

PRESENTATION

Initial Public Offerings: The Underwriting Process

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SPEAKERS



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Overview of Underwriting Process

The Underwriting Process

- The process of underwriting is a critical component of the IPO process.
- Generally, underwriting is the process by which an investment bank, or group of banks, evaluates the risks associated with an IPO and agrees to purchase shares of the IPO at a set price to resell to investors.
- The underwriting process can be broken down into a number of stages:
 - Selection of Underwriter(s)
 - Due Diligence
 - Prospectus Drafting
 - Valuation/Offering Price Determination
 - Marketing the IPO
 - Pricing and Closing of the IPO

Role of Underwriters in an IPO

Role of Underwriters in an IPO

- Underwriters will be involved in every step of the IPO process:
 - Structuring considerations (primary or primary/secondary; stock split considerations, etc.)
 - Assistance with market information for registration statement
 - Diligence process (discussed in more detail later)
 - Testing the Waters (meetings with institutional investors)
 - Management's Model/Analyst Day
 - Road Show, Pricing and Closing

Selecting Underwriters; Engagement Letters

Selecting Underwriters

- During the first month of the IPO process, the Issuer should select its underwriters, legal counsel, and auditor (especially if the Issuer's current auditor is not experienced in IPOs). Some considerations when selecting an underwriter:
 - Reputation
 - Quality of research
 - Industry expertise
 - Leveraging relationships with colleagues/network to identify experienced teams
 - Fit and compatibility
 - Lead or book-running manager.

Engagement Letters

- An engagement letter with underwriters in an IPO typically includes a number of customary provisions.
- Some material items in engagement letters that are more heavily negotiated include:
 - *Reimbursement Clause*: obligations of the parties with respect to the underwriters' out-of-the-pocket expenses incurred by the underwriter, even if the IPO is withdrawn during the due diligence stage, the registration stage, or the marketing stage.
 - *Gross spread/underwriting discount*: Price at which the underwriter purchases the issue from the price at which they sell the issue.
 - *Indemnification Provisions*: Sets forth indemnification obligations of the parties in the event of losses/damages in connection with the IPO.

Underwriters' Due Diligence Process

Section 11 of the Securities Act

- Section 11(a) of the Securities Act imposes liability if any part of a registration statement, at the time it became effective, “contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading.”
- Section 11 liability covers statements made in a registration statement.
- Claims can be brought by a purchaser in the IPO (and not by the government) against:
 - Each person that signs the registration statement;
 - Board members;
 - Experts named as responsible for a portion of the registration statement (like auditors); and
 - Underwriters participating in the IPO.

Section 11 Liability - Defenses

- Issuers are strictly liable under Section 11
- Potential defendants other than the Issuer have the following statutory defenses to Section 11 liability:
 - Due Diligence Defense: a defendant must show that he or she had, after reasonable investigation, reasonable grounds to believe — and did believe — that the included information was true and that no material facts were omitted.
 - Reliance Defense: in the case of a non-expert with respect to expertized portions of the registration statement, a defendant must show he or she had no reasonable ground to believe, and did not believe, that the registration statement contained a material misstatement or omission.

Due Diligence Process

- The underwriters will engage in a thorough due diligence exercise.
- Underwriters take due diligence very seriously, for both liability and reputational reasons.
- The due diligence process starts with a detailed management presentation about the business (usually at the organizational meeting) and continues through all of the drafting sessions and right up to the closing of the IPO.
- Underwriters' counsel will request sources or evidence to “back-up” statements in the registration statement.

Due Diligence Activities

- Extensive Document Request List
- Management Calls
- Customer and Supplier Calls
- Industry Expert Calls (in certain sectors)
- Auditor Calls
- Key Employee Meetings
- Regulatory Review
- Source/Evidence Requests (for statements made in prospectus)

Due Diligence Examples

- Extensive Document Request List:
 - All material customer contracts.
 - All material contracts with suppliers and service providers (including all software and technology agreements).
 - A schedule listing all intellectual property owned by the Company.
 - A schedule of all real property owned or leased by the Company, along with copies of relevant agreements.
 - A list of all insurance policies held by the Company.
 - A schedule of all employees of the Company, along with copies of any employment contracts.
- Source/Evidence Requests (for statements made in prospectus):
 - The Company's current facilities have the capacity to manufacture 2,500 widgets per day.
 - In pre-clinical trials, our product candidate has been well-tolerated by patients and shown promising results in combatting malaria.
 - The coffee segment worldwide is projected to grow by 4.47% (2023-2025) resulting in a market volume of over \$540 billion in 2025.

