

Gentrack IPO Report

10 November 2014

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About the FMA

The FMA is an independent Crown entity with a mandate to promote and facilitate the development of fair, efficient, and transparent financial markets. We work with financial markets participants to raise standards of good conduct, ethics and integrity and to achieve best standards of practice and compliance.

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Report on aspects of the initial public offering of Gentrack Group Limited (Gentrack)

Executive Summary

This report describes our conclusions following a review of matters arising out of Gentrack's initial public offering (IPO) of shares and its disclosure at the time of the IPO. Our review has not covered matters relating to Gentrack's continuous disclosure obligations under the Securities Markets Act 1988 or the NZX listing rules. These matters have been reviewed by NZX.

Background context to the report is provided in the appendix and a glossary of terms can be found at the end of this report.

Based on the information obtained during our review, the FMA has formed the view that Gentrack's offer documents did not contain any untrue statements and were not misleading, but could have been clearer in addressing the likelihood and potential impact of certain risks.

We are of the view that Gentrack followed a thorough and appropriate due diligence process, though some aspects of that process could have been improved by better recording of the directors' assessment of the likelihood of risks.

The FMA will not be taking any action against Gentrack or its directors in relation to the matters considered in this report.

Summary of findings

The following is a summary of the key findings from our review. Information about our review can be found in the appendix.

In our opinion Gentrack's offer documents placed an emphasis on its 'stable revenue base'. However we understand that approximately 30% of Gentrack's revenue is from major projects that do not deliver a stable revenue stream. While information about the non-stable revenue streams was included in the offer documents, we believe the balance of the information could have been improved. We refer to the recommendations in our [Guidance Note: Effective Disclosure](#) concerning the production of balanced disclosure documents.

Gentrack's offer documents included warnings highlighting the generic risks associated with the variability of one-off projects such as major software implementation projects, but did not include any reference to the specific project delays (the Delays) that gave rise to the profit guidance update published on 1 August 2014.

We have considered whether the omission of a specific risk disclosure concerning the Delays might mean the offer documents were false or misleading and have concluded that it did not. A generic risk disclosure about the variability of revenue would not preclude the need for a specific risk disclosure about the Delays if the risk of the Delays were itself material, taking into account both likelihood and potential impact.

Based on the information obtained during our review, we believe that at the time of the allotment of the shares, Gentrack's directors honestly held the view that the Delays would be very unlikely to have any material impact on the revenue forecasts contained in the prospectus. They considered both the likelihood of any impact on the revenue forecasts and the maximum possible impact and concluded that the overall risk was not material. This view was based on certain assumptions about the resolution of the Delays, but we have no reason to believe such assumptions were unreasonable at the time.

We found that Gentrack's directors implemented a thorough due diligence process aimed at identifying and ensuring disclosure of all material risks to investors. We also note that Gentrack engaged professional advisers to assist the directors in understanding their obligations throughout the IPO process. We consider that the directors took their responsibilities very seriously.

While we are satisfied that a sufficiently robust process was followed, there were shortcomings in the recording by directors of their views on the likelihood of any impact of the Delays on the financial forecasts.

In light of the directors' view about the likelihood and potential impact of the Delays on the revenue forecasts, we do not believe the offer documents were false or misleading by reason of omission of a specific risk disclosure concerning the Delays.

We also considered whether there was any reason to believe the decisions of the Gentrack due diligence committee were adversely influenced by conflicts of interest arising from some directors selling shares in the IPO. We have concluded that we have no reason to believe any conflicts of interest influenced the due diligence committee's decisions.

The offer documents produced following the due diligence focused on a limited range of risks that the directors considered to be material to Gentrack's business. We believe that it is appropriate for directors to identify the limited range of material risks they think are relevant to their business and only focus on these risks. Disclosure of a significant volume of immaterial risks or information can make disclosure documents unnecessarily long, impenetrable and potentially misleading.

