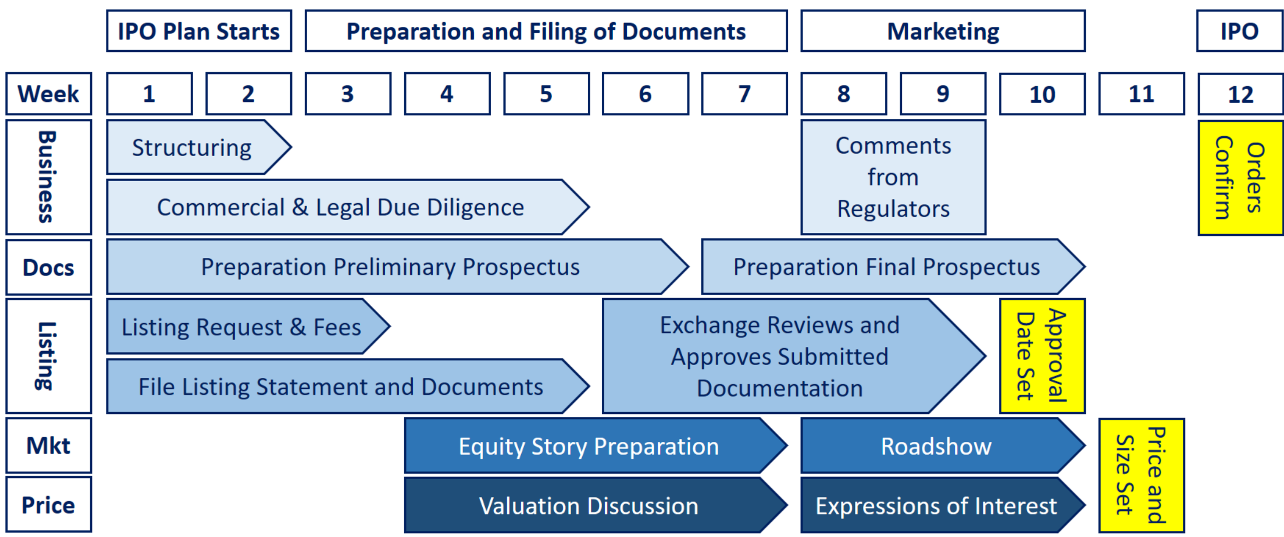
Up next: Spotify goes public with no underwriters. Will that be the tune of the future?

Introduction

The Direct Listing process, also known as Direct Public Offering (DPO), is a procedure by which companies can have their shares publicly traded on an exchange without the assistance of an investment bank. The company, indeed, will just have to submit the necessary documents for the listing, look for investors – both qualified and non-qualified ones – on its own, and sell them shares directly at the opening of the negotiations. As soon as the shares put up for sale are sold, the listing procedure is concluded and shares are available for trading.

The Traditional IPO Process



What the majority of companies usually do when they decide to "go public" is the IPO process, short for Initial Public Offering. This procedure, supported and coordinated by a pool of investment banks, provides for a series of tasks aimed at the best possible positioning of the company in the marketplace and among good-quality investors. The company initially undergoes a so-called "due diligence" phase, covering and reviewing all the legal and financial documentation of the firm, so that future investors can have the guarantee that it is sound from a legal standpoint. One of the most important documents the company must deliver to investors is the prospectus, a file containing key information and data regarding the proposed offering, such as background information about the company, risk factors, metrics on the relevant industry, financial data, management information, legal matters and technical information about the securities offered.

In addition, the company has to file other documents with the designated exchange, which will review them and grant or deny its approval to the company to be available for negotiations on that given exchange.

However, the part of the process by far most important is the preparation of the corporate equity story, meaning the story that company's executives are going to tell investors when, during the 2 or 3 weeks of "roadshow", they are going to meet them. This step is fundamental to the determination of the proceeds the firm is going to raise once it completes the IPO: indeed, following the meetings, investors give a feedback to investment bankers about their view on the value of the company, on the expected price per share they are going to bid, on potential issues they foresee with the operation, and so on. For this reason, the support of an investment banking team results being extremely important for the company and for the success of the operation.

