Staying Private Longer: Why Go Public?

Despite the fact that an IPO has historically been viewed as the crowning achievement for a private company, companies are staying private longer than they have in the past. This trend can be attributed to a number of factors, including the growing supply of private capital, the introduction of more rigid securities regulations, the high cost of public markets, as well as the inherent market risks.

With the increase of funding provided by private markets, many companies are staying private simply because they can. McKinsey & Company reports in its Global Private Markets Review 2018 that global private market fundraising increased by $28.2 billion from 2017, for a total of $748 billion in 2018. Thus, given the abundance of private capital available, companies no longer require public markets for sufficient funding.

The US Jumpstart our Business Startups (JOBS) Act increased the maximum number of shareholders a company can have before it must disclose financial statements from 500 to 2000 shareholders. The increased flexibility due to the higher threshold allows companies to gain better control of choosing when to complete their IPO. For instance, prior to the JOBS Act, Google Inc. chose to go public in part because they had reached the 500-shareholder limit, and would need to comply with public reporting requirements to the SEC.

The heavy costs of going public may also deter private companies from pursuing public markets. The average cost of completing an IPO has been estimated to be approximately $4 million, on top of an average one-time fee of $1 million to prepare the organization to become a public company and the recurring average $1.5 million annually to comply with ongoing regulations.

Other significant benefits to staying private include the ability to maintain control of the company, the ability to execute a long-term strategy rather than focus on short-term quarterly earnings, the minimization of disclosure requirements, and the protection of the company from activist investors and hostile takeovers. Additionally, private companies are better sheltered from events that influence public markets, such as investor volatility, shareholder law suits and systemic risks.

Certain new trends in the private sector have levelled the playing field for private companies such as private liquidity programs and the ability to offer employee stock options. Private liquidity programs enable existing shareholders to sell all or a portion of their shares to a predetermed group of new investors, resulting in a non-dilutive transaction to existing investors and the ability for private companies to facilitate pre-IPO liquidity to employees and early investors.

Other popular practices result in heightened risk when the private company becomes public. For instance, dual-class structures allow certain minority shareholders (typically founders) to retain control, even as economic ownership is diluted. But these structures often come under attack after the company goes public. The directors and officers of public companies also face additional scrutiny in public company financing and M&A transactions.

The presentation will discuss why, in certain circumstances, it has become more feasible for private companies to stay private. Private companies are now equipped with many of the same capabilities and resources as public companies. That said, every company’s situation must be evaluated independently during its go-public or stay-private decision.
Staying Private Longer: Why Go Public?

Elliot A. Greenstone, Davies Ward Phillips & Vineberg LLP
Stephen Glover, Gibson, Dunn & Crutcher LLP
Michael Labriola, Wilson Sonsini Goodrich & Rosati LLP
Niki Fang, Orrick Herrington & Sutcliffe LLP
Eric Bowers, Sonos, Inc.

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Agenda

1. The Panel
2. The Current Trend to Stay Private Longer
3. The Benefits of Staying Private
4. Public Market Risks
5. Private Liquidity Programs
6. Employee Options and Compensation Considerations
7. Dual-Class Shares
8. Fiduciary Duties
9. Q&A
The Panel
Our Panel

- **Elliot A. Greenstone** is an M&A and private equity partner at Davies Ward Phillips & Vineberg LLP.
- **Stephen Glover** is an M&A partner at Gibson, Dunn & Crutch LLP.
- **Michael Labriola** is an M&A partner at Wilson Sonsini Goodrich & Rosati LLP.
- **Niki Fang** is a capital markets partner at Orrick Herrington & Sutcliffe LLP.
- **Eric Bowers** is Director, Legal for Sonos, Inc.
Current Trend to Stay Private Longer
Why Companies are Staying Private Longer

- Private markets are providing more funding
- Capital invested in private companies, globally:
  - 2017: $748 billion
  - 2018: $778 billion
Why Companies are Staying Private Longer

- Private debt fundraising and private credit funds are filling a financing void for many middle-market and sponsor-owned companies.