With the benefit of hindsight it would be easy to assume that any matter that has materialised into an issue should have been considered to be a material risk, however we do not believe this is necessarily the case.

We give significant credit to the fact that Gentrack's directors took professional advice and explicitly considered whether the offer documents required updating in relation to the Delays. We have no reason to believe the directors were unreasonable in their judgment of the risks associated with the share offer based on the information available to them at that time.

On the basis of the information provided and the above findings, the FMA will not be taking any action against Gentrack or its directors in relation to the matters considered in this report.

Recommendations for issuers

Ensure clear, concise and effective disclosure of the likelihood and potential impact of risks

Issuers should carefully consider their disclosure concerning the likelihood and potential impact of risks in their offer documents. Even when issuers meet their legal obligations they are likely to experience negative sentiment from investors if issues arise that are not prominently highlighted as possibilities in the offer documents or where investors have not fully understood the potential impact of the risks that have been disclosed.

Disclosure of the likelihood and potential impact of risks will be even more important when offers of securities are made under the Financial Markets Conduct Act 2013 (FMCA). The Financial Markets Conduct Regulations 2014 require that a PDS for equity securities must include a description of the circumstances that the issuer is aware of that exist or are likely to arise that significantly increase the risk to the issuing group's financial position, financial performance, or stated plans.

The description must include: "particulars that will, to the extent that is reasonably practicable, assist an investor to assess the likelihood of any impact arising from those circumstances, the nature of that impact, and the potential magnitude of that impact."¹ This information must be "worded and presented in a clear, concise, and effective manner."² Therefore directors of issuers have a key role to play in ensuring the most significant risks relevant to the offer are distilled from the universe of all possible risks, and their likelihood and impact are clearly disclosed.

We will closely monitor the standards of disclosure concerning the likelihood and potential impact of risks for offers made under either the Securities Act 1978 or the FMCA and will take action against individual issuers if appropriate.

Ensure an effective and appropriate due diligence process

We encourage issuers to ensure their due diligence processes are appropriate for their particular business and offer. In particular, they should be designed to identify and investigate all material risks in relation to the business, and then those risks distilled further with specific relevance to the offer.

We encourage issuers to maintain a risk register recording their assessment of the likelihood and potential impact of all risks highlighted by their due diligence process. Businesses with existing risk management frameworks should ensure these are considered in the assessment of risks for the offer.

Where new risks arise or existing risks become more significant or imminent after offer documents have been registered but before allotment of the shares, issuers should apply the same standards in considering whether the risks are material. Offer documents will need to be amended if circumstances arise that would have been required to be disclosed or otherwise contained in the offer documents if they had arisen before registration of the documents.

¹ Clause 42 of Schedule 3 of the Financial Markets Conduct Regulations 2014

² Section 61 of the Financial Markets Conduct Act 2013

Appendix – Background to this report

General background

Gentrack Group Limited and Gentrack Share Sale Company Limited registered a prospectus on 26 May 2014 in respect of Gentrack's IPO. The prospectus was amended on 4 June and an investment statement was also published on 4 June.

The pricing of \$2.40 per share was announced on 5 June and the offer was open for firm orders from brokers between 9 June and 20 June 2014.

Gentrack's new shares were issued on 24 June and commenced trading on the NZX Main Board on 25 June 2014.

The IPO involved the issue of 15,000,000 new ordinary shares, together with the allocation and sale to the public of 26,310,972 existing ordinary shares. The total of Gentrack's ordinary shares offered to the public pursuant to the IPO represented 56.8% of the total ordinary shares on issue.

Gentrack's board of directors is made up of the following five directors:

James Docking	CEO
John Clifford	Chairman (Non-Executive)
Leigh Warren	Independent Non-Executive
Graham Shaw	Independent Non-Executive
Andy Coupe	Independent Non-Executive

The prospectus disclosed that three directors sold Gentrack shares pursuant to the IPO: James Docking sold 4,905,465 shares, John Clifford sold 5,025,192 shares and Leigh Warren sold 527,403 shares. However these three directors each retained more shares than they sold pursuant to the IPO. We understand that John Clifford remains Gentrack's largest single shareholder.

