Path to the stock market through Direct Listings: path to success?

Introduction

Back in 2018, when critical discussions on Direct Listings were still ongoing, BSIC published an article, walking the reader through the main aspects of this innovative path to market.

At that time, markets were still waiting for the upcoming Spotify direct listing, which was raising several doubts in terms of feasibility and success.

Ever since then, the process of Direct Listings has been fine-tuned, casting light on the main opportunities and threats that companies face, when deciding to go public this way.

Broadly speaking, a Direct Listing, also known as DPO (Direct Public Offering), is a method used by private companies to list their stock on an exchange, allowing then-privately-owned shares to trade on the stock market, without necessarily issuing new shares and without the help of underwriters. It is considered an alternative to an IPO (Initial Public Offering). However, despite some few similarities existing between DPO and IPO, the two methods differ, as the next sections will point out.

How do Direct Listings work?

In order to understand all the steps involved into a direct listing mechanism, it is worth defining the role of the main character who is responsible for the success (or failure) of the whole process. The Designated Market Maker (DMM) is in charge of maintaining a fair and orderly market, so to facilitate the trading. As such, the DMM has two primary roles in the process: the first is opening the trading at the right "reference price", whereas the second is maintaining price continuity throughout the first trading days, so to minimize the effects of potential mismatch between supply and demand. This latter role turns out to be especially relevant, given the complete absence of any stabilization mechanism from investment banks (i.e. the exercise of the Greenshoe).

In order to determine the aforementioned "reference price", the DMM collaborates with the company's designated financial advisors (that is, investment banking teams). This price is settled in such a way so as to reflect the most recent price at which the company's shares were trading in the private market (sometimes by considering time-weighted averages), if trading actually used to occur. Otherwise, the price is settled by considering fundamentals and valuation techniques carried out by the financial advisors.

The night before the listing, the DMM disseminates the reference price, so that buy/sell orders can be collected the following day. It is worth highlighting that no trade is expected to take place at the reference price. Indeed, this price is purely intended to be the starting point of the "price discovery process", which begins in the very moment when the DMM starts collecting orders. This is indeed a further difference with respect to IPO, since in Direct Listings the price discovery process is a true "live-auction" of undefined size and price. Indeed, both these two variables adjust to demand from investors, and are not settled in advance.

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Pros and Cons of DL versus IPO

In principle, the main concern for a company when tapping the broader investor base, should be the stability of share price in the aftermath of the listing. Having this in mind, investment banks have been supporting the whole IPO process since the 1970s, through investors education in roadshows, a thorough price discovery process, and the potential exercise of the Greenshoe as a stabilization mechanism.

However, in Direct Listing, the role of investment banks has sensibly changed. Indeed, banks are now only supposed to be on the side of the Stock Exchange (mainly the NYSE and NASDAQ nowadays) and of the DMM, during the investigation needed to settle the reference price. As such, there is much more room left for volatility in the share price after the listing has occurred, which constitutes a first driver of uncertainty for the success of a direct listing process.

The second, and somehow debated, potential shortcoming of a Direct Listing process, when compared to an IPO, is linked to liquidity and smoothness of the trading activity. Indeed, Direct Listings do not embed any lock-up-period clause and allow pre-existing and new shareholders to trade from day one. On the one hand, this gives shareholders the opportunity to own very liquid assets from the very beginning and, in principles, this should avoid the artificial wave of trade which often occurs as soon as the 180-days typical lock-up period ends (as observed by the NYSE President Stacey Cunningham). From this perspective, this aspect of Direct Listing seems to ensure a smooth trading activity from day one. On the other hand, however, someone argues this feature paves the way for the exact opposite effect, i.e. to an unstable shareholder base even in the early stages.

Shifting from cons to pros, the direct listing clearly offers a very good opportunity for companies to tap the market, without involving a double-digit number of banks. Consequently, this method clearly involves a significantly lower effort in terms of fees and time, as already hinted at in the paragraphs above.

Anyhow, this aspect is just one of the several advantages that the Direct Listing process offers.

Indeed, a second important reason to undertake a direct listing is to avoid dilution. Indeed, new shares cause equity dilution, because the existing shareholders' ownership claim on the company is reduced. However, since no new shares are issued in a Direct Listing process, no dilution is generated (no new capital is raised, in principle).

A third positive aspect of Direct Listing is connected to the amount of information that the investor base is provided with before the event takes place. As a matter of fact, in an IPO process, institutional investors are educated before the listing occurs, and even participate to the price discovery mechanism. As such, they are endowed with privileged information against the broader investor base. In Direct Listing, instead, the roadshow does not take place, and every market participant is sharing the same amount of information ahead of the listing day. The absence of a roadshow per se, however, might be seen as a driver of potential loss of investors; the roadshows, indeed, are also intended to engage investors in the months that precede the listing, so to warm the markets; with no roadshows, the company runs the risk of losing potential investors' appetite.

Everything considered, however, as explained by some professionals who are actively involved into this new approach to the market, Direct Listings offer the same benefits as IPOs, without the need to go through the cumbersome IPO process. Indeed, even if a company chooses to tap the markets with a Direct Listing, it will still get a currency for future M&A transactions (i.e. the share currency), as well as the access to future new capital raising activities. Moreover, by going public, the company crystalizes a fair valuation directly from the market (under the hypothesis of market efficiency), also building a stronger brand and visibility. Needless to say, the fact

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that the company has gone public encourages the convergence between the interest of the employees and the interests of the company itself; as a matter of fact, employees find their equity options and warrants are now liquid, and they can directly benefit from the increase in their value, which is typically connected to good operational performance.

