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Silicon Valley bankers and lawyers push for an IPO alternative

By Abhishek Banerji, LL.M Candidate 2020 | October 4, 2019

Bankers and lawyers have recently recommended that companies use direct listings as an alternative to initial public offerings (IPOs). A direct listing allows a company's shareholders to sell their existing stock on the stock exchange without having to go through the underwriting process involved in an IPO. However, a direct listing cannot be used as a means for generating capital since it does not entail the issuance of new shares.

Companies that have recently completed a direct listing are Spotify and Slack. However, especially in the case of Spotify, the companies did not require any additional capital. Therefore, there was no need for an IPO in these cases. Furthermore, Spotify's transaction involved two components: a partial direct listing and a partial IPO.

Bankers from Morgan Stanley, Goldman Sachs and lawyers at Goodwin Procter and Latham & Watkins have argued that the underwriting banks involved in an IPO typically price shares at a price cheaper than their true market value. This is common practice among conservative underwriting banks who believe that a company's IPO will not generate a high return. Furthermore, these advisers were involved in the Spotify transaction, and after realizing the gains from the direct listing, now seek to corner the direct listing market.

Within the IPO context, it is the SEC's objective to get U.S. companies to launch their IPOs early, thereby increasing the total number of publicly traded companies. As a result, this would increase the number of retail investors by giving them access to buying shares on the stock exchange. However, given the criticism mentioned above, an IPO may not be the best way for a company to raise capital. Moreover, this criticism is not recent. In fact, within the context of venture capital or private equity transactions, critics question whether an IPO or a M&A transaction is a viable exit strategy. On October 1, 2019, leading venture capitalists met at an invitation-only summit in San Francisco to discuss the viability of a direct listing as an alternative to an IPO. However, the outcome of these discussions is not subject to the purview of the public.

As mentioned above, a pure direct listing does not provide a means of generating capital. Therefore, one solution is to adopt a transaction similar to that of Spotify that includes a direct listing of existing shares coupled with an issuance of new shares. An additional solution is to have companies sell private convertible notes to raise money ahead of a direct listing. This solution is based on an article circulated by Latham & Watkins in the wake of the Spotify transaction. However, critics worry that concurrently raising capital will increase first day price swings of a company's shares after the direct listing. In any case, a direct listing appears to be a viable alternative to an IPO so long as companies do not require further capital in the short term.