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Direct Listings, an Alternative to Stock-based Initial Public Offerings (IPOs)

Introduction

An initial public offering, or IPO, refers to the initial time that a private company offers its shares of stock to the general public to raise capital. After an IPO, the company's shares are traded in an open secondary market, such as an over-the-counter (OTC) stock market or a stock exchange. With the general decline in IPOs, an alternative approach to public stock offerings has emerged—direct public offerings (DPOs). A DPO, called a direct listing or a direct placement, is when a private firm's shareholders sell their shares on a secondary stock market, with the firm issuing no new shares.

Historically, stock-based IPOs were a significant means by which private firms raised funds for various reasons, including capital, operational, and research and development expenditures, and enabled owners to cash out. Between 2000 and 2019, the annual number of IPOs reportedly declined significantly from 406 to 159. That decline was part of the impetus behind the Jumpstart Our Business Startups Act (JOBS Act; P.L. 112-106), which eased regulatory requirements for some aspects of IPOs. Researchers have identified a number of reasons for the drop-off, including (1) an expansion in external private funding for firms that previously might have opted for IPOs and (2) recent structural business changes that reduced profits for small independent firms that heretofore might have opted for IPOs, but instead were acquired by larger more profitable firms.

Two recent potentially watershed IPO-related developments involved the novel use by two large private firms of a DPO as an alternative to an IPO. The two firms were Spotify, a Luxembourg-based music streaming firm, and Slack, a U.S. domestic software firm. Unlike an IPO, a DPO avoids the traditional investment bank IPO underwriting support wherein the banks buy an issuer's stocks and sell them to investors in their distribution networks. Such support can be especially costly for smaller-sized firms. In the wake of Spotify's 2018 and Slack's 2019 DPOs, discussion has grown on the prospect that, especially for high-tech firms, this alternative form of public offering may replace IPOs.

Unlike publicly traded stocks, a firm's private securities, or private placements, are generally exempted from registration with the Securities and Exchange Commission (SEC) if they are restricted to certain employees of the issuing firm, high net-worth investors, institutional investors, and financial institutions. Such companies may later conduct a DPO wherein a firm will list its shares on an OTC stock market or an exchange. When trading in the shares commences on that secondary stock market, the firm's shareholders are then free to sell their shares.

DPOs have largely been conducted by small-cap firms and SEC-registered real estate investment trusts (REITs) that have listed on OTC markets. The NASDAQ stock exchange has reportedly completed about a half-dozen relatively small and obscure DPOs, whereas the New York Stock Exchange (NYSE) has listed Spotify and Slack. Exchange-listed firms face more rigorous requirements than those listed on OTCs.

Case Study: Spotify

Spotify, the music streaming service, was founded in 2006 in Stockholm, Sweden. Now based in Luxembourg, the firm was officially launched in October 2008 as an invitation-only service, but later adopted a "freemium" business model. It offers certain free features while charging for streaming subscriptions with added features. As of June 2020, the firm had 138 million paid subscribers in more than 60 countries. It has continued to incur losses year over year, but somewhat less in recent years.

Several factors reportedly drove the firm's interest in conducting a DPO. Among them were an interest to provide greater liquidity opportunities to its investors in exchange for their holdings of the firm's private securities and a desire to participate in a more universally accessible public offering. In a traditional IPO, investment banks selectively allocate shares to their institutional investor clients. As is typical of private shares, there was rather limited trading of the firm's private shares before the DPO.

To help it conduct the DPO, Spotify hired several investment banks as financial advisors. They helped formulate its goals for the stock offering, navigated the SEC securities registration process, and aided in planning for various public communications about the offering, among other things. IPOs when compared to DPOs involve a more substantial and costlier role by the investment banks, including acting as underwriters.

As part of new rules adopted by the NYSE in 2017 and subsequently approved by the SEC, a company conducting a DPO generally must file a resale shelf registration statement. Such registrations require the company's shareholders to delay selling their registered company shares until the initial trading day. Using this rule, as a non-U.S. firm, Spotify filed the applicable SEC securities shelf registration form for foreign firms, Form F-1, which the agency approved. On April 3, 2018, Spotify's stock began trading on the NYSE at $165 a share, which resulted in a market capitalization of about $29 billion, surpassing a pre-DPO projection of $20 billion.

