CORNERSTONE INVESTMENTS IN IPOS
THE NEW NORMAL FOR EUROPEAN MARKETS?

Ross McNaughton and James Cole of Paul Hastings (Europe) LLP and David Gossen of Deutsche Bank AG, London branch examine the key features and development of cornerstone investments in the European IPO markets.

Cornerstone investments, where one or more investors agree in advance to subscribe for a certain number of shares in a forthcoming initial public offering (IPO), are a relatively new feature of the European IPO markets. They were first seen in Europe around 2011, most notably in the Glencore IPO and have since become an increasingly common feature of European IPOs.

While cornerstone investments are relatively new in Europe, they have been prevalent in Hong Kong for some time. The Hong Kong Stock Exchange (HKSE), unlike European regulators, directly regulates cornerstone and other pre-IPO investments, and has issued guidance on the specific features for pre-IPO investments, including regulation of their key commercial terms, such as lock-up periods, disclosure, price and board nominations.

In Europe, the first examples of cornerstone investments shared similar features and characteristics with their counterparts in Hong Kong. For example, they:

• Typically included a lock-up period that restricted a cornerstone investor from selling its shares for a particular length of time after the offering.
• Were disclosed in the prospectus.
• Were always made at the IPO price.
• Did not come with any board member nomination rights.

The absence of specific regulation of European cornerstone investments has provided greater flexibility for their commercial terms.

This article analyses the development of cornerstone investments and compares and contrasts them to other forms of pre-IPO and concurrent IPO investments. It also considers the use of cornerstone investments in Europe, examines the law and regulation governing these investments, and highlights prevailing market trends and developments regarding their typical commercial terms.

MARKET DEVELOPMENT

Cornerstone investments have been a prominent feature of equity capital markets in Asia, and particularly Hong Kong, for several years. Historically, they were used by investors to secure their share allocations in particularly “hot” deals. They were also used for marketing purposes to seek to give a positive perception to offerings, particularly among retail investors. However, this practice drew criticism from various commentators who questioned the fairness of selected investors receiving a guaranteed allocation in shares that later soared in value, while other investors missed out or were subject to their orders being scaled back. This
criticism led to the HKSE Listing Committee introducing specific rules governing certain features of pre-IPO investments in the form of interim guidance in October 2010, which was supplemented by further guidance in October 2012 and February 2013 (the HKSE rules) (www.hkex.com.hk/eng/rulesreg/listrules/listguid/iporq/guidance1.htm).

The HKSE rules derive from the HKSE’s underlying principle of fair and equal treatment of all shareholders in an IPO. Among other things, the HKSE rules require that:

• Any placing to cornerstone investors must be made at the IPO price.

• Placings to cornerstone investors should be subject to a lock-up period of at least six months following the listing date.

• Cornerstone investors should not have the right to nominate directors following the listing.

• Details of the cornerstone investment, including the identity and background of the investors, must be disclosed in the listing document.

In contrast with Asia, cornerstone investments in Europe are relatively new, and are not subject to specific regulation. During the relatively quiet new issuance market in the period following the financial crisis of 2008, market participants in Europe considered ways that cornerstone investments could be used to enhance deal certainty in the uncertain markets that were prevalent at the time. However, it was not until the Glencore IPO of 2011, which involved both a London and Hong Kong listing, that a European IPO featured cornerstone investors. Since then, there have been several European IPOs featuring cornerstone investments, including the recent examples of: NN Group NV in the Netherlands in 2014; Rocket Internet AG in Germany in 2014; Zalando SE in Germany in 2014; Euronext NV in the Netherlands in 2014; LfC AB in Sweden in 2014; Dustin Group AB in Sweden in 2015; Eltel AB in Sweden in 2015; and Integrated Diagnostics Holdings Plc in London in 2015.

