

Professional Perspective

**IPOs in Germany:
What Potential Shareholders
Should Know**

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Introduction

Ringling the bell at the stock exchange is a landmark step in the history of a company. It is the kickoff for new opportunities and a chance to accelerate growth by making use of the capital market.

As a key player in Europe's economy, Germany is a target for many foreign investors, including private equity firms, public investment vehicles, and retailers. Such investors are increasingly investing in German public companies, such as by acquiring shares on the stock exchange, in private placements, through public takeovers, or through investment in private companies implementing an initial public offering. In 2018, two of the top five IPOs worldwide—Siemens Healthineers and Knorr-Bremse—took place in Germany.

This two-part article discusses the German capital market and its key legal differences compared to the U.S. This part provides an overview of the German capital market, prerequisites and process for an IPO in Germany, and key differences from an IPO in the U.S. Part 2 will focus on the post-IPO disclosure and transparency obligations for a publicly listed company in Germany, the role of its shareholders, and public takeover considerations.

The German Capital Market

Stock Exchanges and Market Capitalization of German-Listed Companies

Germany has eight stock exchanges. The Frankfurt Stock Exchange, “Frankfurter Wertpapierbörse” or FSE, run by Deutsche Börse AG is the most important, with further regional stock exchanges in places such as Berlin, Düsseldorf, and Munich.

The regulated market of the FSE is divided into two segments: Prime Standard and General Standard. The Prime Standard has additional admission follow-up obligations and sets the highest transparency requirements, which also have to be complied with in English. The Prime Standard is consequently tailored for companies wishing to position themselves towards international investors. The management board of the FSE decides on the admission to the Prime Standard, which gives access to the indices DAX®, MDAX®, TecDAX®, and SDAX®.

Founded in the 16th century, the FSE became one of the leading international stock exchanges for securities and bonds and is a preeminent location for companies of all different industries. As of Aug. 2019, approximately 300 companies were listed in the Prime Standard, and 145 companies were listed in the General Standard of the FSE, including 31 and 17 foreign companies, respectively. FSE trading platforms—Xetra and Börse Frankfurt—comprise more than 95% of all German publicly listed companies and around 85% of all foreign publicly listed companies.

In 2018, the total market capitalization of listed companies in Germany was about \$1.755 trillion compared to a market capitalization of \$30.436 trillion for companies listed in the U.S. The DAX index, which measures the performance of the 30-largest and (in terms of free float and market capitalization) most liquid companies, includes 10 companies with a market capitalization of over €50 billion each—for example, Adidas, Allianz, BASF, Bayer Group, SAP, Siemens, and Volkswagen. With a market capitalization of around €123.4 billion, SAP has the highest market capitalization of all DAX companies (as of Aug. 2019).

IPO Landscape

In 2018, Germany experienced one of the most successful years for IPOs. Eighteen companies debuted on the stock exchange with a listing in the Prime Standard, twice the volume of 2017, and the most IPOs in one year since 2007. The IPO volume reached €11.6 billion (compared to €2.8 billion in 2017). With a total IPO volume of €9.4 billion, the IPOs of Siemens Healthineers, Knorr Bremse, and DWS Group accounted for 80% of the total IPO volume in Germany in 2018. With a valuation of €4.2 billion, Siemens Healthineers was the largest IPO in Europe and the fourth-largest IPO worldwide in 2018.

The IPO pipeline in Germany for 2019 and the following years promises further highlights. Siemens Gas and Power, Thyssenkrupp Elevator Technology, Continental's Powertrain, and chip manufacturer Exyte are discussing IPOs. Nevertheless, a number of companies put their IPO plans on hold as stock markets became more volatile in late 2018 due to worldwide economic and political uncertainties. However, Volkswagen still launched the IPO of its trucks business Traton SE in June 2019, and in Sept. 2019 Teamviewer was able to launch the biggest tech-IPO in 19 years, with an IPO volume of €2.2 billion.