  - Increased the maximum number of shareholders a company can have before it must disclose financial statements from 500 to 2000 shareholders (or 500 non-accredited and excluding valid compensation awards).
The Cost of Going Public

- Average of approximately $4 million to complete an IPO
  - Legal fees, accounting fees and other miscellaneous expenses
  - In addition, underwriters typically receive 6-7% of the gross proceeds depending on the size of the deal
- Average one-time $1 million to prepare the organization to become a public company
  - Implement new reporting systems, controls and processes
  - Implement new executive/employee compensation plans
The Cost of Going Public

- Average of $1.5 million annually to comply with ongoing regulations
  - Compliance with SEC disclosure rules
  - Incremental internal staffing costs
  - Quarterly and periodic filings

- Soft costs:
  - Potential shareholder litigation
  - Pressure to impress Wall Street analysts on a quarterly basis
  - Decreased ability to keep financial and business information confidential
Gains in Private Companies Relative to the Public Market

- Report from Goldman Sachs found that over the last two years, the largest newly public companies would have created more value for themselves by staying private.

Exhibit 13: Aggregate annual public gains vs. annual private gains
In $mns: Accounted for the duration the companies have stayed in private and in public; companies included by year of IPO

Source: Company data, Goldman Sachs Global Investment Research, FactSet

Goldman Sachs
Regulatory Policy Considerations

- If companies are staying private longer, is it because of regulatory policies or availability of dry powder?

- Likelihood of such regulatory changes
  - President Trump has taken steps to correct what he perceived to be an oppressive financial regulatory system that he claims is inefficient
    - Financial CHOICE Act is a bill designed to roll back regulations set forth in the Dodd-Frank Act
    - Dodd-Frank Act was passed in response to the 2008 financial crisis, which many observers felt was caused by a lack of effective regulations targeting financial institutions
    - The bill passed in the House of Representatives and has not reached the Senate
  - Repeal CFPB Act was introduced to Congress on May 6, 2019
    - Intended to abolish the Consumer Financial Protection Bureau, a government agency established by the Dodd-Frank Act
Benefits of Staying Private
Benefits of Staying Private

- Maintaining control of the business
  - Avoid dilution of ownership
  - Example: Dov Charney was terminated by the board of directors of American Apparel and failed to regain ownership
  - Even with an ownership structure designed to maintain majority voting control of the shares, there are more voices as the number of shareholders increase, which can lead to loss of focus and destruction of value

- Ability to execute a long-term strategy rather than focus on short-term quarterly earnings
  - Private market investors are willing to wait for long-term returns, which give private companies a chance to innovate and develop outside the scrutiny of public markets
Benefits of Staying Private

- Minimizing disclosure requirements
  - Retains competitive advantage that comes from not disclosing business details
  - Minimizes organization load from regulatory compliance
  - Executive compensation remains confidential
- Minimizing the time and resources that management spends on shareholder-facing activities and regulatory or exchange compliance requirements
- Reduce the risk of activist investors and hostile takeovers
- Easier to maintain the company’s culture, which keeps employees engaged and productive
  - Keeps employees focused on company goals and KPIs, rather than stock price
  - Less legal and compliance oversight of activities to ensure proper disclosure
Public Market Risks
Public Market Risks

- Pressure of profitability on a shorter timeline
  - Companies must have a stable and proven Act I, with sufficient runway to maintain strong and predictable growth
  - Failure to meet target numbers or forecasts results in a decline in the stock price
  - Falling stock prices will cause further dumping

**Example**: Snap Inc., one of the most notable IPOs over the last couple of years, significantly underperformed the S&P 500, and has seen its shares fall 40% since listing in early 2017

**Example**: GoPro went public in June 2014 and saw its stock price more than double after 6 months of strong growth. Market began to saturate and revenue growth slowed. GoPro did not have its second act ready.

