Capital Markets

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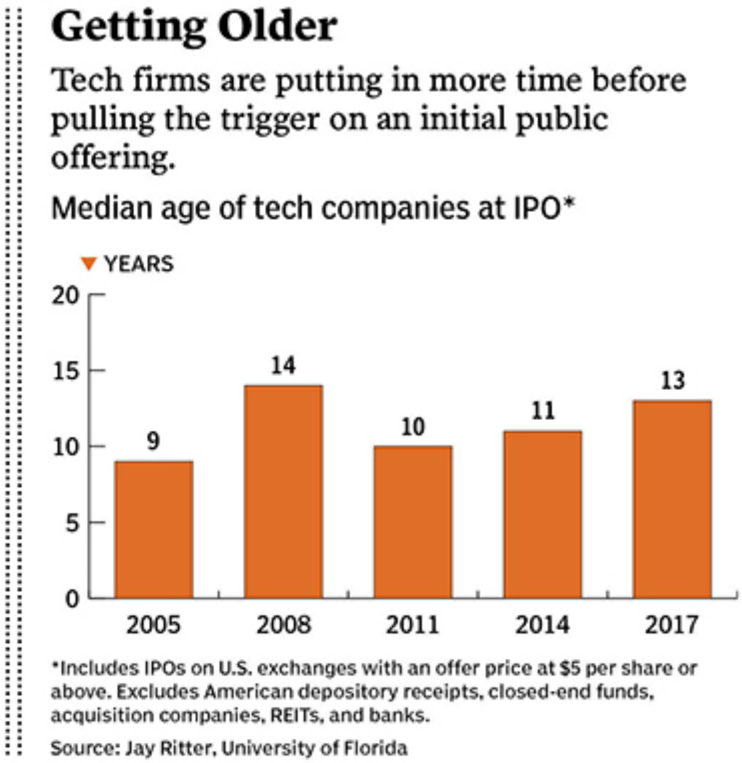
Should You IPO?

Unless your company is big, profitable, and a category leader, the wisest choice may be to wait.

The number of U.S. tech IPOs over the past few years has been disappointingly low, and that trend could continue. Investors hoping to catch an early ride on the next Facebook or Google initial public offering may be waiting a long time. On the issuer side, fewer startup employees and C-suite executives may have a chance at realizing their IPO dreams.

In spite of near-perfect market conditions — booming performance of equities plus historically low volatility for tech stocks — only about 30 technology companies went public in 2017 (not counting those with offer prices below $5 per share), according to University of Florida professor Jay Ritter. Meanwhile, the list of private tech companies worth $1 billion or more, also known as unicorns, swelled to 276 worldwide, according to Crunchbase. That list of richly valued tech startups includes 16 “decacorns,” or unicorns valued at $10 billion or more.

Why are so many growing tech companies (and firms in other industries) choosing to sit on the bench, and for so long? Unicorn CFOs, investors, and consultants say that easy access to continued rounds of venture capital funding, with too much capital chasing not enough deals, makes it much easier to stay privately held. Changes to U.S. securities law have also made it easier to delay issuing on the public markets. Notable tech IPOs that fell flat last year have also induced caution.



If Snap, owner of Snapchat, had performed better after its March 2017 IPO — it went public too early with a valuation that was way too high, analysts claim — more tech IPOs probably would have launched in 2017, says Barrett Daniels, CEO of Nextstep Advisory, an IPO adviser in Burlingame, Calif.

"Because Snap didn't [perform well], I think it opened up a lot of eyes, especially at the other really big companies, and made them step back and say: Maybe we have a little bit of work to do before we go down this path," says Daniels. Blue Apron didn't help when it followed a couple of months later with "quite possibly the worst IPO of our lifetime," Daniels says.

But there are deeper reasons why many companies hesitate to issue equity to the public anymore. For one, going public is no longer necessary for raising capital; in fact, it's best to have all the capital you need before going public. Being public also limits subsequent funding options, forces companies to be overly precise with forecasts, and opens the door to aggressive short-sellers and activist investors. And that's just the beginning of the disadvantages list.

No Need

From the CFO's perspective, there are two reasons to go public: raise capital for the business or provide a liquidity event to employees and early shareholders, says Jason Child, CFO of Opendoor, a $1.1 billion unicorn in San Francisco that buys and sells homes directly online.

Before 2010, if just one of the two factors was in play for a company, that company would conduct an IPO, says Child, who worked through IPOs at Amazon (he was there for 12 years) and Groupon (where he served as CFO). Today, CFOs are much more cautious about moving ahead with an issuance. The CFO weighs whether the company needs capital, and then looks at the potential sources. Because the amount of private capital now coming into the early-stage market for tech companies is so large, the bar for CFOs going public is much higher.

“You can be a little more stringent on making sure you’re ready, because of the fact that you can still probably get capital for the business,” Child says. “It might come with a different set of terms, but at least you have that capability.”

Venture capitalists invested $84 billion in about 8,000 tech startups and other entities in 2017, the most since the early 2000s, according to Pitchbook and the National Venture Capital Association. And unicorns, like Lyft and WeWork, received $19.2 billion, or 23% of all investments. There’s reason to expect this trend to continue, with U.S. venture capital firms raising $32 billion in 209 funds in 2017, marking the fourth consecutive year of surpassing $30 billion.

