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TECH COMPANIES AND DIRECT LISTINGS: THE ALTERNATIVE WAY OF GOING PUBLIC

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AN ALTERNATIVE PATHWAY

From Uber to Jumia and even older technology (tech) companies like Etranzact and Chams Plc, it is arguable that Initial Public Offerings ("IPOs") have not offered great returns for tech companies in Nigeria and across the globe[1].

Investors are speculating on whether the great tech bubble is about to burst because, considering the cost of IPOs, tech companies have to scrutinise the expected returns when contemplating an IPO. One of the solutions to this cost vs returns conundrum appears to be for tech companies to adopt direct listings.

In this article, we will consider what a direct listing is and what it takes to run a successful one, with Spotify as a case study. The article will also consider the regulatory framework of the Nigerian Stock Exchange with regards to direct listings.

DIRECT LISTINGS

Founders and Investors involved with tech companies who wish to raise funds from the public now seem to have their eyes set on an alternative way of raising capital from the public.

Through direct listings[2]. The major rationale behind the preference of a direct listing over an IPO is the fact that, the costs of underwriting, preparing prospectuses, roadshows for IPOs and engaging investment banks are avoided if a direct listing is used by the company.

WHAT IS A DIRECT LISTING?

In simple terms, direct listing is the process by which the existing shareholders of a company and the company itself, sell their shares to the public. So, while an IPO focuses on issuing new shares, direct listing allows a company's existing and outstanding shares to be listed on a stock exchange without following the customary procedures for IPOs such as underwriting offers, issuing prospectuses and executing lock-up agreements[3].

[1] CWG Plc, "4 Nigerian tech companies on the NSE currently trading below their IPO listing price" https://cwg-plc.com/blog-post/4-nigerian-tech-companies-on-the-nse-currently-trading-below-their-ipo-listing-price/ accessed 18 November 2020
[2] Courtney Goldsmith "Major tech companies are ditching IPOs in favour of direct listings – here's why" https://www.worldfinance.com/strategy/major-tech-companies-are-ditching-ipos-in-favour-of-direct-listings-heres-why. Accessed 18 November 2020.
[3] Lock-up agreements are usually clauses in contracts especially during an IPO which prevent existing shareholders from selling their shares for a period of time after the IPO.

In a direct listing, shareholders who wish to sell their shares will sell at existing market prices and not at the nominal price of the shares. Spotify Technology S.A. (Spotify) and Lyft Inc. are prime examples of companies that have utilised direct listings to tap into the capital markets.

In most jurisdictions, direct listing has not been used to raise fresh capital, likely due to regulatory concerns such as the lack of certainty surrounding the direct listing and "Gatekeeper concerns" (key participants in an IPO such as the underwriters are dubbed Gatekeepers, that is, entities that determine whether a company is worthy enough to go public)[4]. For instance, a company that decides to offer shares through a direct listing, may discover that the market valuation of its shares before the Direct Listing is unattractive and will decide to stop the process, therefore ruining contracts and transactions which are built on the success of the direct listing process. If a company and its shareholders stop the direct listing process, they face little or no backlash from the investing public and the regulators because it is not heavily publicized like an IPO, and the financial advisers are not held accountable for the direct listing failing or not kickstarting. Alternatively, if it is an IPO, and the company decides to pull the plug, they may face regulatory sanctions and the damage on the brand of the company may even be worse than the penalties incurred. The financial advisers and the underwriters will also not be left out as they risk being held liable for the failure of the IPO process.

Regardless of the concerns mentioned above, there are cogent reasons why tech companies and security regulators may consider direct listing as a viable alternative to an IPO.

WHY A DIRECT LISTING?

Price Discovery

In an IPO, underwriters usually confer with potential investors on the valuation of shares and based on such discussions, a price is set for the shares to be sold during the IPO. The valuation of such shares prior to the IPO, creates an illusion for the issuing company that their shares are highly priced. The company proceeds to make projections based on such valuations and are surprised by the market valuation of their shares a few days or weeks after the IPO.

[4] Brent J. Horton, Spotify's Direct Listing: Is It a Recipe for Gatekeeper Failure? 72 SMU L. Rev. 177 (2019) https://scholar.smu.edu/smulr/vol72/iss1/12.

An example of this phenomenon can be seen with Jumia. Jumia priced its shares at $14.50 per share and as at April 2020, Jumia's share price had crashed to $3 per share according to the New York Stock Exchange. Currently, Jumia's share price has increased to $12.36 but it is still almost $2 below its original valuation[5].