The prospectus and investment statement included certain forward-looking statements, in particular, information set out under the heading "Prospective Financial Information" in Section 9 *Financial Information* of the prospectus. The prospectus included a clear warning that the forward-looking statements should be read together with the other information in the prospectus, including the risk factors in Section 8 *What are my Risks?* and the assumptions and the sensitivity analysis set out in Section 9 *Financial Information*.

Gentrack's prospectus disclosed that its directors consider about 50-60% of their business revenue to be from relatively stable sources, including annual fees payable by customers for software licensing, support and maintenance. However, a significant portion of the business revenue is derived from new one-off projects such as major software implementation projects, which are a less stable revenue sources.

Less than 6 weeks after allotment of the IPO shares, on 1 August 2014, Gentrack issued a profit guidance update (the Profit Guidance) indicating that "whilst trading year-to-date has been in line with the forecasts set out in its Prospectus dated 4 June 2014, the [Gentrack] Board now considers that it is likely that its financial results to 30 September 2014 will be lower than forecast". In particular, Gentrack indicated that it expected reduced revenue, pro forma EBITDA and statutory net profit after tax for the period. The update indicated that the reductions were primarily due to:

“- a delayed go-live on a major project where a dispute has recently arisen between Gentrack and the customer on the payment for the extra effort required from Gentrack to complete the project, which Gentrack expects to be subject to mediation; and

- a delay in signing a substantial upgrade contract with an existing customer, which is still expected to be signed by the financial year end.” (the Delays)

The FMA’s review

The FMA contacted Gentrack’s professional advisers on 1 August 2014 to seek an explanation of the matters involved in the Delays. We emphasised the importance of keeping the market fully informed. In particular we queried whether a more detailed explanation of the matters should have been included in the Profit Guidance.

On 6 August 2014, Gentrack publically issued an update on its Profit Guidance. The update provided additional context around the matters originally raised in the Profit Guidance.

Following the Profit Guidance we have continued discussions with Gentrack’s directors and its professional advisers. Our review focused on trying to understand the nature of the matters that led to the Delays and understanding the directors’ assessment of the likelihood and impact of the relevant risks in the lead-up to the share allotment. The purpose of the review was to determine whether any further action by the FMA was appropriate.

Our review considered whether there was reason to believe Gentrack breached certain provisions of the Securities Act 1978 and/or the Securities Regulations 2009 in relation to:

- a. the description of the risk factors associated with the share offer in the offer documents; or
- b. the description of the principal assumptions on which the PFI in the offer documents was based.

Our review also considered whether the process followed by Gentrack’s directors in preparing for the IPO was appropriate.

Gentrack’s directors and professional advisers have fully cooperated with our review and provided explanations and documentation as requested. We coordinated our review with the NZX, who have shared responses and documentation provided to them by Gentrack. We have also held a meeting with the full board of directors of Gentrack (excluding Graham Shaw who was unavailable).

Gentrack’s continuous disclosure obligations, after the listing of its shares on the NZX Main Board, were not considered in our review and are not within the scope of this report. These issues have been considered as part of a review by NZX.

Gentrack’s IPO process

In preparation for its IPO, Gentrack planned and undertook a detailed due diligence process which commenced in January 2014. A due diligence committee (DDC) was established in January 2014 and met 11 times up to the date of allotment of the new shares.

Gentrack’s directors James Docking, John Clifford and (from March 2014) Graham Shaw were members of the DDC. Roy Grant, a former Chief Financial Officer of Gentrack, was also a member of the DDC. Leigh Warren (director) attended DDC meetings as an observer. Andy Coupe also attended DDC meetings as an observer from his appointment as a director in April 2014.

