KNOWLEDGE@WHARTON | pwc

July 2014

http://knowledge.wharton.upenn.edu | www.pwc.com

Can Companies Adapt to Changes in the IPO Environment?

Can Companies Adapt to Changes in the IPO Environment?

At one time, an initial public offering (IPO) was considered de rigueur for growing companies — a seemingly endless availability of capital plus the panache conferred by a public listing helped to spur an avalanche of filings that swelled to more than 600 in 1996. But a spate of regulatory burdens — like the Sarbanes–Oxley Act (SOX) — raised the costs of going public, helping to curtail IPOs while spurring more interest in alternative capital sources, say experts from Wharton and PricewaterhouseCoopers (PwC).

"Companies and private venture sponsors now have multiple options when it comes to considering liquidity and sources of capital," including venture capital, private equity and debt, says Mike Gould, partner at PwC. Wharton finance professor Luke Taylor adds that "by volume, there's been a pretty big shift toward M&A as a means of exit, at least among venture-backed companies…. But the IPOs tend to be bigger exits…."

> "Companies and private venture sponsors now have multiple options when it comes to considering liquidity and sources of capital."
>
> —Mike Gould

While some sophisticated companies are thinking of alternative exits, the IPO market is not exactly drying up. The U.S. IPO market in 2013 was the most robust since 2007, as 238 public companies raised $56.9 billion, eclipsing the 146 IPOs that raised $42.9 billion in 2012, according to PwC's Annual Capital Markets Watch.

The strong showing continued into the second quarter of 2014, as 89 public companies debuted, representing $21.5 billion in proceeds, notes PwC's Q2 2014 IPO Watch. For the first half of the year, there were a total of 160 IPOs, generating $32.4 billion in proceeds compared to 97 IPOs totaling $21 billion in the same period the previous year. "The improving domestic economy, rising confidence among CEOs and continued record low interest rates all combined to fuel very strong activity in the U.S. capital markets during the first six months of the year," says Henri Leveque, partner at PwC.

Beyond access to capital, the incentives for launching an IPO include the ability to use publicly traded stock as a currency to acquire other companies, to attract talented employees, to diversify and reduce investor holdings and to provide liquidity for shareholders. A public listing may also enhance a company's brand and reputation in a new market.

While many firms still see public offerings as the way to go, says Gould, the first question that companies need to ask is: "What do we hope to gain from going public?" A public company must "meet shareholder and market expectations from day one. Companies will need to address ongoing compliance and regulatory requirements, operational effectiveness, risk management, periodic reporting and investor relations."

Downside Concerns

In the late 1990s and early 2000s, companies had a sense of having arrived when they did an IPO. But today, an IPO can also give rise to mixed feelings, notes Neil Dhar, a PwC partner. A CFO recently quipped to Dhar that the good news is the board wants to go forward with an IPO, and the bad news is that the board wants to go forward with an IPO. Going public can mean a lot of liability and stress. "He was glad about the capital infusion, but was concerned about possibly being pressured to manage for quarterly results instead of for long-term results."

Other issues that can dog a publicly held company include legal concerns: 94% of the U.S. merger and acquisition deals announced in 2013 valued at more than $100 million were challenged

in shareholder lawsuits, notes a survey by Boston-based Cornerstone Research, Inc.

And a PwC survey of newly public companies found that 48% of respondents said the cost of doing an IPO exceeded their expectations. Added to direct costs are ongoing tangible and intangible costs associated with transparency and disclosure requirements, as well as other issues.

SOX, for example, requires CEOs and CFOs to report the effectiveness of internal control over financial reporting. The company's external auditor is required to annually attest to the effectiveness of the company's internal control over financial reporting. Further, as the economy becomes more global, public companies considering overseas or dual listings will need to evaluate the impact of International Financial Reporting Standards on the offering process.

