Is the IPO dead?

Introduction

Bullish tech valuations have companies flocking towards stock exchanges to make their debut on public markets. The IPO market is hot according to data from Zephyr, which says 53 companies worldwide went public in September[1], a 331% increase compared to the same time last year. 22% of those were tech companies forming an ever-expanding list of big names such as Snowflake, Unity and Palantir. Amidst this flurry of new listings, tech companies came up with creative twists on the IPO including SPAC listings, direct listings, and atypical offering placement mechanisms. This article demystifies alternatives to the traditional IPO and discusses whether they are value-add or fad.

Alternative #1: Reverse takeovers (also known as SPAC listings or Reverse Mergers)

The Claim: ***Reverse takeovers cut the middlemen (greedy investment banks) and are faster and cheaper***

Our Take:

In a reverse takeover, a private company (A) purchases enough shares of a "shell" public company (B), also known as SPAC, so that the private company (A) gains control over the public one. Then, the shareholders of the private company swap their shares for those of the shell company and there we go, company A is now publicly traded.

This year saw 91 new SPACs, which raised over $35bn. Opendoor, a real estate company based in San Francisco, is one of the latest to jump on the SPAC listing bandwagon. It will make its debut on the public market by merging with one of the shell companies of venture capital firm Social Capital's – Social Capital Hedosophia Holding Corp. II – in a deal that values Opendoor at $4.8bn.

Reverse takeovers are alluring: they take only a couple of weeks, compared to months or even years for an IPO and they allow the company to negotiate the offer price. This is very different from a normal IPO, where institutional investors determine pricing. Having a say in valuation is crucial for companies with complicated equity stories, which would get annihilated by investors in the standard book-building process. In the case of Virgin Galactic for example, a space travel company with almost no revenue, convincing one SPAC sponsor that the business was worth over $1bn was easier than trying to educate hundreds of investors on the matter. Moreover, the SPAC founder's seal of approval sends a positive signal to the market, which would otherwise be ridden with fear.

The notion that SPAC listings cut the middleman however is a misconception: unfortunately, there is no escape from investment banks. A sponsor needs one to IPO his SPAC and the to-be-listed company needs one to merge with the SPAC; both things cost fees. The SPAC records the IPO fees on its balance sheet as "deferred offering costs" and the listing company implicitly pays for them when they merge. The warrants that SPACs offer investors as an incentive to buy in represent another implicit cost, which may materialize in the future in the form of share dilution. Finally, SPACs also have additional management fees to cover operating expenses, which can add $2m to the bill. Compare all these costs to the management fee (~0.5% of offering proceeds), underwriting fee (~0.5%), and performance fee (~1.5%) in a traditional IPO, and it is not immediately clear which of the two is cheaper.

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Either way, listing fees are small money compared to the real problem: the IPO under-pricing also known as the IPO pop. This refers to the fact that companies' stock price goes up 10-20% on average on the first day of trading, which suggests the traditional IPO process leaves money on the table. Critics of the IPO attribute the IPO pop to an agency problem, whereby investment banks are incentivized to choose a low IPO price to keep their institutional investors happy so that they can continue earning commissions from them through Sales & Trading. Many idiosyncratic factors affect share price trajectory on the first trading day, and the type of companies opting for SPAC listings is different from the type going for normal IPOs, which makes it hard to compare the two and know whether SPACs can indeed mitigate the pop. A point often neglected however, is that banks have incentives to price IPOs high, not just low. Firstly, to ensure repeat business from the listing client (in the form of future seasoned offerings, block trades, M&A deals, financings, etc.) and to maintain a good reputation, which will get mandates from other companies looking to IPO in the future. Secondly, investment banks stand a lot to gain from Greenshoe options if they price the company high. A Greenshoe describes a mechanism that stabilizes a company's share price in the days or weeks following the IPO. As part of this mechanism, investment banks make money the more the company's stock price tumbles: recall Uber's train wreck of an IPO, where underwriters made $106m from IPO fees and ~$200m from Greenshoe options.

While it is hard to see through and make sense of all the factors affecting IPO pricing, it is easy to see that a traditional IPO has perks. Whereas an IPO feels like an all-inclusive resort, a SPAC listing feels like getting thrown into the wilderness. Indeed, the IPO package comes with valuable equity research coverage by the bank's analysts, a careful selection of the highest quality investors, and aftermarket support if needed by the company. In a SPAC listing, none of this is a guarantee, which means the stock is likely to face more volatility and trade lower.

Overall, we believe SPAC listings make sense for complex companies, which investors would penalize because they would struggle to understand it through standard IPO marketing activities. For most other companies however, SPAC listings do not offer benefits that clearly outweigh those of an IPO.

Alternative #2: Direct listings

The Claim: ***Direct listings are cheaper, create fewer misaligned incentives and provide better liquidity for selling shareholders than traditional IPOs***

Our Take:

Direct listings are not entirely new. In fact, companies across different industries have been using them for years. Only recently has the process garnered media attention following direct listings by high-profile technology companies such as Asana and Palantir Technologies.

Recent regulatory changes have made direct listings a viable alternative to IPOs for even more firms than before. In the past, companies could not raise any new capital during a direct listing, which turned away firms in need of cash. However, as recently as end of August 2020, the SEC permitted private companies to raise capital on any direct listing on the New York Stock Exchange, a move which paves the way for more such listings in the future.