In 2018, approximately 210 IPOs in the U.S. raised \$54 billion, while IPOs in Germany raised about \$13.5 billion. But the \$13.5 billion resulted from only 18 IPOs, meaning the average volume per IPO in Germany was \$750 million, compared to approximately \$250 million per IPO in the U.S. One-hundred of the 210 U.S. IPOs had an average deal size between \$25 million and \$150 million, and nine were over \$1 billion.

Even though most German companies are only listed in Germany, some companies envisage a dual listing in the U.S. and Germany, while others are exclusively listed in the U.S. This depends on the business the company generates in the U.S. and soft factors such as decisions on headquarters and the location of investors. German biotech companies, for example, are often keen to go public in the U.S. rather than in Germany to capitalize on the large and knowledgeable investor base in the U.S.

Investment of Foreign Shareholders in German-Listed Companies

Foreign investors have become increasingly important to the German stock market and have increased their investment activities in recent years. By the end of 2018, approximately 55% of shares in the companies included in the DAX were in foreign hands. Of those, 26% were held by investors from other European countries, and 22% were owned by U.S. investors.

With an average shareholding of 63%, institutional investors have a particularly strong interest in DAX companies. Strategic investors such as family offices or companies hold an average of 12%. Private investors hold about 10%, while approximately 3% of the shares are treasury shares or held by state institutions. The remaining 12% are not allocated to a specific group of shareholders.

Private Equity-Backed IPOs in Europe

Between 2013 and 2017, around 40% to 50% of the total number of IPOs in Europe accounted for PE-backed IPOs, i.e., in such IPOs a financial sponsor classifying as a private equity firm had influence on the IPO company at the time of IPO or was directly involved. In PE-backed IPOs, the secondary tranche in the IPO compared to the primary tranche is usually significantly higher compared to non-PE-backed IPOs as private equity firms use IPOs as a first step to divest an investment. Subsequent secondary sell-downs are used to fully dispose of the portfolio company. Hence, with around 61% of the overall proceeds, the majority of proceeds in PE-backed IPOs go to the selling shareholders.

IPO in Germany: Exit Alternative in Private Companies

Shareholders of private companies have two primary exit options: sell shares through a private M&A-transaction or pursue an IPO of the company and sell shares to the capital market.

In an exit scenario, often both options are pursued in parallel until one wins (a so-called dual track). In these cases, the IPO track serves as a floor for the pricing and determines a strict timeline for the preparation of both tracks. Investors often ultimately decide for the trade sale exit because the IPO price is discounted, the IPO does not allow an immediate exit of 100% of the shares and the success of an IPO is uncertain given volatility in the stock market.

Even though a private M&A deal is often the preferred route for divestment, an IPO remains an attractive alternative.

Reasons for an IPO

Taking a private company public can be very attractive for the company, its management, and its shareholders.

For the IPO company, the listing grants access to the equity capital market and diversifies its range of financing options. Not only through the IPO, but also through the implementation of subsequent capital measures, the company can raise

fresh money without being dependent on debt financing from banks. In addition, debt finance commitments might be (partially) replaced and the IPO company thus becomes less reliant on bank financing.

The company also gains increased market awareness, which, in combination with increased transparency, may have positive effects on the perception of the company by its customers, suppliers, and prospective employees. It is highly attractive for the management and employees to work for a publicly listed company. The listing also creates the opportunity to implement a share price-based employment participation program, which incentivizes employee performance. Finally, the company may target add-on acquisitions by using its shares as acquisition currency based on an objectively valued share price on the stock exchange.

Shareholders benefit two-fold from an IPO of the company they are invested in. First, they profit from the divestment in the IPO. Public markets may offer higher prices per share than a private purchaser might be willing to pay. However, while a private company is often sold 100% in a private sale, a shareholder usually retains a certain percentage of shareholding when taking a company public. In Germany, often less than 50% of the existing shares in the company are sold through an IPO. The remainder stays with the existing shareholders and is subject to a lock-up agreement with the underwriting banks.