> "The improving domestic economy, rising confidence among CEOs and continued record low interest rates all combined to fuel very strong activity in the U.S. capital markets during the first three months of the year."
>
> —Henri Leveque

There may even be some evidence to suggest that IPOs are not as efficient as issuers would hope, Taylor adds. "There's a big misunderstanding about IPO underpricing," he says. "When new offerings like Twitter [which soared some 73% above its offering price during the first day of trading, jumping from $26 a share to more than $45] pop up, I see it as money that was left on the table by the company."

Underwriters and early investors make out well, Taylor explains, but "extreme underpricing may indicate that the investment banks erred on the low side in their pricing advice," essentially resulting in a shortfall for the company.

Historically, a significant number of IPO investors have not made out too well either, according to David Musto, a Wharton finance professor. Even in the booming 1990s, evidence indicates that investors who bought and sold newly public companies on the first day of trading tended to profit nicely, but those who purchased IPO stock in the secondary markets and held on to it tended to see constrained gains or, in some cases, a loss on their initial investment.

"The results indicate that many IPOs were indeed underpriced initially" he explains. "The market valuation may quickly rise, but then tends to stall or even fall back."

There are exceptions, such as social media companies, where the current consumer demand translates into hefty market valuations. "But overall, the takeaway for investors is that if you can buy into an IPO early before it lists, and then sell the stock the first day of trading, you're likely to make money. But if you hold it longer, your gains may be less — although as a group IPOs continue to be up on their IPO price." Musto notes.

Intangible Benefits

For some issuers, the benefits of an IPO go beyond tapping a new capital source — a new stock market listing can enhance brand recognition. A public company's stock may also function as a kind of currency for attracting and retaining employees, or for a merger or acquisition.

But companies have other options, including exempt offerings and private equity (PE) transactions.

Exempt offerings (144A offerings) are transactions where securities are sold on a restrictive basis to sophisticated investors with very limited SEC filing and reporting requirements, notes Dhar. "Because there is no requirement for a Securities and Exchange Commission review process, the transaction can be completed faster, generally at a lower cost compared to an IPO."

Further, in a 144A offering, funds can be raised immediately, but the costly and cumbersome public company reporting obligations are deferred until the securities are later exchanged for registered securities.

PE sales are also gaining steam, with more than 500 PE firms in operation, each with assets of $1 billion or more, according to some reports. In a PE transaction, shares are sold directly to private buyers outside of an exchange, which may enable the issuing firm to initially transfer more equity at a lower cost — and without a mandatory SEC review. Underwriters are generally not required in a private sale, although they may add valuable support, say PwC experts.

One example of a private sale is Facebook's late-March announcement of a planned $2 billion purchase of Oculus VR, a virtual reality headset company, notes Musto. The $2 billion deal reportedly includes a $400 million cash component and $1.6 billion in Facebook stock, and was to close in the second quarter of 2014.

> "The takeaway for investors is that if you can buy into an IPO early before it lists, and then sell the stock the first day of trading, you're likely to make money. But if you hold it longer, your gains may be less — although as a group IPOs continue to be up on their IPO price."
>
> —David Musto

"The Sarbanes-Oxley Act may have had the unintended consequence of spurring more private placements," he observes. "Instead of startups seeking to go IPO, they may consider a model that will be a threat to a company like Facebook — or one that complements it — in the hopes that a tech giant will buy the startup."

"In today's low-interest rate environment, the cost of PE capital may be higher, but billions of dollars are sitting on corporate balance sheets, and PE investors want to put them to use," notes Dhar. PE portfolio companies generally have a three- to seven-year exit strategy. "At the end of that timeframe the investors will usually look to either sell the securities to another firm that has synergies, or to another PE investor, or they may go with an IPO, especially in a relatively strong market like this one."

Weighing IPO Costs

Top management knows that going IPO is a transformational experience and requires significant changes to processes, reporting and other structures. Yet many companies embark upon this process without understanding all of the costs.

