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IPOs and Direct Listings: The Same, Only Different

“Exits” are the *sine qua non* of high risk/reward startup success. The place where business accomplishments intersect with financial reward for investors, founders and shareholders generally. The payoff for those who made the big, early and risky bets (career and capital) when others folded.

The IPO has been the Holy Grail of the startup exit world since the early days of the modern venture capital business. While the IPO has always taken a back seat to M&A-driven exits in terms of numbers, it has always been the real attention getter. For a founder, there is nothing quite like the charge that comes with taking a company – their company – public.

The IPO, it turns out, is not the only way to take a company public, just the overwhelmingly popular way. That might be changing, though. Over the last year or so, there has been a lot of noise – and even a couple of deals (notably Spotify and Slack) – about the “Direct Listing” public offering alternative. Let’s call it the DLO.

<u>A Rose by Any Other Name</u>. Before talking about the differences between the DLO and the IPO, it’s important to point out a crucial similarity. *Whether a company gets there via a DLO or an IPO, at the end of either transaction it is a public company, subject to all of the financial and other reporting requirements of public companies generally.* As far as the SEC is concerned, for periodic and event-driven reporting purposes and disclosure/accounting purposes, there is no difference between a company that goes public pursuant to a DLO and a company that goes public via an IPO.

<u>Might Not Smell the Same</u>. With that important reminder that a public company is a public company, whether it got that way via an IPO or a DLO, out of the way, let’s look at the biggest difference between the IPO and the DLO. In a DLO, unlike an IPO, the company does not create or sell any shares to the public. Rather, existing shareholders sell some

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of their shares to the public. That means, among other things, that the company does not raise any capital in a DLO.

	DLO	IPO
Investor Liquidity	Yes	Yes
Company Capital Injection	No	Yes
SEC Reg Compliance	Yes - same	Yes - same
Cost	Lower	Higher

Note, however, in both the IPO and the DLO, the company establishes a public market for trading its shares, and thus provides the basis for liquidity for shareholders generally – albeit subject to restrictions on timing and volume under federal securities laws and in many cases to contractual limitations between shareholders, investors, and the banks involved in the offering.

Why the DLO? The IPO has been the king of the public offering exit hill since the dawn of the venture capital business fifty and more years ago. Is the DLO a worthy challenger?

The primary attraction of the DLO – for the company, at least – is the cost. IPOs are significantly more expensive.

In an IPO a group of investment banks provides two services to issuing companies: underwriting the transaction, and marketing it to select buyers "building the book." The "underwriting fee" of 4-7% of the total offering value (sometimes as low as 2% in very large offerings) and the marketing expenses can run into an additional several million dollars or more. Beyond that, the nature of the IPO transaction – the banks actually buy the new shares issued by the company and resell them to the public (that's what "underwriting" refers to), is such that there is an incentive for the banks to underprice the shares – or, from the company's perspective, leave money on the table. (Historically, a significant majority of IPOs result in a closing price on the day trading starts that is significantly higher, often 30% or more, than the price paid by the investment banks for the shares.)

Now consider the DLO. First, there is no underwriting fee – as there is no underwriting. The selling shareholders sell their shares directly to the public. Second, the nature of the marketing process is much less expensive. Finally, with the shares passing directly from willing sellers to willing buyers, the closing price on the day of the offering tends to be pretty close to the opening price. (And even if there is any money left on the table, the company didn't leave it there, as the company did not sell any shares.)

The bottom line is pretty clear: the DLO is a much better deal for the issuing company than the IPO. Assuming, don't forget, that the company did not need any capital out of the offering.

Of course, just the opposite can be said for the investment banks. And so, it is no surprise that the investment banking community has not been very enthusiastic about DLOs. And that does matter, as banks, through their coverage of companies trading in the public markets, have some influence on how

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the public perceives various companies, and thus how much investor interest there is in various companies.

At the end of the day, the cost advantages of the DLO, even acknowledging banker biases against DLOs, are quite significant. Most companies heading for liquidity via a public offering would probably prefer the DLO vehicle (again, assuming raising capital is not among the objectives). And yet, the vast majority of companies, in pretty much every kind of market, hot, cold or middling (including the current market), take the IPO route. The relevant questions are why, and is that likely to change.

DLOs, Today and Tomorrow. Probably the biggest reason the DLO is being talked about these days is tied to the very unusual – arguably even unique – nature of the current exit market. Historically, the vast majority of venture-backed companies looking for an exit have done so in the context of needing to raise more capital as well as create a public market for early investors. As stressed several times, if a company considering a public offering exit route needs capital as part of the deal, the DLO just plain doesn't work. (At least not today: there has been some early noise about creating a DLO option that would include some newly issued shares being sold by the company along with the sale of shares by existing shareholders. Which – given that IPOs now and again include some shares offered by existing shareholders as well as the shares newly issued by the company – seems reasonable.)

In the "age of the Unicorn" there are, unlike in any past market, quite a few companies that need to create a public market to provide liquidity for early investors but don't need capital (even if they are burning through that capital at prodigious rates – another topic for another day). Further, many of these companies have been around longer than their peers in earlier markets. They are bigger, and have more customers and public visibility, factors that make DLOs, with their focus on more diverse/smaller buyers, more practical. The big question for folks who favor the DLO model in theory is whether these market conditions reflect a "new normal" (or at least new "not unique") or are an aberration.

Your guess on that is probably as good as mine. That said, my guess is that the current DLO-favorable environment is (i) winding down post the WeWork experience; and (ii) if not unique, an aberration that will only appear now and again, and not be a part of every open market "exit window."

Ultimately, I don't think the banks, powerful as they are, can stop the DLO phenomenon cold, but I don't think market conditions, over the foreseeable future, will force them to try. DLOs are here to stay – but not here in a very big way, and not likely to be part of a "new normal" any time soon. Unless and until, at least, the DLO evolves to include a capital raising component for companies. Stay tuned.

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