Perceived DPO Pros

Observers have identified a number of potential benefits of DPOs. They include the following:

- The overall costs of conducting a DPO tend to be less than that for IPOs because they do not entail generally costlier underwriting. Some, however, have observed that particularly for large IPOs, the conventional underwriter's cost is highly negotiable and frequently a fraction of the traditional cost. Slack and Spotify also paid fees to banks for advising on their DPOs. Slack reportedly paid $22 million in such fees. Spotify reportedly paid between $42 million and $49 million, although part of these price tags may have derived from the novelty of the deals.

- Firms conducting DPOs have no limits on the firm's early investors, senior officers, and directors selling their shares. In a typical IPO, a lockup agreement between an issuing company and its underwriters stipulates that such sales may not occur for six months.

- DPOs do not involve raising new capital, but after they are conducted, the issuer may be able to raise capital on favorable terms.

- IPOs involve the issuance of new shares, resulting in share dilution, which can reduce the value of existing investors' shares, thus reducing their proportional ownership of a firm. With no new shares being issued, DPOs do not result in diluted shares, thus avoiding the aforementioned impact on the shareholders.

- Firms that conduct IPOs are frequently said to leave "money on the table"—the number of new shares an issuer sells times the difference between the initial IPO offer price and the first day of the trading closing price. As a result of such initial IPO underpricing, an issuing firm's original investors incur an opportunity cost. Some research reports that from 2000 to 2017, the aggregate amount of money left on the table for moderate-sized IPOs (between $25 million and $100 million in 2011 inflation-adjusted dollars) and large-sized IPOs (of more than $100 million in 2011 inflation-adjusted dollars) was $38.9 billion and $23.7 billion, respectively. Because DPOs do not involve the issuance of new shares, firms that conduct them leave no money on the table.

Perceived DPO Cons

Observers have identified a number of potential disadvantages of DPOs. They include the following:

- An IPO typically involves underwriting investment banks doing something called book building, which involves the banks ascertaining signs of interest in the issuing firm's stock at various price levels to arrive at both an IPO size and share price. Also, as part of an IPO, the underwriting banks may acquire additional issuer shares to help stabilize share prices when trading begins. DPOs involve neither book building nor underwriter share support. Some reporting suggests that DPOs tend to experience comparatively greater initial stock price volatility than IPOs. An attendant concern is that lacking such share support, first-day DPO trading prices have a greater likelihood of significantly sinking than do IPO prices. Reports indicate that neither Spotify nor Slack experienced any of these potentially problematic first-trading-day scenarios.

- Some reporting suggests that liability risks for an issuer in a DPO are more limited than in a traditional IPO, potentially narrowing opportunities for legal redress by aggrieved shareholders. The limited risks are said to be because the issuer is not selling any of its shares to investors; only its shareholders do so. Also, an IPO's underwriters are reportedly liable for misrepresentations and omissions in the underwriting process. By contrast, some observers say that such legal obligations are not as clearly established for the banks that advise on DPOs.

- Non-U.S. firms that conduct DPOs could have diminished U.S.-based litigation exposure when their assets are primarily located outside of the United States. This could limit litigation-based monetary awards received by aggrieved shareholders. For example, in its registration statement, Spotify described itself as having such diminished litigation exposure.

- Some research argues that IPO underwriters perform a critical gatekeeping role with respect to prospective exchange-listed firms. The argument is that underwriters screen out firms that they project will not generate long-term investor profits from firms that they project will. As a result, it is argued that because DPOs lack such roles for underwriters, investor protections are reduced.

Emerging Developments

At present, there is a widely held view among practitioners and observers that firms with an interest in conducting a DPO that involves an exchange listing will generally be confined to firms (1) with a public brand, like Spotify and Slack, and (2) that do not need to raise new capital.

On August 26, 2020, the SEC approved a NYSE proposal to allow firms that list on the exchange to conduct a DPO that would also enable them to raise new capital as in an IPO. The same month, the NASDAQ stock exchange, the NYSE's principal competitor, requested SEC approval of a broadly similar proposal to the one approved for NYSE.

This more expansive type of DPO would allow a firm's initial shareholders to sell their shares, while also enabling the firm to raise new capital by selling newly issued shares to the public. Some observers think that the new structure may help to expand corporate interest in conducting DPOs.

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