Once all of these operations are concluded, the company sets the actual price per share it is going to ask to investors, and the next day its shares hit the market.

At the beginning of negotiations, in order to shield potential volatility in the stock price, investment banks usually call for a "greenshoe" provision (deriving its name from the first company featuring this option, the Green Shoe Manufacturing Company, now part of Wolverine World Wide Inc.), an option giving the bank the possibility to sell more shares (borrowed from the company) than those initially planned in order to better accommodate demand. In case of over-buy pressure, the shares will be sold on the market and the proceeds will flow to the company to close the borrowing, whereas in case of over-sell pressure, the bank will buy shares from the market in order to close the borrowing, thus sustaining the share price.

Lastly, a group of significant initial company's shareholders usually have a "lock-up" period of 90 to 180 days, during which they are prevented from selling any shares in the market, in order not to put downward pressure on the price of the new securities.

How Does Direct Listing Differ?

The first and most tangible difference between the two methods is the different amount of fees the company is required to pay: in a typical IPO deal, investment banks, especially in the US, can ask up to 7% of the total proceeds of the offering, whereas for a DPO, not having investment bankers' support, the fees and costs the company has to bear are far lower. As a consequence of the lack of intermediaries, the Direct Listing procedure is also quicker and thus results in a significantly lower commitment of the management team.

Another key aspect to mention is the fact that for a DPO, the management is not required to complete any "roadshow", potentially never meeting investors before the first trading day. Although this could be theoretically possible, firms pursuing this kind of operations tend to hold "pre-deal investor education" events, during which they try to give the broadest view possible to perspective investors, presenting themselves as they would have done in a typical roadshow, but concentrating the effort in just a couple of days. As one may appreciate, this kind of events tend not to have the same impact on investors as the roadshow would have, so there is likely going to be poor price discovery and demand generation power.

Lacking the whole process of going and meeting with investors, the DPO does not provide for a proper bookbuilding process, thus leaving the management of the company with great uncertainty about what the demand for shares is going to be and at which prices. Worsening even more the situation, when the company's shares start trading, a DPO does not provide for any buffer against price volatility (a tasked carried out by the "greenshoe" provision in an IPO), which would have already been a problem, giving the lack of investor education and the possibility also for retail investors to purchase shares at the opening of negotiations.

Although this may seem absurd for a company wishing to raise capital, it should be pointed out that what usually happens when a company completes a Direct Listing is that no new shares are issued, thus providing for the sole liquidation of existing shareholders and no capital raising.

Issuing little to no new shares, current company's investors have the advantage of facing little to no dilution in terms of voting power and earnings, which undoubtedly represents good news for them.

Finally, unlike in typical IPOs, current company's shareholders face no so-called "lock-up" periods, thus they can – in case no private agreement preventing it is in place – potentially liquidate 100% of their holdings as soon as the market opens, which is good for them, but potentially ruinous for the share price, as the market would be flooded with supply.

However, although the 2 processes differ for a significant number of features, both of them lead to the same results: indeed, the company eventually has the possibility to further gather equity capital through rights issue, it has a source of currency for future M&A activity, it has provided shareholders with liquidity, it has gained international visibility and it has now the possibility to create incentives for management to better align its interest with those of shareholders, through the issue of stock options plans.

First Direct Listings

The first notable cases of direct public offering appeared during 1980s, when Ben & Jerry's Ice Cream successfully raised $750,000 on the OTC market. At that time, news was usually published by local press and investors dialled the company directly to subscribe the shares offered. In 1995, microbrewer Spring Street pioneered raising capital with marketing done via the internet. The first direct-listed large company was Freddie Mac (OTCQB: FMCC), which completed its DPO in 1989.

Most recent direct listings occur on the Nasdaq, on which DPOs has been permitted for a long time. For private companies there are two ways to gain liquidity on the Nasdaq market. The first is to rely on the Nasdaq private market, an end-to-end platform that facilitates the transaction of traded shares. We have seen a sharp increase in the volume of these transactions, although the sales usually involve institutional investors. Alternatively, a private company could sell shares first to institutional investors, promising a prompt listing at the same time. Then, the company will go through the usual filing and review process with the SEC, which finally cancels those shares during this last pre-IPO round, opening the way for on-exchange public trading. Inevitably, shares are traded at a slow pace in the first 3-4 months of negotiations.