This was dramatically illustrated in a PwC study "Considering an IPO? The costs of going and being public may surprise you," which revealed that the one-time costs associated with an IPO had exceeded the expectations of some 48% of participating U.S. CFOs.

The costs associated with going public can vary significantly based upon the size of the offering, size and complexity of the company, and their current level of preparations. However, there are four basic buckets of costs, notes Gould. First are expenses directly attributable to the IPO, "which are netted against the proceeds." These include underwriter discount fees equal to about 5%-7% of gross proceeds, and "another $3.7 million, on average, for road show expenses and for legal, accounting and printing fees associated with drafting the registration statement and comfort letter."

The second bucket of costs, which can easily total another $1 million or more, are typically incurred for: tax and legal restructuring in anticipation of the IPO; additional audit, interim and quarterly reviews; and advisory accounting and other costs to make the financial statements SOX compliant. Also included in that estimate are valuation reports, new articles of incorporation, the audit committee charter and by-laws, and other agreements.

The third bucket can also run to $1 million or more and consists of one-time costs for converting to a public company. These are also expensed as incurred, and include costs or charges: to implement new financial reporting systems and processes; to document internal

controls and comply with SOX; to identify and recruit a new board of directors; and to implement new executive and employee compensation plans.

Even after completing an IPO, a company typically incurs ongoing, incremental costs associated with being a public entity. This fourth bucket may run $1.5 million or more each year, and can include internal staffing costs for accounting, tax, legal, human resources, technology, internal audit and investor relations services, as well as outside professional fees for legal and accounting advice.

"The planning process for an IPO can start the day a company is incorporated or as late as three months before a public offering."

—Derek Thomson

Given the number of variables, any particular IPO can be considerably more expensive, cautions Gould. "In some cases a company may spend $10 million in order to raise $30 million in an IPO. So it's important to bring management and outside advisors together early on to thoroughly investigate the costs and benefits of an IPO, and of the alternatives to an IPO."

The Right Team

"That's one of the reasons that an increasing number of companies are using independent capital markets advisors to help them navigate the process," Gould explains.

Independent capital markets advisory firms, also known as IPO advisors, are often staffed with former investment bankers and other experts. Among other services, they can help management build the IPO plan, keep task lists, monitor progress and forecast delivery dates. They may get involved at the start, gathering information for the registration statement, and then help throughout the process, from assisting during the SEC comment period to helping the firm prepare as it makes the transition to a public company.

Initial considerations about going public are often limited to a company's owners and its CEO (who may also be an owner). If they decide to move ahead, the CFO is usually brought in at this time and will become the focal point of the IPO execution.

"The planning process for an IPO can start the day a company is incorporated or as late as three months before a public offering," says Derek Thomson, a director at PwC. PwC recommends an orderly plan over one to two years. "This window gives a private company time to think, act and perform as a public company."

Early on, however, a company may wish to add staff in marketing, operations, development and finance with public company experience. It may also want a CFO who has previously been through the IPO process.

The company should also consider a search for qualified outside board members, and may wish to build relationships with an investment banking firm, law firm, accounting advisors and an independent auditor, since these help establish credibility.

In the pre-IPO period, an issuing company typically considers questions like how much money to raise, what type of security to issue and what the preliminary valuation should be, observes Taylor. "During this time — known as a beauty pageant or bake-off — a lead underwriter and other underwriters in the syndicate will be selected, the underwriting contract will be negotiated, and board approval will be sought."

It's also important to have the right team before beginning the road show — the issuer's presentation of securities to potential buyers. "The road show is when you'll be gathering important information related to the pricing of the securities," Taylor says. "During the road show, top management will travel around the country, or internationally, to give presentations to analysts, fund managers and potential investors

— the issuer will gather 'soft' information about the demand for its securities."

During these presentations the rule of thumb is to lay out the proposed deal and highlight the key investment selling points, typically with five or six bullet points, explains Dhar.