Second, throughout the subsequent holding period, the existing shareholders benefit from any increase in company value following the IPO and participate in the economic success of the company after taking it public. After expiry of the lock-up period, which usually lasts around six months, the existing shareholders might consider selling (part of) their remaining shares through a secondary placement. Since the share price provides an objective valuation of the company, temporary stock exchange upswings can be utilized to generate a higher profit in a secondary sale of the retained shares. A secondary sale can be completed and closed in a short timeframe of under one week, which is a clear time advantage compared to a private sale.

Downsides of an IPO

However, an IPO also has disadvantages, which need to be weighed against the benefits.

An IPO is cost-intensive. Underwriters, advisers, auditors, and public relations specialists must be engaged, IPO insurance secured, and market studies commissioned for the IPO prospectus. Shareholders and the company share costs on a pro rata basis depending on the split of the proceeds between primary proceeds (raised through a capital increase) for the benefit of the company and secondary proceeds gained through the placement of existing shares.

For the company, an IPO results in a high standard of disclosure and transparency obligations going forward. The company will be required to publish comprehensive financial information on a quarterly or semi-annual basis and to disclose ad-hoc notifications, capital, and voting rights information, as described in Part 2 of this two-part article. The company must also establish and maintain an investor relations department for its shareholders as well as investor communications.

The shareholder of a private company heading for an IPO should consider that, unlike in an M&A scenario, it will not be able to dispose of 100% of its shareholding at once. In addition, its shareholding will be diluted by an IPO capital increase, if any, subsequent capital increases, and the sale in its stake. Its dominant shareholder position and shareholder rights potentially existing prior to the IPO will be weakened. Since it might not hold the majority in the shareholders' meeting anymore, it has fewer possibilities to enforce its interests. In the shareholders' meeting, the shareholders are only entitled to elect the members of the supervisory board of the company. It does not allow the shareholder to instruct or even elect the members of the management board of the company anymore.

In addition, the shareholder is required to disclose its shareholding in the IPO company as part of the IPO process and is obligated to disclose future acquisitions or disposals of shares in the company in case he or she reaches, crosses, or falls below certain thresholds of shareholding. Finally, shareholders invested in public companies are heavily depending on macroeconomic factors unrelated to the company itself that may have an impact on the share price.

IPO Readiness and Process

The IPO process starts long before the first day of trading. Before the bell at the stock exchange rings, issuers must undergo various steps that not only need to be thoroughly prepared by the IPO company and its advisers but also by its shareholders. Those steps include among others: recruiting appropriate advisers and banks, preparing the company for

its IPO, elaboration on the IPO procedure, and drafting of the underlying documentation, as well as the successful marketing and offering of the shares.

First, the private company has to be made ready to go public. Being IPO-ready requires establishing an equity story to sell the shares, assessment of the financials, certain legal changes to the corporate governance, and, most often, a change in the legal structure of the company.

Equity Story. The equity story of the company is one of the most essential factors to ensure a successful IPO. It, together with the financials of the company, will sell the IPO to investors.

The company should be well-positioned on the market with a compelling strategy and growth opportunity that will positively influence the development and profitability of the company in the future. The historical financials of the company should draw the conclusion of a compelling outlook for the next years. However, it has to be emphasized that no quantitative guidance may be disclosed in the IPO documentation (unless certified by an auditor). Past financials, strengths and strategies, and the valuation of the company as communicated to analysts and investors should enable the latter to build their own future business model for the company.

Financial Statements. One of the key aspects to assess the IPO readiness of the company are its financials. Generally, the consolidated financial statements (balance sheet, income statements, and cash flow statement) of the past three financial years prior to the IPO must be disclosed and discussed in the IPO process as well as the last interim financial statements. In addition, the application of International Financial Reporting Standards is a prerequisite not only for the listing going forward, but also with respect to the last two years prior to the listing. Since many German companies report their financials by applying German GAAP, they need to convert their financial statements to IFRS, which is very time-consuming and might delay IPO preparations significantly.