Gentrack's due diligence process included the production, review and update of PFI and financial forecasts. The directors considered the matters that gave rise to the Delays in detail in advance of allotment of the shares. A DDC meeting was held to consider the status of these specific matters on 18 June 2014 (prior to allotment of the shares).

Disclosure of the risks from variable project revenues

The following disclosures, amongst others, were made by Gentrack in its offer documents.

Section 8 *What are my Risks?* of Gentrack's prospectus referred to the risks associated with variable project revenues, in particular it said:

"A significant portion of Gentrack's core business is the implementation of challenging, complex software projects. There can be a range of factors that might result in a project not being delivered, either in a timely fashion or at all. Some factors are within Gentrack's control (for example, human error and the level of resources deployed), while others are outside of Gentrack's control (such as a failure by a third party). A failure to successfully implement a project for a customer in a timely fashion could have a material and adverse effect on that customer. Any such failure could erode the revenues that Gentrack would receive from the project, or expose Gentrack to significant additional costs or contractual penalties. As a result, Gentrack's financial performance may be adversely affected if it fails to implement projects, or experiences delays in the implementation of projects, for its customers. Such failures or delays may also adversely affect Gentrack's reputation in the market, which may reduce future revenues."

Under the heading "Specific assumptions" in section 9.4 *Prospective financial information* of its prospectus, Gentrack makes references to the assumptions on which it has based its forecasts of variable project revenues. In particular it says its prospective revenue forecast has been determined based on, amongst other things:

- "(a) Continued growth in Annual Contracted Revenues and non-contracted Support Services revenue derived from Gentrack's existing customer base.
- (b) New business opportunities which Gentrack has assessed as existing within the addressable market for its products and services and the expected growth rates in each market.
- (c) Historical sales track record and the existing sales pipeline for Gentrack."

Under the heading "Group sensitivity analysis" in section 9.4 *Prospective financial information* of its prospectus, Gentrack provides a warning that: "Whilst Gentrack has a significant level of contracted and repeat customers, part of the revenue during the Prospective Period is assumed to arise from new customer relationships. The timing and quantum of these new relationships are a potential source of uncertainty." A sensitivity analysis table is also provided, which is described as showing the "estimated impact of a pro-rata change in sales, assuming the product and market mix is unchanged".

Relevant legal requirements

Under the Securities Act 1978, issuers and their directors are responsible for ensuring offer documents do not contain untrue statements. A statement will be untrue if it is misleading in the form and context in which it is included in the offer document or it is misleading because it omits further information material to that statement.

The Securities Regulations 2009 requires prospective financial statements to be prepared in accordance with Financial Reporting Standard No 42 (Prospective Financial Statements) as approved under the Financial Reporting Act 1993 (FRS-42).

FRS-42 requires disclosure of all significant assumptions underlying the prospective financial statements.³ Gentrack addressed this requirement under the headings “General Assumptions” and “Specific Assumptions” in section 9.4 *Prospective financial information* of its prospectus.

FRS-42 also requires disclosure of the likelihood and potential impact of risks associated with prospective financial statements.⁴

The New Zealand courts have confirmed, more generally, that it is not sufficient to simply identify potential risks in a prospectus. A prospectus is required to “bring home the imminence”⁵ of those risks.

³ Paragraph 51 of FRS-42

⁴ Paragraph 49 of FRS-42

⁵ *Jeffries v R* [2013] NZCA 188, Randerson J at para [89]

Glossary

FMA/ we/ us	The Financial Markets Authority
Delays	The commercial delays described as being the primary reasons for Gentrack' s lower financial forecasts, as described in Gentrack' s profit guidance update dated 1 August 2014
Gentrack	Gentrack Group Limited
IPO	Initial public offering of shares
NZX	NZX Market Supervision
offer documents	The prospectus and investment statement produced in relation to the Gentrack IPO
PFI	Prospective financial information