

Examining the risks and benefits of IPO alternatives: Direct listings & SPACs

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With the recent, highly publicized Coinbase and Roblox direct listings and the SPAC boom over the past year, alternatives to the traditional IPO are in the spotlight. It seems that more and more companies are looking for ways to bypass the IPO process and go public through these alternative methods.

While these IPO alternatives are generally viewed as faster and cheaper methods to take a company public, there are, of course, many factors to consider when looking at any avenue to go public.

TRADITIONAL IPOs

Most experts feel that the traditional IPO is not going anywhere and will continue to be the most widely used method for going public. According to Renaissance Capital's Q1 IPO Market Review, the US IPO market had its busiest quarter in over twenty years, with Q1 of 2021 seeing 102 IPOs raising \$40.3 billion. These numbers follow the momentum built during 2020 when there were 218 IPOs, totaling \$78.2 billion in proceeds.

Because of the expense and time associated with IPOs, many companies are considering alternatives or waiting much longer to go public.

The traditional IPO is the ultimate liquidity event for "healthy" companies interested in raising capital and providing an exit via the public markets for their early founders and financial sponsors, but many companies feel this process leads companies and investors to leave too much money on the table.

In a traditional IPO, companies utilize investment banks to help them through the process, with the bank setting up a (now virtual) roadshow to shop it around to institutional investors.

The investment bank, functioning as an underwriter of the price to public, also sets the initial offering price, which is designed to be below market, provide a discount to the bank's best customers, limit after-market trading via lock-up agreements, and lead to a jump on the first day of trading and an orderly and upward trading market thereafter.

This is very beneficial for the bank and its institutional investors, but some founders and early investors in the company will complain about the size of the IPO discount and the amount of value that is transmitted to the investment bank and its customers.

There is also the issue of time. The traditional IPO process is seen as incredibly time-consuming with the roadshow process, paperwork, and financial disclosures.

Because of the expense and time associated with IPOs, many companies are considering alternatives or waiting much longer to go public. When looking at other methods to go public, there are several options, with direct listings and SPACs being the most popular today.

WHAT IS A DIRECT LISTING?

Direct listings¹ are less common than a traditional IPO or a SPAC, with only a handful of high-profile listings in the past few years. The interest in direct listings started with the Spotify and Slack offerings a few years ago and just got a recent boost from the much-anticipated Coinbase listing.

This option allows companies to bypass working with a bank or going through the roadshow process, leading to cost savings and a much less time-consuming process. It also allows the company to control the listing price and avoid lock-ups.

Direct listings used to be viewed as an attractive option for companies who had wide consumer followings, a significant employee shareholder and early investor base, a vibrant trading market in the secondary markets, and who do not need to raise capital, letting investors sell their shares, but not issuing any new shares.

That changed when the SEC updated the rules surrounding direct listings, allowing companies to list directly while also issuing new shares. This change makes the direct listing appealing to a broader range of companies.

Because companies do not work with a bank in a direct listing and bypass the investor roadshow, they are generally best suited for companies with a higher level of name recognition. When companies don't have a Wall Street underwriter selling their story,

it becomes increasingly essential for the company to be well known.

WHAT ARE SPACS?

Special Purpose Acquisition Companies or Blank Check companies have had a meteoric rise in popularity in the past year. Renaissance Capital's Q1 IPO Market Review noted that there had been more SPAC offerings in Q1 of 2021 than all of 2020, which is impressive considering that in 2020 more than 200 SPAC offerings were bringing in about \$75 billion in proceeds.

A group of investors creates SPACs with the sole purpose of acquisitions. The SPAC² is a public company that acquires private companies they target, and that acquisition takes the target company public.

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Just like a direct listing, SPACs are generally seen as cheaper and faster. They also bypass the high costs of an IPO by eliminating the need for a banking partner or roadshow, and the time savings is significant. The SPAC IPO process can take just months.

This method could be a better option for pre-revenue companies or those that might be seen as not ready to go public. The SPAC founders also keep 20% of the equity, making them less favorable for the target company.

There is also the issue of SPAC oversaturation. With so many SPACs popping up, companies could now be the target of multiple blank check entities leading to higher acquisition prices.

The long-term after-market trading of companies that merge with SPACs is yet to be proven,³ with significant downward pressure exerted by the overhang of so many shares of common stock and warrants issued to the SPAC promoters and initial investors.

On the surface, direct listings and SPACs might seem like much more attractive options to the traditional IPO, especially as they become more high-profile. But as with anything, there is much more below the surface. Each option comes with its own hidden costs, and each company must carefully consider which method will be the most beneficial for their specific circumstances.

Notes

¹ <https://bit.ly/3nwdMe0>

² <https://bit.ly/2R4Jjrr>

³ <https://bit.ly/3uhtSK0>

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