Recent add-ons to the IPO group or restructuring measures within the IPO group may be reflected through combined financial statements and/or pro-forma financials, which are included in the IPO prospectus subject to certain statutory conditions with regard to the time periods in which they occurred. Such financial statements often need to be newly drafted and audited, which may also have a significant impact on the envisaged IPO timeline.

Corporate and Legal Structure. Prior to listing, the IPO company needs to be in the form of either a German stock corporation, "Aktiengesellschaft" or AG, a partnership limited on shares, KGaA, or a "Societas Europaeas" or SE. The stock corporation and the SE are most common. The KGaA is most often seen in the context of a family owned company in which the control should remain with the family even after listing.

A change in legal form includes the amendment of the articles of association to reflect the standard for public companies. In addition, the right composition of the supervisory board (gender quota, independent members, etc.) needs to be implemented and the agreements with the members of the management board, in particular their compensation, should be in line with the German Stock Corporation Act, "Aktiengesetz," and the German Corporate Governance Code, "Deutscher Corporate Governance Kodex."

Depending on the size of the IPO group, the supervisory board may be subject to co-determination rules under German law. One way to prevent future co-determination is by selecting the form of an SE for the IPO company, which allows the company to "freeze" the status related to co-determination prior to the change in legal form. Whereas the AG requires a two-tier board structure, the SE allows for a one-tier board structure. Even though the German Stock Corporation Act and the German Corporate Governance Code apply accordingly to the one-tier board structure, companies are reluctant to opt for the one-tier board structure. They want to avoid interpretation difficulties, since the law is originally geared towards a two-tier board structure, and to keep competencies with the supervisory board, which, under a one-tier board structure might need to be transferred to the shareholders' meeting. As of Sept. 2019, only one publicly listed SE proceeded with a one-tier board structure, but changed its board to a two-tier structure just recently.

Capital Structure. The capital structure of the IPO company is also worth a closer look.

The capital structure of the issuer has to allow the share price to be in the normal range of usually €10 to €30. This might require the conversion of capital reserves or a shareholder loan into share capital in order to increase the share capital. If these options do not exist and the share capital is not high enough for an IPO, another possibility is to set up a new IPO

company on top of the company and to contribute the IPO group into this newly established IPO vehicle as part of a capital increase by contribution in kind. By contrast, in the U.S., the share capital pre-IPO is most often not a problem because one can simply amend the articles of association and create the capital structure required to take the company public.

If the company intends to issue primary shares in the IPO, the capital increase will be implemented immediately prior to the IPO. The new shares will be subscribed by the underwriters in connection with the IPO and allocated to the investors together with the existing shares offered by the selling shareholders. The primary component usually facilitates the marketing of the shares, since not only the shareholders but also the company benefits from the IPO.

The articles of association of the IPO company should include authorizations for the management board, with the approval of the supervisory board, to increase the share capital via authorized capital (up to 50% of the existing share capital) and conditional capital to ensure financial flexibility of the company going forward. Any creation of authorized and conditional capital after the IPO might be difficult to achieve since it requires a resolution of 75% of the votes cast of the general meeting of the company.

Role of Underwriters. If a listing in the regulated market is the intended goal of the IPO, the issuer is required to appoint a credit institution to accompany its IPO. Different than in the U.S., it is not possible for the issuer to directly list shares on the stock exchange itself. The credit institution will usually support the issuer with preparation of the IPO and underwrite the offered shares. The support will include the definition of the equity story, the drafting of the analyst and road show presentation, approach of the investors, advice to the issuer as to timing and pricing, signing of the prospectus and applying for listing at the stock exchange. Depending on the size of the IPO and the issuer, additional banks might join and support the IPO as joint global coordinators and co-bookrunners.