- Result: As of July 2019, 94% decrease in stock price since its high in 2014
Public Market Risks

- Amplified effects of systematic risks (i.e. recession)
- Company finances and other business data are available to the public, which may work against company interests
- Required disclosures such as compensation of senior management personnel is often under fire from stakeholders
- Company is subject to greater risk of shareholder suits
- IPO failure can be disastrous for companies
Private Liquidity Programs
Private Liquidity Programs

- An organized and controlled process to enable a large number of existing shareholders and employees to sell all or a portion of their shares to the company or a pre-determined group of new investors
  - Company typically has control over all aspects of the transaction including identity of buyers, price, seller participation levels, and timing
- Transaction is often non-dilutive to existing investors
- Can put real value on a company’s stock options while remaining private
- Facilitates pre-IPO liquidity for early investors and employees
- Can be challenging to execute these programs long-term, given rates of return expected from investors
- Portfolio of investors is critically important to the success of these programs
- Secondary markets can assist to relieve liquidity pressure from employees and investors
Private Liquidity Programs

- Secondary liquidity has become more common for larger companies
- Increase of 74% in total number of private liquidity programs between 1H2017 and 1H2018

<table>
<thead>
<tr>
<th>1H 2017</th>
<th>1H 2018</th>
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<tbody>
<tr>
<td>19</td>
<td>33</td>
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<tr>
<td>$733M</td>
<td>$10B</td>
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<td>7</td>
<td>20</td>
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<td>12</td>
<td>13</td>
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<td>$12.8M</td>
<td>$18.3M</td>
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Nasdaq Private Markets
Private Liquity Programs

- Meaningful shift in the primary driver of secondary activity in the market to third party purchasers from buybacks.

- Reflects two trends:
  - the continued strength of the private sector and investor demand
  - more companies taking an arms-length approach to pricing and allowing outside investors to determine pricing
Employee Options and Compensation Considerations
Types of Stock Options

- Stock Options come in two types:
  - **Incentive stock options** (ISOs): the employee is able to defer taxation until the shares bought with the option are sold. The company does not receive a tax deduction for this type of option.
  - **Nonqualified stock options** (NSOs): the employee must pay income tax on the 'spread' between the value of the stock and the amount paid for the option. The company may receive a tax deduction on the 'spread'.
# Debate on the merits of stock option plans

<table>
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<tr>
<th>Pro</th>
<th>Con</th>
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<td>Allows a company to share ownership with the employees</td>
<td>In a down market, because they quickly become valueless</td>
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<td>Used to align the interests of the employees with those</td>
<td>Dilution of ownership</td>
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<tr>
<td>of the company.</td>
<td></td>
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<tr>
<td>Less expensive and easier than providing cash compensation</td>
<td>Overstatement of operating income</td>
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Dual-Class Structures
What is a Dual-Class Structure?

- Traditionally, “one share one vote” was a fundamental principle of corporate democracy.
- Dual-class structures instead create two (or more) classes of a company’s common stock, typically involving multiple voting shares (typically a “high vote” class with 10+ votes per share).

  ➤ Dual-class structures allows certain minority shareholders (typically founders) to retain control, even as economic ownership is diluted.
Dual-class structures in Big Tech

- Dual-class structures traditionally used by media companies to preserve editorial independence (e.g., Liberty Media, The New York Times and Viacom) and family-run firms (e.g., Volkswagen, Ford)
- Became increasingly prevalent in Big Tech following Google’s use of a dual-class structure for its IPO in 2004
- Big Tech companies contribute disproportionately to increasing number of listings on major stock exchanges of dual-class structures
- Wave of high-profile IPOs and recent direct listings involving dual-class structures: Facebook, LinkedIn, Groupon, Alibaba, Fitbit, Square, Dropbox, Spotify, Lyft, Pinterest and Slack

⇒ **Snap Inc. issued 0 vote shares in its 2017 IPO.**

- Lyft went public on March 29, 2019, with a dual-class structure. However, in a letter to Lyft's directors, a group of investors have called for Lyft to eliminate its dual-class shares.
Dual-class structures in Big Tech (cont’d)

- Insights from Larry Page and Sergey Brin’s 2004 “Letter from the Founders”:

“From the point of view of long term success in advancing a company’s core values, we believe this [dual-class] structure has clearly been an advantage ... [leaving] our team, especially Sergey and me, with increasingly significant control over the company’s decisions and fate, as Google shares change hands ... New investors will fully share in Google’s long term economic future but will have little ability to influence its strategic decisions through their voting rights.”
### Debate on the merits of dual-class structures