**KEY FEATURES**

A cornerstone investment is an agreement by an investor, usually a large institutional or sovereign investor, to subscribe for a fixed monetary amount of shares in an IPO. This agreement is usually definitively committed to shortly before the IPO price range is announced and the prospectus is published (see box “Cornerstone timeline”). The price at which a cornerstone investor will invest is usually at, or determined by reference to, the IPO price. There is typically a lock-up period preventing the investor from selling its shares for a set period following the IPO, and the principal commercial terms of the cornerstone investment are generally disclosed in the prospectus (see “Lock-ups” and “Disclosure” below).

Importantly from an investor’s perspective, a cornerstone investment brings with it a guaranteed allocation of shares; that is, the investor’s order will not be subject to scaling-back, as might otherwise be the case in the context of a successful IPO bookbuilding process (see box “Bookbuilding”).

From an issuer’s perspective, having one or several cornerstone investors can increase deal execution certainty by pre-selling a portion of the shares to be sold in the IPO and reducing the amount of shares required to be sold in the bookbuilding process. It also has the added benefit of driving...
anchor investments

"Disclosure" below.

the IPO is not imminent, the absence of the requirements for private companies and, as they:

process, but unlike cornerstone investments, investments are also designed to add the order book at, or towards the beginning IPO process. They constitute a commitment as with cornerstone investments, anchor investments (see box “The IPO timeline: investment options”).

pre-IPO strategic investments

Pre-IPO strategic investments are investments made in companies when an IPO is contemplated but well before the preparatory stage has commenced. These typically, although not exclusively, have more flexibility than a cornerstone investment and may be structured by way of a pre-IPO convertible bond or similar instrument. As they are not made within the context of an IPO process, these investments contain fewer restrictions on the disclosure of information to an investor in a pre-IPO strategic investment as compared to a cornerstone investor. This is due to the absence of significant disclosure requirements for private companies and, as the IPO is not imminent, the absence of the inside information-related concern that an investor should only receive information that is to be disclosed in the IPO prospectus (see “Disclosure” below).

anchor investments

As with cornerstone investments, anchor investments are made in the context of an IPO process. They constitute a commitment from an investor to place a sizeable order in the order book at, or towards the beginning of, the bookbuilding process. Anchor investments are also designed to add immediate momentum to the bookbuilding process, but unlike cornerstone investments, they:

• Do not come with a lock-up.
• Do not generally require disclosure in the prospectus.
• Do not come with a guaranteed allocation.
• May be subject to scaling back in the bookbuilding process.

making a cornerstone investment

In Europe, a traditional IPO timeline typically consists of: a preparatory stage; pre-deal investor education; and a bookbuilding period.

Preparatory stage

The preparatory stage of an IPO generally takes at least three months. During this time, the issuer prepares to go public and undertakes any required corporate reorganisation, implements governance measures (such as identifying and appointing additional board members and appointing committees), prepares the prospectus and briefs the analysts, who then write pre-deal research on the issuer. There may also be early-look or pilot fishing meetings with investors to start to expose the issuer to the broader investment community and explore market appetite for the IPO.

During this preparatory stage, an issuer may identify and approach prospective cornerstone investors, generally with the assistance of the underwriters involved in the IPO. Once interested, investors are made subject to appropriate confidentiality undertakings, following which they will carry out their due diligence and valuation work on the issuer.

Due diligence undertaken by a cornerstone investor generally includes a mixture of documentary and management due diligence. While cornerstone investors can obtain information in advance, usually in the form of a near-final draft prospectus, as a general rule it is important that cornerstone investors do not receive any material information that is not ultimately included in the prospectus, as they will not want to run the risk of becoming an insider, and more importantly from the issuer’s perspective, the prospectus must include all material information for an investment decision in the IPO.

For this reason, the investment decision for the cornerstone investor is generally predicated on receipt of the final prospectus, and a marked version of the prospectus is often provided to the cornerstone investor to highlight any changes against the draft of the prospectus, or sections of the prospectus, that it reviewed as part of its due diligence. This creates a timing tension, as the cornerstone investor must be committed in principle ideally well before the launch of the IPO and, accordingly, the key disclosure sections of the prospectus should be substantially complete before they are shared with the cornerstone investor.