Timing. The preparation of an IPO in Germany takes around five to six months depending on the corporate set-up and the financials of the company. If the company has already set up a data room, for example for a preceding bond or M&A-process, and/or has issued notes with a respective comprehensive bond prospectus, preparation time may be shortened. Regarding the financials, the company must have a complete and compelling set of financials in place that allow for the required disclosure and discussion in the IPO documentation.

The launch date is generally driven by the 135-day rule, which stipulates that settlement of the IPO must be no later than 135 days after the date of the last balance sheet date referred to in the IPO prospectus. This results in four IPO windows per year between inclusion and discussion of the respective financials (full-year, half-year, or quarterly results) in the IPO documentation and the end of the 135-day period. The specific timeline is agreed between the issuer and the underwriters and their counsel, respectively.

IPO Prospectus

The prospectus is the main document of the IPO process. It contains the legally required information to allow investors to form a true view about the securities being offered, the business of the company and the related risks. The IPO prospectus shall, on the one hand, exclude a potential prospectus liability of the issuer and the underwriters and, on the other hand, serve as a marketing document for the IPO.

It includes, among other information, risk factors related to the company, the industry, and the shares, the management's discussion and analysis of the financial statements, information on the business of the issuer, its market and competitors, the management of the company, and the public offering of the shares. The three financial years prior to the IPO as well as the latest quarterly financial information of the current financial year of the issuer must be included and discussed in the IPO prospectus. Certain audited pro forma financials in case of a material acquisition of the IPO company may also be included. A quantitative financial outlook might be included in the prospectus provided this has been officially certified by an auditor. Otherwise it remains with a rather qualitative outlook.

Further, the IPO company is required to disclose the use of proceeds resulting from the IPO in detail by breaking down the intended actions that shall be taken with the proceeds. Generic disclosures such as "general corporate purposes" or "working capital use" as often read in U.S. IPO prospectuses, is not sufficient.

As a result, the IPO prospectus discloses more details about the company than any other document that will be published in the company's lifetime. The issuer must establish a comprehensive data room to allow legal advisers to conduct due diligence and verify the content of the IPO prospectus.

The German Financial Supervisory Authority, "Bundesanstalt für Finanzdienstleistungsaufsicht" or BaFin, must approve the IPO prospectus for publication. The approval process may be agreed with BaFin upfront and usually takes six to eight weeks from the first submission until approval. BaFin adheres to the detailed timetable that has been agreed upfront, which allows for a precise timing of the IPO. This is different in the U.S. even though the review process itself is similar.

Compared to the requirements for the registration statement to be filed with the SEC for an IPO in the U.S., the approval of the IPO prospectus in Germany does not require the submission of any further material contracts or agreements. Nevertheless, material agreements as well as financing agreements must be described in detail in the IPO prospectus itself.

Furthermore, slightly different than in the U.S., the IPO prospectus approval process with BaFin is always strictly confidential until approval and subsequent official publication of the approved prospectus. This allows the company to pull the IPO up until the very last day before launching the IPO.

Exemption from IPO Prospectus

It is not possible to launch an IPO without a prospectus unless it is exempted under the German Securities Prospectus Act, "Wertpapierprospektgesetz," and/or the Regulation (EU) 2017/1129 of the European Parliament and of the Council (Prospectus Regulation), which came into force in July 2017 with most provisions being applicable since July 21, 2019. An exemption is stipulated for a private placement to only qualified investors or to fewer than 150 non-qualified investors per EU member state. Further exemptions relate to small IPOs that have a volume below €8 million, and simplified prospectus requirements are stipulated for issuers that qualify as small and medium-sized enterprises or emerging growth companies.

Marketing and Offering

In parallel to the drafting and review process of the IPO prospectus, the underwriters start a so-called "pilot fishing" outreach to get initial feedback from investors. This serves as a basis to assess the "appetite" of investors and potential success of the IPO. Different than "testing the waters" communications in the U.S., any materials for the pilot fishing do not need to be filed with or reviewed by the regulator. Upon positive feedback of the investors, the marketing continues with the preparation and distribution of the analyst presentation. The analyst presentation provides analysts and researchers with the relevant information to allow them to prepare research reports, which are published hand-in-hand with the company's first official announcement of a potential IPO to the market, its so-called "intention to float."