Underwriting Agreements

Underwriting Agreements

- In connection with the IPO, the underwriters typically enter into an underwriting agreement with the issuer of the securities and any selling stockholders.
- The underwriting agreement sets forth the terms and conditions pursuant to which the underwriters will purchase the offered securities and distribute them to the public.
- Both the Issuer's and underwriters' legal counsel play critical roles in negotiating key provisions of the underwriting agreement.

Underwriting Agreements – Starting Points

- Most investment banks and law firms that regularly represent underwriters in IPOs have “form” underwriting agreements.
- “Form” underwriting agreements are tailored to the structure and terms of the IPO.
- Underwriters’ counsel researches and reviews recent underwriting agreements filed for similar IPOs.
- Underwriters’ counsel typically sends a first draft of the underwriting agreement to Issuer’s counsel.

Underwriting Agreements – Material Terms

- Certain material provisions of underwriting agreements that are most heavily negotiated:
 - Representations and Warranties (including scope, “materiality” and “knowledge” qualifiers, etc.)
 - Definition of Material Adverse Change or Material Adverse Effect
 - Underwriter Information Carve-out
 - Indemnification and Termination
 - Lock-ups
 - Offering Expenses
 - Deliverables

Marketing the IPO

Testing the Waters

- Issuers may meet with institutional investors and solicit preliminary indications of interest in the coming IPO at any time prior to the launch of the formal road show (including before the first SEC submission).
- Usually, these “testing the waters,” or TTW, meetings do not occur during the “quiet period.”
- The SEC Staff routinely asks to see copies of the TTW materials used in these meetings.
- TTW meetings are optional and not part of the program in every deal.

Road Show

- Occurs during the “waiting period,” or the time between the first public filing with the SEC and effectiveness of the registration statement.
- Ideally, the Issuer will have been preparing the road show presentation in parallel with drafting registration statement.
- Distilling the Issuer’s story into a 30-minute pitch can be challenging.
- The road show slides will get plenty of attention, since the road show is at the center of the marketing process.
- On the road show, the underwriters are building an order book of indications of interest from investors.

Road Show Process

- May involve significant travel for the Issuer’s management team.
- The road show generally begins with a “teach-in” to the sales forces of each of the lead underwriters.
- Often continues through a series of group meetings (typically lunches) with buy-side institutional investors and one-on-one meetings with the largest institutional investors.
- “Flip books” must be retrieved from meeting participants after road show presentations.
- Retail investors see a video recording of an early road show meeting, which is made public.

Pricing and Closing

Pricing the IPO

- The day before the IPO, the underwriters and board of directors of the Issuer set the final offering price, generally referred to as “Pricing.”
- Final price determined by analyzing the offers received from institutional investors.
 - The condition of the market, strength of demand for the shares, as well as the mix of investors at each price are the strongest factors in determining the final price.
- At this point, the Issuer knows exactly how much money it will raise in the offering, regardless of price fluctuations that will occur once trading begins.
- The Issuer’s board of directors (and often, a “pricing committee”) approve the pricing of the IPO.

Closing the IPO

- Generally, bids from institutional investors should exceed the number of shares available in the IPO.
- Underwriters allocate the shares on the morning of the IPO.
 - Balancing based on expected behavior of potential shareholders
- Price discovery begins once the market opens.
 - However, trading on the IPO will not immediately begin.
 - Stock exchange begins to receive and record offers to purchase and sell the Issuer's shares from the open market.
 - The Issuer will also select a designated market maker.
 - The major exchanges determine an equilibrium price, which becomes the opening price.

Trading Begins; Stabilization Activities

- Once the opening price is set, the Issuer's stock finally begins to trade hands on the open market.
- First-day trading on IPOs can be very volatile.
- To stabilize volatility in the first day of trading, most underwriting agreements contain greenshoe provisions.
 - A greenshoe option allows underwriters to purchase and sell additional shares—usually up to 15 percent of the original offering.
- Underwriters will exercise the greenshoe option if demand for the Issuer's stock exceeds supply.
- Alternatively, if demand is weak and the price drops, the underwriters can repurchase shares from investors to boost the stock price.

Closing the IPO

- About three days after the IPO has been executed, the transaction is closed after final due diligence procedures have been completed.
- During this process, the Issuer receives the proceeds of the offering from the underwriters after the underwriters have taken their commission.
- The underwriting agreement will contain provisions that survive the closing of the IPO.

Questions?

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