The cornerstone investment due diligence process, and the questions and answers that typically follow, may help to frame and craft the final prospectus content. From a commercial perspective, the cornerstone investors’ views on valuation will also help to refine the price or price range at which the IPO is ultimately launched.

At the end of the preparatory stage, and before a public launch of the offer through publication of an intention to float announcement (ITF), the issuer and the underwriters for the offering will require some form of commitment from the cornerstone investor(s) to invest, subject to confirmation as to the eventual price range. This would ideally be contractual but, in practice, cornerstone investors will typically want to cross-check their valuation and views on the issuer with those of the investment analysts and so this agreement more usually takes the form of a so-called “moral commitment”.

pre-deal investor education

Pre-deal investor education immediately follows the publication of the ITF, when the underwriters’ analysts release their investment research on the issuer and hold investor education meetings with
key investors. This process typically lasts around two weeks. Using feedback from the meetings, the issuer and the underwriters will use this time to finalise and determine the price range at which the IPO should be made.

Assuming that the price range is within the range expected by a cornerstone investor, at this point, if it has not already, the cornerstone investor will sign a binding cornerstone investment agreement. The cornerstone investor will also agree on the form and content of its description and its cornerstone investment commitment that will be included in the IPO prospectus.

**Bookbuilding period**
Following pre-deal investor education, the price range for the offering is announced, a price range prospectus is published containing the disclosure of the cornerstone investor(s), and a bookbuilding period commences. The bookbuilding period generally lasts for two weeks, during which investors submit their orders into the bookrunners’ order book. The issuer and the bookrunners determine the final price at the end of the bookbuilding period, which is then communicated to the market.
The final price determines the price that the cornerstone investor must pay for its stake, subject to any price thresholds that the cornerstone investor negotiated into its agreement.

Given the binding nature of the investment agreement, cornerstone investors are on risk during the two-week bookbuilding period for any movements in the market that might affect the size of the offering and ultimate purchase price of the shares offered in the IPO. During stable markets this risk is low but it may become more acute during times of increased volatility. This was seen, for example, in the October to November pricing window in 2014, as a result of, among other things, declining oil prices.

To meet this risk, regardless of market volatility, a cornerstone investment agreement will usually include a provision, as an express condition to subscription, that the final offer price per share is within the agreed price range. While it would be very unusual for a cornerstone investor to commit without the benefit of this condition, there has been at least one example (Polymetal International Plc’s IPO in 2011), where one of the underwriters, VTB Capital, agreed to subscribe for $100 million in the offering in light of, among other things, the long-standing relationship between the VTB group and Polymetal.

Another way in which cornerstone investors have sought to mitigate market risk is to insert a specific maximum subscription price. The IPO of Aena, the Spanish airport operator, involved three cornerstone investors: Corporacion Financiera Alba; Ferrovial; and The Children’s Investment Trust. When Aena’s IPO initially launched in October 2014 with a price range of €41.50 to €53.50, market conditions were relatively unstable and each of the cornerstone investors committed to their investments subject to different maximum price caps: €53.33 for Corporacion Financiera Alba; €48.66 for Ferrovial; and €51.60 for The Children’s Investment Trust.

Ultimately, the IPO failed to price after its initial launch and was postponed until markets had stabilised, relaunching in January 2015 with a revised price range of €43 to €55. Shortly following the relaunch, the price range was again revised upwards to €53 to €58, with the IPO ultimately pricing at the top of the range and above the maximum price condition imposed by two of the cornerstone investors.

**DEVELOPMENTS IN THE EUROPEAN MARKET**

Given the absence of specific regulation of cornerstone investments in Europe, the development of cornerstone investments in Europe has been largely market-driven. An analysis of the details of recent deals involving cornerstone investors reveals some interesting trends, particularly as regards key commercial terms such as lock-up periods, price, disclosure and board nominations.

