) confer similar tax benefits to the individual, although VCT investments are limited to £100,000 per tax year. ■

ensured that the drafting of the prospectus received careful attention from the start.

There can be an important transitional process as founding directors of a company, who may well not have direct experience of life in a plc, come to terms with the different standards required between private and public companies. In this case the finance director can have a valuable role to play in judging what regulations, contractual arrangements and governance structures are appropriate for the company, given its heritage.

INVESTORS

At the end of the day you have to find a group of investors who believe in the company's prospects and believe they can invest in expectation of a rising share price. Different factors are relevant to different categories of investors and I mention a few investor-related matters and judgements we faced.

I had not appreciated the importance of the taxation benefits of investing in AIM shares. Briefly, AIM shares are treated for UK tax purposes as unquoted investments and thus can give rise to significant taxation advantages for certain classes of investor if held for several years (see *Figure 4*).

On our broker's advice we targeted a number of venture capital trusts and high net worth individuals who would be interested in purchasing shares and holding them for a prolonged period of time. This would ensure that such shares would be unlikely to be sold shortly after flotation, an action which could potentially depress the share price.

We had to asses certain judgmental issues on matters which might have drawn adverse comment from investors. AIM shares are not subject to the Association of British Insurers (ABI) guidelines, so there is flexibility to depart from ABI norms. However, we did not wish to pursue an excessive level of flexibility, as it might have raised concern with investors, particularly with respect to possible non-pre-emptive share issues. Also, we chose to adopt a high standard of corporate governance which was beyond that strictly necessary for an AIM company, but which reflected our intentions on desired best practice for OverNet Data.

Getting the investment message right for investors proved a challenging but ultimately rewarding exercise. We found that we needed to simplify our story and limit it to a few key points. This made it far easier for potential investors to digest the business opportunity in a short presentation. Those that wished to were able to question us on the complexities of the business to the extent they required, but we avoided bombarding potential investors with unnecessary information that might have confused them. Preparing answers in advance for likely (or difficult) questions proved to be time well spent.

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One matter that all potential investors sought comfort on was the intentions of the pre-flotation shareholder base. There was a concern that existing investors, who were already sitting on a substantial profit, might sell significant numbers of shares immediately following flotation and thereby depress the share price.

This concern was overcome by negotiating suitable lock-in arrangements with existing shareholders, with them agreeing that they could not sell shares immediately following the flotation. These restrictions fell away on a tapered basis over a 12-month period.

Alternative arrangements were needed for the founding directors who held significant stakes in the company. My advice to any budding finance director is to get such lock-in arrangements agreed at the earliest date possible, as they become more difficult to negotiate the closer one gets to a flotation.

Finally, there is the psychology of the investor in the flotation process, the preferential allocation of shares to the (limited number of) persons contained on the chairman's list, and the overall allocation of shares. No institution or investor wants to commit too much to an issue until they are sure it will be successful.

However, once everyone believes such an offer will be successful the telephone does not stop ringing.

We were fortunate enough to have our placing oversubscribed. However, unfortunately this, by definition, means that investors get their applications scaled back, so they get less than they wanted. One inevitably gets a few irate telephone calls from disappointed punters.

You can do it if you really want

Much of the above process is well within the skill set of many treasurers. The main difficulty is managing the many disparate matters, along with the fact that for most finance directors it may be the first (and last) time they undertake such an exercise.

I hope the above has given any potential finance directors within our readership enough confidence to believe that an AIM float may well be within their capability. ■

David Tilston is Finance Director of OverNet Data. He is a Fellow and member of the council of the Association.