Liquidity events for employees and shareholders are also less dependent on IPOs these days. The IPO is the most efficient market for a private company aiming for liquidity: There’s a seemingly infinite availability of potential buyers to set the right price, Child says.

But there are other options — employees can sell private shares on secondary markets and even borrow against their options through companies like Sharespost. Private companies can also conduct direct sales, allowing a new investor to purchase outstanding shares directly from one or more existing stockholders, according to law firm WilmerHale. Or a company can take an investment followed by a stock redemption — a new investor injects funds directly into the company in an amount that exceeds the company's current needs, and the company then uses the excess funds to redeem a portion of the stock held by one or more existing stockholders.

Bigness Required

While more IPO alternatives are available, breaking through on the public markets is more difficult. Equity investors have informal requirements for what they want in an IPO company, and fewer and fewer firms qualify. To launch an IPO today, a company needs to be bigger, more profitable, and growing faster than it would have had to be 10 to 15 years ago, says Hollie Haynes, founder and managing partner of Luminate Capital Partners, a San Francisco–based private equity firm.

Amazon's successful public offering in 1997, for example, raised $54 million. The company's revenues were only $16 million in the quarter it debuted, and the business was unprofitable. Snap's "unsuccessful" IPO in 2017, in contrast, raised $3.5 billion.

More tech companies are driven to launch as a large-cap stock now because of the greater demand by the investing public and institutional shareholders for large-caps, agrees Sonya Brown, general partner and co-head of growth equity at Norwest Venture Partners. "Both the [need for] liquidity in the market and the cost of being public have forced companies to focus on being larger than they have been in the past," Brown says.

Another factor is the lack of boutique market makers and research firms to support smaller IPOs, says Paul Pedevillano, whose VE Advisors provides CFO services to early-stage tech companies. As those niche banking firms have died off, it's become harder for small tech companies to maintain investor interest.

"The irony here is that the IPO is a fundraising event, but it's really only available to companies that don't need the money."

—HOLLIE HAYNES, managing partner, Luminate Capital Partners

From the business perspective, unless a company can claim category leadership, with a large addressable market and competitive advantage, it's probably also going to have a difficult time, Child says. Public markets are not a great source of primary capital, and public investors don't want to fund business plans, Haynes emphasizes. "The irony here is that the IPO is a fundraising event, but it's really only available to companies that don't need the money," she says.

Held to Account

If it sounds challenging to squeeze through the eye of the IPO needle, there's more to consider. To help answer when an investor asks about Opendoor's timeframe for going public, Child keeps a mental scorecard. For example, the top question on the scorecard is: Are the "table stakes" in place? In other words, does finance have a tight accounting close process, where the CFO knows the numbers within five to six days, and the results are as forecasted for the month, quarter, and year?

If a CFO can't forecast the top-line and bottom-line numbers with accuracy of 95% or better for quarters or 75% to 80% for the year, then the company is probably not ready to go public, Child says. Shareholders will measure a publicly traded company by how well the company, and its CFO, deliver on its forecasted numbers and execute against the forecast.

"The market does not love volatility," Child says. "Public markets punish your lack of ability to forecast or to really understand what's going to happen in the next quarter or next year. That is something that's a key part of the calculus or decision process of whether or not a company is ready to go." The CFO also has to be skilled in explaining the business and helping the investor understand it, Child says.

If a company doesn't meet these specifications, the going can be rough. Company founders and CFOs who take their companies public need to understand and accept the criticism they will be opening themselves up to, along with the fact that their stock will become open to shorting, Child says. "Don't go public until you're ready for the fact that people can short your stock, and they can short it for a bunch of reasons," he says.

Another disadvantage is that once a company goes public, its financing options are basically limited to more public equity issuance or debt financing, says Luminate Capital's Haynes. "When you're private, you can do all sorts of different types of structured securities with a million different venture and private equity investors," she notes. "If you are really good at marketing, you can find somebody to invest in your company in some creative way. It just gets a lot harder to do that once you're public."

SoftBank Group’s $100 billion Vision Fund, which includes investors Apple, Qualcomm, and Sharp, is a prominent example of a liquidity financing option available to unicorns. In January, SoftBank’s fund completed a deal to become the largest shareholder in Uber, providing liquidity to Uber’s early employees ahead of the company’s planned 2019 IPO.

A Healthy Trend

Putting off an IPO like Uber has clear advantages. Even for investment bankers and exchanges, which want to set good expectations of new issue performance and promote confidence in IPOs, it’s better to have no deals than experience more Snaps and Blue Aprons.

Beginning Of A Rebound?

+43%
Number of U.S. tech IPOs in 2017*

+212%
Total 2017 proceeds*

11.7%
First-day return in 2017, all IPOs

-11%†
IPOs in the pipeline for 2018

*Compared with 2016
†As of December 19, 2017, according to Renaissance Capital
Source: Jay Ritter, University of Florida

Changes to U.S. securities law under the Jumpstart Our Business Opportunities Act may be helping in this regard. Before the 2012 law was passed, private companies with 500 shareholders were required to follow SEC registration and reporting requirements; the JOBS Act changed the threshold to 2,000 shareholders and eliminated options holders from the count.

