Direct listings: The IPOs of the new decade or a passing phase?

With Airbnb and other unicorns potentially following the example of Slack and Spotify, are direct listings set to take off?

By Rupa Briggs

Disruptive technology startups, such as Spotify, Slack and Airbnb, have made it their mission to break with tradition. It is only fitting that some of these businesses are rejecting the conventional firm-underwritten initial public offering (IPO) model in favor of the direct listing approach.

The trend began when music streaming service Spotify conducted its direct listing on the New York Stock Exchange (NYSE) in April 2018 and continued with the direct listing of the messaging service Slack in June 2019. Travel and hosting business Airbnb and food delivery service DoorDash are rumored to be planning to take the same route in 2020.

In the current direct listing model, a company does not raise capital in a public offering. Instead, it lists on a stock exchange shares held by its existing shareholders to permit such holders to sell their shares directly to the public via the exchange.

This contrasts with a traditional IPO where investment banks act as intermediaries between the company and shareholders selling in the IPO on one hand and investors on the other. In a direct listing, all investors are free to buy from the selling shareholders, and the stock price is determined by supply and demand. This is different from a traditional IPO, a carefully choreographed exercise in which a company works with one or more investment banks to underwrite the share issuance, setting the price in advance of the listing, and selling the shares principally to institutional investors through the banks' distribution networks. In both a direct listing and an IPO, the company must file a registration statement with the Securities and Exchange Commission (SEC) that includes detailed information about the company and its financial results, and go through the SEC review process.

US $19.5 billion

Slack's market capitalization at close of trading on the day of its direct listing in June 2019

The benefits of a direct listing

For large privately owned consumer tech companies with strong brand followings and a broad investor base, a direct listing has considerable upside. First, a direct listing represents a liquidity event for existing shareholders as it enables them to cash out immediately upon the listing, rather than having to wait an extended lock-up period—typically 180 days from pricing in a traditional IPO. Existing shareholders also avoid dilution, as current rules do not permit the issuer to raise new capital in a direct listing.

In some cases, tech company founders and investors have been vocal about leaving value on the table when selling stock through a traditional IPO, especially when they see price bounces on the first day of trading. By contrast, in a direct listing, where the market itself sets the price, it may be possible to secure a price much closer to the true value of the business.

Relatedly, there are no underwriters and consequently no underwriting fees in a direct listing, although the Slack and Spotify direct listings involved sizable flat fees to advisors. Underwriting fees in a traditional IPO typically range from 4 percent to 7 percent of gross offering proceeds, far exceeding direct listing advisor fees.

Today's disruptive technology companies are building valuable brands based on transparency and direct communication with their consumer base. Keeping with this ethos, a direct listing is perceived as a more democratic process than a typical IPO, because access to first-day trading is open to all investors, not just to an underwriter's network of contacts (largely institutional investors that are repeat players in new offerings). Moreover, because there is no book-building in a direct listing, companies can dispense with traditional IPO roadshows, that have more tailored audiences, and conduct a webcast investor day during which all potential investors can simultaneously access company information. Unlike in a traditional IPO, a company conducting a direct listing can also provide public company-style financial guidance to investors.

The rules might change

Despite these advantages, direct listings remain rare. One large barrier for many companies is that while an IPO enables a company to raise new capital from investors, a direct listing currently does not. However, this may be set to change. In November, the NYSE proposed amendments to its rules to allow primary share sales by companies during the direct listing process. The SEC rejected the initial proposal by the NYSE, which subsequently submitted a revised proposal in December 2019.

The new proposal seeks to expand the scope of direct listings by permitting companies to raise capital in connection with such listings. To that end, the NYSE proposed amending the criteria by which a company can satisfy the exchange's key initial listing requirements in a primary direct listing to permit a company to list its common equity at the same time it sells shares in the opening auction on the first day of trading on the NYSE.

The SEC has not yet responded to the revised NYSE proposal, but a reform could give a boost to direct listings, which currently represent a path to a public listing only for well-funded companies that do not need to raise additional capital. Reports indicate Nasdaq is also considering submitting a similar proposal.

Direct listings are not for everyone

While the direct listing process works smoothly for high-profile companies with well-understood business models and large investor bases, many companies are outside that category. In 2019, biotechnology companies accounted for approximately 24 percent of US IPOs. Most of these companies are far from household names. Considering their value—or even their viability depending on where they are in the drug development or FDA approval process—it would be difficult for regular investors, other than those with a professional interest in the sector, to purchase shares of such companies in a direct listing. A biotech company's decision to go public is driven more by the need to access additional funding for product development and commercialization and not necessarily to provide liquidity for existing shareholders.

Companies with complicated business models or compelling growth stories in highly specialized or technical industries may find that a traditional IPO roadshow provides a better opportunity to explain the company strategy and growth story to small groups of prospective buyers. This helps educate the potential shareholder base on the

company's attributes. Moreover, one aspect of a traditional IPO process that many companies value highly is the ability to personally educate the research analysts who will cover the company on its business and financial model. Research analysts are not permitted to participate in direct listings. For unicorns with strong consumer followings, like Slack and Spotify, post-listing research coverage is all but assured, but for smaller, lesser-known issuers, building a relationship with key research analysts in their sector is an essential element of going public.

The direct listing model is also not appropriate for private equity portfolio companies or special-purpose acquisition companies (SPACs). Portfolio companies by their very nature are held by one or a few large sponsors and therefore lack the sizable pre-IPO investor base needed in a direct listing. SPACs are blank check vehicles that raise capital from public investors in order to acquire an operating company. SPAC IPOs have dominated the market in recent years and comprised approximately 25 percent of all US IPOs in 2019.

In practice, these different goals and rationales for going public mean that while direct listings may grow in popularity, there will always be a significant number of companies for which direct listings are not a suitable option for going public.

At a crossroads

The acceptance and popularity of direct listings may also be affected by perceptions of performance, but with relatively few examples to draw on, current data is far too limited to predict direct listing's future market adoption.

All eyes will be on Airbnb. If the company opts for a direct listing and the offering is judged a success, the trend will likely gain strength and others could follow—certainly in the technology sector and possibly in other consumer-facing industries. Support for the NYSE's primary direct listing proposal from the SEC could also tip the scale toward more direct listings.

However, it is worth noting that in the technology sector, fashions fade fast. In 2004, Google caused a stir by conducting its public listing through a Dutch auction, a novel idea, at least on the stock market, which also bypassed the traditional underwriting process. The sale was successful and prompted several other technology companies, including NetSuite and Rackspace, to follow Google's example. Then the fad passed. Time will tell if direct listings face a similar fate.