The table here below summarizes some of the main aspects highlighted throughout this paragraph.

FACT	THE POSITIVES	THE NEGATIVES
limited role IB team	lower fees	no price stabilization mechanisms
no roadshow	save time and no info asymmetry	potential loss of investors and no price discovery
no new shares issued	no dilution	no capital is raised
no lock-up	liquidity from day one	less stabiliy

Direct listing candidates: eligibility criteria

So far, two Stock Exchanges in the US are home to direct listings: the NYSE and the NASDAQ.

To be listed on the **NYSE** throught Direct Listing, the company must meet one of the following criteria:

1.	Have at least 400 shareholders, each of at least 100 shares or if less than 100 shares, of a trading unit
	*Same condition applies for affiliated companies and for companies listing following emergence from bankruptcy.
2.	**For companies listing in connection with a transfer or quotation or upon exchange of a common equity security for a listed Equity Investment Tracking Stock:**
	Have at least 400 holders each of at least 100 shares or if less than 100 shares, of a trading unit **OR** Have a total of 2,200 stockholders Together with an average of 100,000 shares (for most recent 6 months) as monthly trading volume

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	OR Have a total of 500 stockholders Together with an average of 1,000,000 shares (for most recent 12 months) as monthly trading volume

Towards the end of 2019, the NYSE proposed new rules regarding direct listing, aimed at encouraging more companies to use this method as a way to pave the way for capital raises.

As can be inferred from the table here above, among the best candidates for Direct Listing we find companies who are emerging from bankruptcy, coming from spin-offs, and exchanging common equity for listed equity investment tracking stock. What is worth pointing out is that these companies usually share the fact that they do not seek fresh new capital when entering the Direct Listing process.

Case-study: Spotify and Slack

Spotify Technology S.A. [NYSE: SPOT] – Mkt Cap as of February 14th, 2020: $25.99bn

Slack Technologies Inc. [NYSE: WORK] – Mkt Cap as of February 14th, 2020: $15.41bn

As Direct Listing gained popularity, in recent times there have been some big tech firms trying to avoid the traditional channels to the markets, as well as the complexity and the fees that come along them. Among these firms, Spotify, the leading music-content streaming company, received significant attention from the financial press and other developing tech companies when it announced its atypical market listing, in March 2018.

During an investor presentation, Daniel Ek (Spotify's CEO), said: "You won't see us ringing any bells or throwing any parties. The traditional model for taking a company public isn't good for us." And he had some reasons to believe so.
Spotify constituted a major breakthrough in the music industry, due to its ability to provide music through great streaming technology, which created data and user-tailored music. In fact, this has made Spotify's brand very strong. Spotify's streaming service knew very accurately what its client wanted, making music lovers extremely loyal to this service.
Spotify's executives were truly convinced that they did not need any additional cash to develop, aside from the regular revenue sources. Direct listing perfectly fitted these circumstances, because it would have allowed ordinary investors to bet on the firm's growth, allowing greater liquidity for investors, without the need to sell further shares and raise further capital.
At the time, the streaming service was pushing to become more profitable. Specifically, Barry McCarthy (the CFO that led the company to its market listing) was looking to turn the profit margin positive, as he did with Netflix when it went public. Having this in mind, he was trying to avoid the significative fees connected to IPOs, which could have costed over two- or three-times what Spotify paid for financial advisors through Direct Listing.
Alongside potential gains also came several risks. In fact, banks, investors, and the financial press expressed some concerns on the lack of the typical marketing activity that usually comes with an IPO, and on the absence of stabilisation agents for volatility reduction. From their standpoint, these facts could make the listing very vulnerable to a rapid decline in the share price.

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Not long after Spotify, Slack was the second tech company to choose Direct Listing. The working-place messaging app could somehow be compared to Spotify, both in terms of objectives and risks. The young, fast-growing, but still loss-making firm, valued at $13bn in March 2019, would have probably been trading its shares on the opening-day at an even higher price, if it had gone for IPO. However, Slack decided that it did not need further capital, and that it would have saved money through a Direct Listing, without selling any additional shares.

For Direct Listings, it is very hard to even know in which direction the share price will move. Indeed, while in IPOs the uncertainty mainly focuses on the amount of demand, in Direct Listing uncertainty also comes from the absence of information on how much share capital will be sold by existing shareholders. Market participants demonstrated reluctant to take part to this kind of exchange, where both supply and demand were hardly known. This caused the downfalls that both Spotify and Slack experienced at first.

Spotify's direct listing opened at $165.90, about 26% higher than the NYSE set reference price, and closed at $149.01 (-10% from opening), but then kept rising for a few months. As for Slack, it opened at about $37, peaking at $42 before falling to $20.

Silicon Valley's youngest have been watching the two very different performances, raising several doubts. However, there are tech firms which can rely on a strong brand recognition and are considering Direct Listing as well. Among them, we find Asana (a business software company led by Facebook co-founder Dustin Moskovitz), and Airbnb. Waiting for these next cases to hit the marketplace.

TAGS: #Nasdaq, #NYSE, #Spotify, #Slack, #Airbnb, #Asana, #DirectListing, #IPO, #SiliconValley

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