Because nearly all tech startups issue shares or options to their employees, and because the SEC reporting requirements were just as onerous as simply going public, the 500-shareholder rule essentially meant that companies would file IPOs as they neared the threshold, says Nextstep's Daniels. Now, fewer companies are being "pushed" into the public markets prematurely.

The longer period of being private can help the evolution of a tech company's technology and business model. Brad Schneider, CFO of Rocket Lab, a commercial satellite launch business based in Los Angeles and valued at $1 billion, says tech companies have to make sure that they don't neglect funding their technology development in favor of building out manufacturing capacity or pursuing other investment priorities of later-stage companies. "Tech development needs a lot of capitalization and a lot of patience from investors," he says.

"Born from experimentation and innovation, these business models often take years to develop," echoes Nikhil Abraham, CFO of Udacity, an online education firm. "If a company has figured out enough of its model to raise significant private capital to fund operations, it seems sensible to continue experimenting to improve financials out of the public eye."

And patience appears to be more common now, as a change in thinking at the single biggest capital source for tech startups — venture capital firms — takes hold.

In 2017, the number of venture-funded companies exiting through either an initial public offering or an acquisition dropped to 769—the lowest since 2011. Pedevillano of VE Advisors says a key difference with the newest generation of venture capitalists is that they're more interested in building good relationships with the founders and bringing in successful entrepreneurs to mentor and provide services to the companies they invest in.

"The relationship between the VC investor and the company used to be much more combative."

PAUL PEDEVILLANO, founder, VE Advisors

"The relationship between the VC investor and the company used to be much more combative," Pedevillano says. "When I got started, the one thing VCs wanted was their entrepreneurs to be poor so that their entire focus was on making the company successful and having the big liquidity event."

He explains: "The VCs now are more amenable to founders getting some liquidity prior to an IPO or prior to a sale to take the pressure off of short-term thinking, because the founder may have kids in college, or they've never had a hit, or whatever," he says.

Companies and their early-stage investors are increasingly creating separate series of shares for founders that can convert to preferred shares in later rounds of equity financing, so the investors in those later rounds buy those shares from the founders to give them some liquidity, Pedevillano says.

Venture capitalists want to maintain the growth momentum of the early-stage tech company, he explains, focusing on how to accelerate growth and investing more money if that will help the company grow faster. The sale or IPO discussion begins only when growth slows.

“I’ve never sat in a board meeting where an investor says we’re going to build this to flip it to somebody,” Pedevallino notes. “They want you to build the greatest company possible, because if you build a great company, price will never be an object when you either go public or sell the company.”

Unavoidable?

As unicorns age, their investors will eventually seek an exit, which could spur more of them to commit to IPOs, however unattractive they may seem. And not every company is going to follow the unicorns’ route — some will try to list earlier. That’s because the financial profile of a company that is heavily funded by private capital for years is not something desirable to retail and institutional investors in public markets.

A company with total capital invested that is high relative to the size of the business, and that is still burning through lots of cash, makes for a financial profile difficult for the public market to accept, says Haynes.

In essence, the easy availability of venture capital for new rounds of financing can become a crutch for companies to put off the phase of development when they start to show profits. “Showing current profitability or a very near-term path to it is really important,” Haynes says. “It’s a top-three issue for [public market] investors.”

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Just Another OK Year?

The last really good year for U.S. tech IPOs was 2014.

The number of tech-company IPOs in 2017, 30, was slightly below average for the last 10 years, according to figures compiled by Jay Ritter, professor at the University of Florida. From 2013 through 2016, the number of tech companies launching IPOs was 43, 53, 36, and 21, respectively. In the years prior to the recession, the tech IPO numbers were much higher, peaking at 75 in 2007.

The 2014 number, 53, generated great expectations for tech IPOs for subsequent years, but tech companies failed to deliver, despite excellent market conditions, says Barrett Daniels, CEO of Nextstep Advisory. “You would think that the IPO market would be having an absolute heyday, but it’s not. It’s just been OK.”

In 2018, the conditions again could be ripe for a monster tech IPO season, Daniels says. Overall, by January 24, nine issuers in the U.S. IPO market had raised about $6.2 billion, according to Renaissance Capital. The biggest tech deal completed ($2.3 billion) was PagSeguro Digital, a Brazilian fintech operation that offers payment services to small and midsize companies. Big names that could come to market this year include Lyft, Dropbox, Adyen, Airbnb, Pinterest, Zuora, and Credit Karma.

Daniels anticipates just another “OK” year, though, for the same reasons that tamped down offerings in 2017. He worries that aging unicorns staying private longer could be stifling the rate of startups and innovation over the long term.

“The nature of Silicon Valley is people leaving startups to go do new startups, and that has fundamentally changed,” Daniels says. “Employees are being locked to these companies for much longer than they used to. Who knows if the next Google is handcuffed to a desk at Airbnb because the person doesn’t want to leave $2 million in options behind? And who would?” —**K.B.**