**Lock-ups**

The inclusion of a lock-up period for cornerstone investors is a typical feature in Europe. This originally stemmed from the fact that lock-up periods are mandatory in Hong Kong. However, lock-ups are not applied consistently across Asia; for example, in Singapore, lock-ups are not typically imposed on cornerstone investors.

Although European IPOs have included a lock-up for cornerstone investors, there is now an increasing trend not to have them. None of the cornerstone investments in the Kennedy Wilson, Hispia, Merlin Properties, Pershing Square, Lifco, Eltel, Dustin or Malin IPOs made reference to lock-up arrangements.

In addition, where there is a lock-up period, a six-month period is not necessarily market standard. For example, in the Rocket Internet IPO and the Aena IPO, cornerstone investors were subject to a one-year lock-up period, and the “reference” investors in Euronext’s IPO were subject to an even longer lock-up period of three years.

The benefits of lock-ups are well known. They provide greater stability or confidence in post-IPO share performance and as the lock-up results in lower liquidity, fewer free float shares are available to buy after an IPO, which helps to drive demand. Lock-ups also provide a managed overhang so the market can anticipate when a secondary exit from the lock-up is likely to occur.

**Price**

There has generally been an expectation in the European market, derived from the Hong Kong market, that cornerstone investors would invest in an IPO at the same price as investors participating through the order book (see box “The IPO timeline: investment options”). While this is usually the case, there have been recent examples where cornerstone investors have subscribed for their shares at a discount to the IPO price.

For example, the “reference” shareholders in the Euronext IPO subscribed for their shares at a 4% discount to the ultimate IPO price, although they were subject to a three-year lock-up period (see “Lock-ups” above). Similarly, in the NN Group’s IPO in 2014, cornerstone investments were structured through an exchangeable bond, where the cornerstone investors also benefited from a discount to the IPO price. Both of these offerings were listed on the Euronext Amsterdam Stock Market. Whether similar pricing structures could be used on IPOs listed on other exchanges should be assessed at an early stage, as they could be restricted by both local listing rules and corporate law.

Where regulations allow for a differential between the IPO price and cornerstone subscription price, there are several commercial factors to be considered in whether such a discount would be merited. Cornerstone investors are at risk of market movements for a longer period than investors who place their order through the bookbuilding process, given that a binding cornerstone investment agreement, which is generally subject to few conditions, is entered into before the price range is announced and the roadshow and order taking begins.

In some circumstances, the promise of guaranteed allocation may not be enough to compensate for the amount of on-market risk. However, as discussed, there may be a perception that the mere fact of a cornerstone investor’s participation is an endorsement of the offering. This may give momentum to the order taking and potentially increase the ultimate IPO price and, therefore, the discount at which that cornerstone investor is obliged to invest under the terms of the cornerstone investment agreement. Ultimately, however, the amount, if any, of an IPO discount will depend on the expected level of demand for the shares and how important it is to the cornerstone investor to receive a guaranteed allocation in the offering.

**Disclosure**

While there is a specific requirement for disclosure of the identity of cornerstone investors and the amount of shares that they have committed to buy under HKSE rules, in Europe, the inclusion of such disclosure is determined under general disclosure principles.
From a legal perspective, in the UK, the applicable disclosure requirement is that a prospectus should contain all information necessary to enable investors to make an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the issuer and the rights attaching to the transferrable securities (section 87A(2), Financial Service and Markets Act 2000). If the offering is also to be made into the US, disclosure standards under the US Securities Exchange Act of 1934 will apply, meaning that the offering document should not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading.

While the size of the cornerstone commitment is likely to be considered material in the context of the IPO for liquidity purposes, the identity of the cornerstone investor may not be material. However, from a commercial perspective, including this disclosure may give a positive perception to the marketing of the issue and the offering as a whole. By analogy, the identity, and even existence, of anchor commitments are not generally disclosed to the market, and investors are not told of other investors’ individual positions when they subscribe to an IPO through the order book.