Underwriting Agreement. Immediately prior to approval and publication of the IPO prospectus, the underwriting agreement is finalized and signed. The underwriting agreement is the most important agreement between the issuer, the selling shareholders, and the underwriters. It sets forth the terms of the IPO, the placement of the shares, termination rights, indemnity clauses, and representations and warranties from the company. It also contains lock-up obligations of the company, its management, and selling shareholders, which are standard for a period of 180 days to 12 months, but not obligatory.

Different than in the U.S., the underwriters are not financed through a spread between the sales price of the shares to the underwriters which is stipulated in the underwriting agreement and the public IPO price. In Germany, the underwriters agree on a fixed and discretionary commission to the banks. The commission is often stipulated in the engagement letter and relates to the volume of the IPO.

Subscription Period. Following approval of the IPO prospectus by BaFin and its publication thereafter, the public offer starts. The subscription period usually lasts for around two weeks. During that time, the issuer and the syndicate of the accompanying banks perform roadshows at various finance venues to market the offer to potential investors.

Pricing and Book Building. Determining the price is an essential step in the course of a securities issue. The price will determine the proceeds and, thus, the success of the transaction. The offering price can be determined as a fixed price, through a so-called tender or auction procedure, or as part of a book building procedure.

The book building procedure is the most common. It is based on a price range determined in advance by the underwriters and the company following the due diligence performed in combination with a targeted investors' survey. The price range will be published by the company at the beginning of the offer period.

All offers received during the marketing phase will be registered in a central order book. After the subscription period ends, the book will be closed and the underwriters and the company will agree on the final offer price according to the existing bids as well as the allocation of shares based on the determined allocation criteria. In the course of the allocation, the company and the syndicate manager decide if and how many shares an investor shall receive based on the bid it has submitted. This kind of price determination leaves the company with the option to influence the kind and spread of their future shareholders in the course of deciding on the offer price.

For the final allocation decision, the intended shareholder structure as well as the achievement of a sufficient free float of the securities will be the central criterion. The latter is not only a requirement for the securities' admittance for stock exchange trading on the regulated market, but also for well-functioning stock trading in general.

Private Placement. In contrast to the public book building process, shares may also be offered through a private placement exclusively to a limited circle of investors. This offering will not be published until listing of the shares with the stock exchange. Private placements have been more prevalent in recent years since they allow the company to prevent a public offering and to remain confidential for as long as possible. Even though the IPO process remains the same and an IPO prospectus will be required for listing, the IPO timeline can be more flexible and may be adapted to a volatile market.

Agreement Among Shareholders of the Company

In addition to the preparations described above, the existing shareholders might agree on certain shareholder rights and obligations post-IPO. Prior to an IPO, the rights of the shareholders in the private company are rather comprehensive and allow the shareholders to resolve on multiple decisions of the company and to instruct the management board accordingly.

Following the IPO, shareholders that still hold a substantial stake in the company might want to align their votes in the shareholders' meeting and/or to agree on the selection of the members of the supervisory board to exercise influence on the company. In addition, they should agree on a procedure as to the further sell down(s) of shares after expiry of the lock-up period by one or several of the shareholders.

Result

The consideration of an IPO for a German private company and as an exit alternative for its shareholder(s) can open a broad range of opportunities for the company and its investors. Regardless of whether aiming for an IPO in the U.S. or in Germany, the equity story of the IPO company is ultimately key for a successful listing. Further, the right timing and success of the IPO depends on the preparation of the IPO company and its shareholders. The preparation might start many months in advance by setting up the right financials and guiding the company towards the harbor of the IPO with advisers, auditors, company, and shareholders working hand-in-hand.