<table>
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<th>Pro</th>
<th>Con</th>
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<tbody>
<tr>
<td><strong>Focus on long-term goals</strong></td>
<td>Lack of accountability</td>
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<tr>
<td><strong>Pursuit of idiosyncratic visions:</strong> E.g., Facebook’s acquisition of Instagram in 2012: Zuckerberg’s 57% control of voting rights allowed him to move quickly to purchase Instagram for $1 billion (Instagram now worth an estimated $35 billion). By the time Facebook's board was brought in, the deal was all but done – though Facebook's board did vote on the deal, it was largely symbolic</td>
<td><strong>Idiosyncratic visions can grow obsolete</strong></td>
</tr>
<tr>
<td><strong>Investor Choice</strong></td>
<td><strong>Misaligned incentives:</strong> if decision-making shareholders have low equity shareholding, they are less affected by bad decisions</td>
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<td><strong>Overall increase in opportunity to invest in high-growth companies</strong></td>
<td><strong>Potential litigation and associated costs</strong></td>
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Considerations regarding dual-class structures

- Shareholders may allege breach of fiduciary duty by executives for leaving investors with less valuable non-voting shares
  - In 2012, Google moved to dilute the voting rights of Class A shareholders by issuing to them third-tier Class C shares with no voting rights as “dividends.” Shareholders filed suit alleging breach of fiduciary duties. On the eve of trial, the parties agreed to settle the case by letting the market decide the value of lost voting rights. When the non-voting shares ended up trading at a material discount to the original Class A shares, Google was forced to pay over $560 million to the plaintiff investors for their lost voting rights.
  - Suits for breach of fiduciary duty were also filed against Facebook due to a similar post-IPO plan to distribute non-voting shares in order to solidify founder and CEO Mark Zuckerberg’s control.
Fiduciary Duties
The Board of Directors and Directors’ Duties

- Directors do not directly manage the business of the company, but they are ultimately responsible for the management of the corporation.
- The Board of Directors appoints officers to run the day-to-day operations, but should be informed about the business and be involved in and approve major decisions for the corporations.
- Directors have 2 primary fiduciary duties to the corporation:
  - Duty of care
  - Duty of loyalty
Duty of Care

Duty to make careful, informed decisions by assuming an active role in the decision-making process

Assure to have the information required to take action

Devote time to review information

Obtain the advice of experts
Duty of Loyalty

- Duty to act in the best interest of the corporation and its stockholders

- Implicated by transactions in which a director is:
  - Not independent
  - Has a substantial self-interest which is not consistent with the interests of the corporation

- Restrict the interested director’s influence
  - Disclose the full extent of his or her interest
  - Abstain from voting on the matter
Fiduciary Duties in a Public Company

- Compared to a private company, directors and officers of a public company face the following challenges:
  - Higher scrutiny in review of compliance
  - More thorough disclosures required
  - Higher potential of shareholder lawsuits

- As a result, heightened degree of vigilance required from the directors and officers in the accomplishment of their duties
## Challenges to a Public Company Deal

Four challenges faced in a public company deal context due to enhanced review of compliance:

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<thead>
<tr>
<th>Category</th>
<th>Challenges</th>
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<tr>
<td><strong>Price</strong></td>
<td>• Is the sale price adequate to compensate for forgoing the standalone opportunity?</td>
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<td></td>
<td>• Is it the best reasonably available?</td>
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<td><strong>Process</strong></td>
<td>• No single blueprint for best process; consider:</td>
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<td></td>
<td>• Pre-agreement market check</td>
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<tr>
<td></td>
<td>• Post-agreement market check</td>
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<td>• Did someone self-deal, or act for a selfish reason as part of a “final stage transaction”?</td>
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<tr>
<td><strong>Disclosure</strong></td>
<td>• Did the interested directors or majority stakeholders disclose their interests? Did they abstain on voting on the matter?</td>
</tr>
<tr>
<td><strong>Coercive/ Preclusive Deal Protections</strong></td>
<td>• Deal protections help ensure a higher degree of closing certainty for a deal that the board has determined is fair, advisable and in the best interest of the seller’s stockholders</td>
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<td></td>
<td>• Are deal protection provisions reasonable?</td>
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Thank You