The 2014 IPO of Pershing Square reflects this approach. While details of the total number of cornerstone investors and their aggregate investments were disclosed, the identity of only those cornerstone investors that would hold more than 3% of the issuer’s voting rights and share capital following the IPO (of which there were four) were disclosed. This was presumably on the basis that this constituted a threshold ownership notification requirement in the Netherlands (as it would in the UK for UK-incorporated issuers under Disclosure and Transparency Rule 5.12R) and disclosure of the identity of the remainder was presumably held to be immaterial on this basis.

Any lock-up of a significant IPO cornerstone investor is likely to be considered material from a liquidity perspective and would generally be disclosed in the IPO prospectus.

**Board nominations**

The ability for cornerstone investors to nominate or put forward a nominee for membership of the board of the company to be listed is starting to feature in the European IPO market. This is not permitted under the HKSE rules and did not feature when cornerstone investments were first adopted in Europe.

In Merlin Properties’ 2014 IPO, two of the cornerstone investors were each entitled to nominate one person to the board for so long as they held at least 3% of the company’s share capital for at least the first year following the IPO.

Similarly, the largest cornerstone investor in the Eltel IPO, subscribing for 10.5% of the offering, was entitled to nominate a board member candidate at the first AGM following the company’s listing. In that case, Eltel’s two largest shareholders, also selling shares in the offering, agreed to vote in favour of the appointment of the cornerstone’s nominee to the board.

A nomination right was also included in the Euronext IPO, where the reference shareholders in that deal, which bought their interests in the company shortly before its IPO at a discount to the IPO price, had the right to nominate one-third of Euronext’s supervisory board for so long as they held at least 25% of the issued share capital of the company.

**FUTURE TRENDS**

While cornerstone investments are now a relatively established feature of European IPO markets, similar arrangements are beginning to be seen in secondary and follow-on offerings. For example, at the time of writing, Dufry AG’s recent takeover offer for World Duty Free, financed in part by a CHF 2.2 billion rights issue, includes a CHF 850 million underwritten portion with GIC Pte, Temasek Holdings Pte and the Qatar Investment Authority (QIA) each committing to backstop CHF 450 million of shares that existing shareholders did not take up. In effect, GIC, Temasek and QIA are acting as sub-underwriting cornerstone investors in the rights issue.

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Given the absence of specific regulation in Europe, the commercial terms attaching to cornerstone investments are likely to continue to evolve. For example, for IPOs where guaranteed allocation is not a key concern, cornerstone investors may require increasingly favourable pricing terms, although this trend is likely to require careful consideration of the relevant overriding legal principles of equality of treatment of shareholders and other stakeholders in order to avoid favouring one group of shareholders over another.

Other contractual features may also begin to become more commonplace. For example, cornerstone investors may request a “right to match” provision in their investment agreements in circumstances such as Aena’s, where the maximum IPO price range conditions are exceeded in view of high demand for the shares and a subsequent increase in the price range occurs.

Pre-IPO strategic “crossover” investments, where investors invest before, during and after an IPO, are increasingly used in biotech and healthcare IPOs to reduce the levels of risk. Valuations in this sector are generally positively affected by the use of these investments by sector specialists, whose validation of a name can be highly persuasive in the subsequent IPO.

While these types of IPO investments are generally made before the IPO preparatory stage, there are cases in which their use may need to be considered with subsequent cornerstone style investments. If this is the case, the interplay in their respective terms will need to be carefully considered. In the internet and technology IPO boom of the late 1990s, a number of US IPOs featured concurrent private placements to strategic investors. With cornerstone investments featuring in US IPOs such as Markit Ltd in 2014 and Jumai International Holding Limited in 2015, these investments now offer an important concurrent liquidity option for US IPO issuers, both in the technology and other sectors.

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