	NEXEON OTC: NXNN	FORTRESS BIOTECH Nasdaq: FBIO	OvaScience Nasdaq: OVAS	BIOLINERX Nasdaq: BLRX
Total Raise(Est.)	$10,644,992	$25,800,000	$35,000,000	$24,000,000
Listing Price	$2/share	$10/share	$8/share	$6/share
Price 27/02/2018	$0.76/share	$4.05/share	$0.98/share	$1.01/share
Mkt Cap 27/02/2018	$20.695 Million	$205.159 Million	$34.963 Million	$107.353 Million

The recent examples of direct listing, which are scant even over a 10-year period, are characterized by small capital raises, small enterprises and mostly biotech/life science businesses: 2 out of the 4 operations were carried out by companies with less than $50 million market capitalisation. The only one with over $200 million was Fortress Biotech, a parent company focusing on providing funding and management services for its subsidiaries to achieve their goals.

Generally, the biotechnology sector has witnessed significant public offering activities over the past years: since 2013, around 30 drug developers have completed IPOs annually. Despite a decrease in Q1 as a result of the 22% loss in Nasdaq Biotechnology Index during 2016, the final number of healthcare companies' IPOs in U.S. reached 44 last year.

Thus, it is natural for active players developing new medicines or providing medical treatments to opt for alternative ways of raising capital from the investors, in light of the costs they bear and their sizes. Given the amount of capital raised, pricing and price volatility of shares has not been a concern for these companies, which are clearly targeting the specific group of public investors informed about the industry and capable of making decisions based on

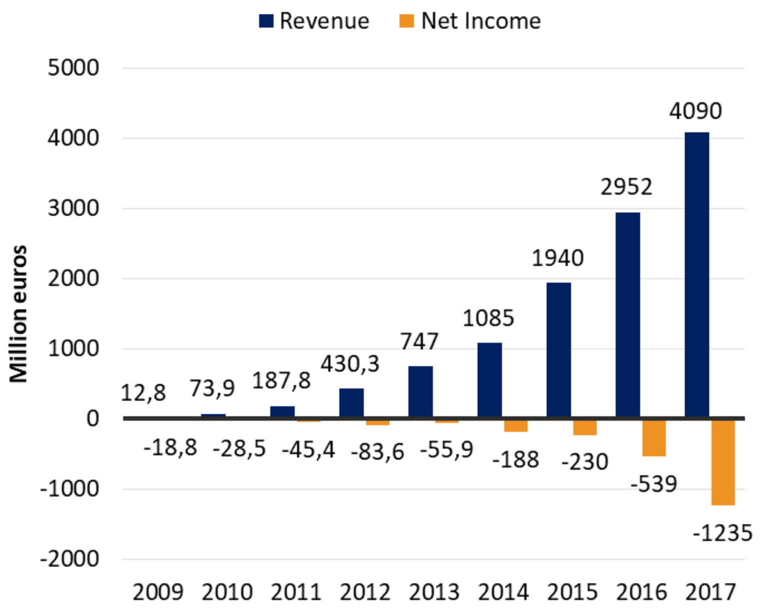
metrics and events, such as the upcoming experiment results. Another benefit provided by Nasdaq is the possibility to return to the market for follow-on offerings. Moreover, for foreign biotech firms such as the Israeli company BiolineRX, dual-listed on Nasdaq, US equity markets are the ideal place to raise significant finance in order to grow.

It is believed that 2018 is not going to be a slowing-down year for biotech IPOs, as we have seen a rally in Nasdaq Biotechnology Index over the last year. Hence, small and private biotech firms are likely to be among the leading firms in direct listing activities. As for other potential big-size and high-profile tech-firms, all eyes on Spotify, the result of its bold move could be an inspiration, or a cautionary tale.