"Extreme underpricing may indicate that the investment banks erred on the low side in their pricing advice."

—Luke Taylor

Information, such as data analysis and the executive summary, should be short and to the point, he says. "But you also have to be prepared to go one-on-one with individual investors, and ensure that you're able to drill down to the main points of your story and explain why your management team is the right one for the company. Investors will be on the lookout for weaknesses in your argument."

There is also a need to describe your company in a "crisp and concise way," says Thomson. "If you go into too much detail about your company's supply chain and value proposition, the investors' eyes may glaze over. Instead, you've got to be able to communicate in a short and concise way just how your company will make money."

Determining where to list is another critical decision.

"Many elements must be considered," says Dhar. "Let's say you're a software company based in Europe — should you list in your home market or in another venue? Key consideration points will include who you anticipate will buy your stock, and where you plan to grow."

Listing in multiple markets may be an option, he adds, "but then you also have to consider how you'll meet the reporting requirements in each market, how you'll communicate with investors, and what peers your company will be compared with. These kinds of decisions usually require a great deal of forethought and analysis."

The next stage is the "book building" process, when underwriters accept orders for shares from investors, who indicate the number of shares they want and the price they are willing to pay.

The goal: Discover the right offer price and find investors to buy shares, says Taylor. "At this point, the prospectus may be amended as needed." The day before or morning of the IPO, the underwriters will set the final offer price and the number of shares to be issued.

Developing an exit strategy — whether an IPO or another approach — is critical in today's globally interconnected and highly regulated environment. But the options have evolved fast, market demands are higher and evaluating the best path has become more complex. Regardless of the final approach, a growing company that takes the right steps at the start can save a significant amount of time and resources.

This article was produced by Knowledge@Wharton, the online business journal of The Wharton School of the University of Pennsylvania. The project was sponsored by PwC.

www.pwc.com http://knowledge.wharton.upenn.edu

Founded in 1881 as the first collegiate business school, the Wharton School of the University of Pennsylvania is recognized globally for intellectual leadership and ongoing innovation across every major discipline of business education. With a broad global community and one of the most published business school faculties, Wharton creates economic and social value around the world. The School has 5,000 undergraduate, MBA, executive MBA, and doctoral students; more than 9,000 annual participants in executive education programs; and a powerful alumni network of 92,000 graduates.

ABOUT KNOWLEDGE@WHARTON

Knowledge@Wharton is the online business analysis journal of the Wharton School of the University of Pennsylvania. The site, which is free, captures relevant knowledge generated at Wharton and beyond by offering articles and videos based on research, conferences, speakers, books and interviews with faculty and other experts on global business topics.

For more information: http://knowledge.wharton.upenn.edu

PWC DEALS

PwC's Deals practitioners help corporate and private equity executives navigate transactions to increase value and returns. In today's increasingly daunting economic and regulatory environment, our experienced M&A specialists assist clients on a range of transactions from smaller and mid-sized deals to the most complex transactions, including domestic and cross-border acquisitions, divestitures and spin-offs, capital events such as IPOs and debt offerings, and bankruptcies and other business reorganizations. We help clients with strategic planning around their growth and investment agendas and advise on business-wide risks and value drivers in their transactions for more empowered negotiations, decision-making and execution. We help clients expedite their deals, reduce their risks, capture and deliver value to their stakeholders and quickly return to business as usual. Our local and global deal strength is derived from our deal professionals in 35 cities in the U.S. and across a global network of firms in 75 countries. In addition, our network firm PwC Corporate Finance provides investment banking services within the U.S.

For more information, visit www.pwc.com/us/ipo

ABOUT THE PWC NETWORK

PwC firms help organizations and individuals create the value they're looking for. We're a network of firms in 158 countries with close to 169,000 people who are committed to delivering quality in assurance, tax and advisory services. Tell us what matters to you and find out more by visiting us at www.pwc.com.