Negative sentiment towards the traditional IPO process probably most contributed to direct listings' rise to fame. Aspects such as IPO lock-up agreements along with pricing and allocation processes are frequently subjects of discussion. Indeed: lock-up agreements, although being able to prevent flowback risk, create a lot of uncertainty for insiders. Even though on many recent IPOs, companies managed to negotiate an early release of the 180-day

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lock-up, the issue persists. Direct listings come to the rescue, as they involve no lock-up agreement, and all the company's insiders are free to sell their shares on the first day of trading.

Another major concern with traditional IPOs is the improper pricing mechanism, which as discussed prior, can set the company's offering price too low. In a direct listing, pricing is purely market-driven and is not disturbed by investment banks' misaligned incentives. It is interesting to note however, that direct listings are not immune to the IPO pop: Asana was up 43% and Palantir 34% on their first day of trading.

Additionally, since investment banks play a lesser role than in a direct listing, there is no need for a large syndicate. This means lower fees paid to investment banks. To compare: Spotify did its direct listing at a $29bn market capitalization and paid $35m in advisory fees while Snap went public at a $24bn market capitalization and paid $85m in underwriting fees. Slack did its direct listing at a $16bn market capitalization and paid $22m in advisory fees, while Lyft went public at a $24bn market capitalization and paid $64m in underwriting fees.

Yet, the direct listing does not come without any shortcomings. One of them is the need for company's management team to take control of the investor education process, as the investment bankers are not involved in investor meetings. This requires the management team to be experienced with navigating the complex public offering landscape.

Direct listings also lack the input from research analysts and their forward financial models, which are indisputably very useful for companies in an IPO. Investment banks do not allow their research analysts to participate in a direct listing due to regulatory restrictions. While a well-known company may get significant coverage from research analysts despite their banks not participating in the IPO, a lesser-known company may not.

Furthermore, direct listings cause more uncertainty as the market for the company's shares is limited by the number of shares that the insiders choose to sell on the open market. What is more, the company needs more time to educate their insiders about the direct listing process and how to sell shares.

All in all, despite additional experience needed within the company and some possible complications, direct listings seem to be an attractive alternative way to go public, especially for big name technology companies. With regulations becoming even more in line with firms' expectations and objectives, we can expect an increasing number of companies' management teams favouring direct listings in the future.

Alternative #3: Different offering placement mechanisms

The Claim: ***The way banks typically allocate shares to investors is highly subjective and does not extract the maximum possible value for the listing company***

Our Take:

Sometimes, companies follow the standard IPO procedure but with slight modifications at the last step – the offering placement.

In a traditional IPO, investment banks allocate shares at their own discretion. In theory, this guarantees a healthy aftermarket. Indeed, investment banks know how to steer clear from the investors that would dump their entire stake on day 1 and cause the company's stock price to plunge. They evaluate investors' orders based on price, but

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also look at qualitative factors such as the investor's IPO investment history, typical investment horizon, and interest shown at the roadshow.

The standard offering placement mechanism has downsides, however. The first is that it does not give companies the highest price they can get. The second is that it creates an agency problem, which could see investment banks allocating shares to their buddies, rather than to the best bidders.

Despite these issues, companies have mostly stuck to tradition regarding the share allocation mechanism. A slight "twist" can be observed in the recently announced IPO of Unity, a loss-making videogame software development company that raised $1.5bn. The "twist" is that Unity executives got involved in the final pricing and share allocation, thanks to a Goldman Sachs online system that made this possible. In theory, Unity's approach increases transparency and reduces agency costs. We will never know however whether involving Unity's management had a positive impact on the IPO: the company still saw high volumes of trading on the first day and was arguably under-priced, since its share price shot up 27%.

History has seen some companies take an even bolder approach to share price allocation. The most notable example is Google's use of the so-called "Dutch Auction", a very rarely used method. The process automatically determines the offering price based on bids received from potential investors, as opposed to global coordinators setting it. The issuing company sets a total number of shares and, at times, a potential price range. Investors submit a conditional order for a predetermined quantity and the highest price they are willing to pay per share. The issuer starts allocating shares to the investors, starting from the ones that offered the highest bidding price and moving on until all shares are allocated. The offering price is set at the lowest accepted bid. Once this is done, investors who bid at least the offering price know that their orders will be filled.

A Dutch auction guarantees the highest possible price for a company's shares, but several reasons explain why no recent IPOs adopted this method. Firstly, the listing company is likely to face more volatility in the aftermarket. Furthermore, investment banks tend to be less willing to allocate research and sales resources to an IPO where they do not play an important role. This in turn also makes institutional investors less willing to invest, since information about the company is scarcer.

To summarize, one can see why that the investment bank-driven share allocation mechanism has held up for a long time. Involving a company's management in the share allocation process like Unity, while not a negative thing, likely does not add much value. Dutch Auctions extract the highest price from investors, but they are also riskier.

Conclusion

IPO critics and SPAC sponsors may see the IPO's death as imminent, but we believe it is here to stay. Reverse takeovers and direct listings are welcome alternatives to the IPO, which make the listing process highly customizable to a company's needs in case a normal IPO does not suit it. These alternatives are by no means panaceas, however. Each comes with its own risks and none has definitively solved the under-pricing issue. Finding out how much a private company is worth is expensive no matter how you do it.

[1] Excludes deals with value <€100m

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