The Spotify Case

Spotify AB is a music, podcast and video streaming service headquartered in Stockholm, Sweden. The firm operates under the so-called "freemium" business model, meaning that it offers both a free service that is monetized through advertising as well as a premium, subscription-based service where users pay a monthly fee for ad-free content and additional features. At 71 million paying subscribers as of December 2017, Spotify's music streaming franchise is the largest in the world. Despite aggressive competition from technological hegemons such as Apple and Amazon, Spotify has been able to grow subscription numbers by 46% YOY. Its closest competitor, Apple Music, boasts just 36 million paying subscribers.

Since launching its service from the Swedish capital in 2008, the firm has since expanded to 61 markets worldwide, notably excluding China and India. Spotify's user base is heavily concentrated in the Americas and Europe, where an estimated 90% of its monthly active users (MAUs) reside. In its quest to expand globally, Spotify has formed partnerships with Microsoft and Sony. Most recently, it has also engaged in a reciprocal share swap with TME, the music arm of Tencent, China's largest internet company by market capitalization. An examination of Spotify's acquisitions throughout the last years hints at a second source of value creation – besides the streaming business itself – that the firm is pursuing. The March 2014 acquisition of The Echo Nest, a music data analytics company, was quickly followed by the acquisition of Seed Scientific, an advanced data analytics firm, in June 2015 and the purchase of CrowdAlbum's technology allowing the analysis of music on social media in April 2016. By aggregating data on consumer behaviour within the music industry of not only its own user base but beyond it, Spotify is able to aid record labels and artists in developing an optimal strategy to bring their creations to market, while also providing its users with a more personalized experience.



Despite impressive revenue growth over the past years, Spotify has yet to turn a net profit. In 2017, the firm generated €4.09bn in revenue and reported a net loss of €1.24bn, of which €910m can however be attributed to the one-off investment expense related to its share swap with Tencent. Interestingly, Spotify has since 2016 enjoyed positive cash flows. Cash flows from operation of €179m and free cash flows of €109m in 2017 mean that the firm does not have to raise any additional cash externally. Furthermore, Spotify has been able to grow gross margins from 11.64% in 2015 to 20.75% in 2017. This was attained through the negotiation of lower rates from the record labels Spotify licenses music from.

The Filing

After years of rumors regarding an IPO or direct listing, Spotify AB filed to go public on February 28th, 2018. Following private negotiations with the SEC in Q3 and Q4 of 2017, Spotify finally obtained approval to file an F-1 form, a catch-all securities registration document for foreign issuers in the US. The firm plans to list on the NYSE under the symbol SPOT as "soon as practically possible", which analysts expect to be no later than March/April. Private transactions in the month of February imply a mid-range valuation of $19.7bn, although the firm was valued up to $23bn over the same time frame. Spotify plans to sell the equivalent of $1bn of its existing shares. Given the unprecedented size of the direct listing as well as the high volatility generally associated with direct listings, it is not yet clear what the figure will mean in terms of equity. Although they will not underwrite the offering, Spotify is being advised by investment banks Goldman Sachs, Morgan Stanley and Allen & Company, which act solely as consultants with the designated market maker (the "DMM") to arrange the listing. Fortune magazine estimates that ECM fees will total just $30m. By comparison, Snapchat, which at a $23bn pre-IPO valuation is somewhat similar to Spotify's, paid underwriters $98m in fees during its 2017 IPO. This figure amounted to roughly 2.5% of IPO proceeds, which is already a heavy discount compared to the typical underwriting fee of 4-7%. Besides saving money on banker fees, Spotify's concentrated ownership and positive cash flows are likely reasons for its decision to attempt a direct listing. Since almost 40% of the firm is held by its co-founders Daniel Ek and Martin Lorentzon, and as Tencent, the third-largest shareholder, is barred from liquidating its 7.5% stake, the listing can more easily be controlled and directed by Spotify's current shareholders while positive cash flows alleviate the firm from a dependence on cash raised during the IPO from an operational perspective. Lastly, and perhaps most importantly, Spotify enjoys heavy publicity around the globe. The firm is well known and has benefitted from strong media coverage of its upcoming listing, making a traditional equity story preparation and roadshow by investment bankers virtually unnecessary.