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PERSPECTIVE

Direct listings: expanding the paths to public

By Sara L. Terheggen

While 2020 was a tumultuous year on many fronts as a result of COVID-19 and the election, the capital markets couldn't be bothered. It was too busy doing deals. 2020 was a great year for companies going public. In fact, traditional initial public offerings had their best year since 2014. Estimates indicate 194 companies went public in 2020, raising \$67 billion in capital. In addition to traditional IPOs, 248 SPACs raised around \$83 billion in 2020. Given SPACs typically have 18-24 months to locate a target, that gives 248 companies in 2021-2022 the opportunity to go public through a De-SPAC process. 2021 also brings with it a new exit path for public companies, direct listings. Historically, direct listings have not been utilized with much frequency as it only provided liquidity for existing shareholders. However, in December 2020, the Securities and Exchange Commission approved an NYSE proposal to allow companies using the direct listing route to also raise new capital. Some believe this shift is a gamechanger that will usher in a new wave of direct listings as companies opt out of the classic IPO process. While it is definitely true that direct listings, similar to SPACs, offer companies more options to becoming a public company,



the classic IPO route still offers benefits that will keep it a preferred choice for many companies.

Like any strategic decision, evaluating whether going public through a classic IPO or a direct listing process is all about determining a company's objective. Then, a company must be able to honestly evaluate its resources and its strengths and weaknesses as it relates to its debut on the public market. There is not a one-size-fits-all direction and there are several key distinctions between the

two types of going public options, distinctions that ensure both have a place in the new IPO landscape.

Disclosure and Diligence

One distinctive difference between a classic IPO structure and a direct listing is the disclosure and diligence process. In a classic IPO, which is the route most people think of when thinking about a company going public, a working group (consisting of the company, underwriters, their respective counsel, auditors and often

other advisors or consultants) spend countless hours together to prepare a Form S-1, or F-1 for a foreign private issuer. This is the predominant disclosure document in connection with going public. In addition to drafting this significant disclosure offering document often through several working group sessions, the underwriting syndicate and legal counsel will undergo an extensive diligence process. This diligence process feeds dynamically into the registration statement drafting process. The overall drafting process also provides a company with the distinct opportunity to vet their story and their marketing message and to hone their approach. This disclosure and diligence process can significantly improve the outcome of both the registration statement and the interactions with investors during the roadshow.

In a direct listing, while the disclosure document is the same, the working group is much more streamlined and would not include underwriters and their counsel. Direct listings do not require a firm-commitment underwriter. As a result, there is also no diligence process. The lack of diligence and therefore oversight on disclosure is cited as a significant downside for direct listings. Even though the SEC approved the direct listing proposal by the NYSE, certain SEC commissioners believe investors will lose a key protec-

tion by removing underwriters. This is because they believe the diligence process undertaken provides an important independent check on the company and its disclosures. Without it, some believe the registration statement will naturally contain more misstatements and omissions and there will be less confirmatory diligence around the statements that are made in the disclosure document. This can lead to more confusion for investors interested in participating in a direct listing but it can also increase overall liability for the company.

Pricing Function

Another key consideration and fundamental difference between a classic IPO structure and a direct listing is the pricing function. In a classic IPO, a price range is set following a negotiation between the company and the underwriters, and such range is included in the registration statement that is used for marketing on the roadshow. Upon conclusion of the roadshow, the underwriters will propose an exact price per share to the company and a total size of offering. In many cases, the exact price per shares falls within the initial range provided, or just under or just

over depending on demand and market interest.

In a direct listing, pricing is a function of trading price. Prior to the initial trade date, the stock exchange will publish a reference price set by one of the company's market makers. This reference price generally takes into account pre-listing dynamics (such as price of private trades) but this price is not constrained in the way an IPO price range is constrained. SEC rules mandate how much above or below a classic IPO can price but nothing mandates trading above or below the reference price in a direct listing. The new NYSE proposal does institute a new order type called the IDO order whereby there would be a price range included and the primary component of the direct listing could not be executed unless the entire quantity of shares included in the IDO order was sold within the specified range.

Critics of the classic IPO process have long lamented the pricing function of classic IPOs as broken because often the IPO price set and the initial trading price on the exchange are wildly different resulting in a significant pop in the stock price. Many believe direct listings will rectify this but it re-

mains to be seen how the IDO order mechanic could force a similar pricing dynamic.

Market Presence

Another major reason why a company may still choose a classic IPO route is to gain one important byproduct of the disclosure and diligence process, and ultimately the roadshow, market presence. For a company that does not have a strong market presence or strong institutional investor relationships, the classic IPO route can provide invaluable feedback and contacts that will serve as a critical foundation for future capital raising for a company.

Direct listings do not offer this same benefit but if a company already possesses a strong market presence or consumer brand, a classic IPO route may not be necessary to generate demand for their stock and such companies may naturally attract the type of investor base they seek. Spotify is a good example of a company who was able to benefit from the direct listing process because of its brand recognition.

Classic IPOs and Direct Listings are Both Viable Options

While a classic IPO and a direct listing ultimately both lead

to a company becoming public, these paths can be quite different. The choice of which path depends upon the needs of a company, its current market presence and its ability to successfully execute one route over another. While cost can also play a factor and it is widely publicized how much cheaper a direct listing can be for a company wishing to go public, cost should not drive this critical of a decision in the evolution of a company. There will be cost involved regardless of route taken and the benefits achieved from the classic IPO route may be well worth the added cost depending on the company. A strong management team and board of directors will not be driven by the cost of an underwriting fee, but rather the value it brings with it. While direct listings offer another viable option for companies seeking to go public, the classic IPO route is not going anywhere, anytime soon. Both give companies optionality on the path to becoming public which is a good outcome for the market and investors. ■

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