This is why direct listings are considered favourable as the price of shares is determined by the buy and sell orders made by investors through the stock exchange. The price of the shares is discovered through a truly market-driven process and seems more efficient than an IPO and its "consulting process"[6] of pricing shares.

Liquidity

Existing shareholders who purchase shares during an IPO are usually restricted from selling their shares for a set period of time post listing, due to lock-up agreements. This is typically to ensure stability of shares of the company after the IPO and to aid the supply of shares to new investors as the company wants to ensure that every new share acquired is from the IPO and not existing shareholders.

A direct listing on the other hand, does not usually involve any lock-up stipulation. Therefore, there is liquidity for existing shareholders during the process of going public as the shareholders can sell their shares through the exchange.

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The type of investors involved in an IPO comprise of investors who receive an initial allocation of shares[7], and institutional investors. In addition, IPOs set a total maximum number of shares that are being offered to investors.

Meanwhile, in a direct listing, there is no fixed number of shares to be sold to the public and there is no set offering price on the shares. Investors will place their orders for the shares listed on the exchange for any price and size they believe is proper with their respective broker. This process will kickstart the price-setting process on the stock exchange. This open access to sell and buy shares created by a Direct Listing is an efficient way of pricing shares upon the opening of trading.

[5]"Yahoo! Finance Jumia Technologies AG (JMIA) NYSE - NYSE Delayed Price. Currency in USD" https://finance.yahoo.com/quote/JMIA/?guccounter=1&guce_referrer=aHR0cHM6Ly93d3cuZ29vZ2xlLmNvbS8&guce_referrer_sig=AQAAAGovXFxqRzznVHRmPFmOgbjtL9fTT27PGsrljvjA49AQxDTwaGspEeNf9zD1aHJdcNO5-pjdheKNW-GL1YmcPM-QbJgXX4mKuWPkTWr32dfO99Q3ov48ZrwgeHRMLfbTyfRUv9LLkosbSDeyB_0EyzFJk3rveeOJBVxWVvwWLhFw. Accessed on 14 October 2020.

[6] The process is called a book building process. Underwriters collect thoughts on price from potential investors and companies and collate them into an Order Book. Based on the thoughts in the book, the price of the shares is set.

[7] The shares allocated must not exceed the fixed number of shares being offered to the public.

CASE STUDY: SPOTIFY TECHNOLOGY S.A (SOCIETE ANONYME)[8]

On 3 April 2018, Spotify, a tech company, offered the largest direct listing in corporate history. Spotify became a public company by offering its shares through a direct listing on the New York Stock Exchange ("NYSE").

The goals that Spotify wanted to achieve were:

- To offer greater liquidity to its existing shareholders, without raising capital and without the restrictions imposed by standard lock-up agreements;
- Provide unfettered access to its shares, giving its existing shareholders the ability to sell their shares immediately after listing at market prices; and
- To conduct its listing process with maximum transparency and enable market-driven price discovery[9].

Therefore, in order to achieve these goals, Spotify and its advisors had to take a different path towards listing on the NYSE:

1. Pre-Listing Concerns

The US Security and Exchange Commission ("US SEC") highlighted the risks of direct listings and noted that due to the novel nature of a direct listing, the price of the shares and the volume of shares traded on the day of listing may be more unpredictable than an IPO as investors tend to rush at anything deemed novel or new.

2. Use of Peculiar Security and Exchange Commission Forms

Since the company was departing from a traditional IPO, instead of filling forms to register its shares, what Spotify did with the US SEC was to register with the US SEC, a resale registration statement. A resale registration statement is a registration statement filed with the SEC that registers under the US Securities Act the resale of outstanding shares by the holders of such shares pursuant to the registration statement as long as the registration statement remains effective.

[8] "Anonymous company" Another name for a company with its liability limited by shares. Usually used in jurisdictions that operate civil law.
[9] Spotify Case Study: Structuring and Executing a Direct Listing Posted by Marc D. Jaffe, Greg Rodgers, and Horacio Gutierrez, Latham & Watkins LLP, on Thursday, July 5, 2018 on the Harvard Law School Forum on Corporate Governance.

3. Price of Shares

Usually, the Prospectus of a company that wishes to go public, contains the expected price of the shares but this was not the case for Spotify as the company used a preliminary Prospectus (the first draft of a prospectus subject to change by the company or any other relevant party in the process of going public) to explain how the price of the shares would be achieved and also gave a brief history of the company's private placements.

4. Distribution of Shares

Since there were no underwriters in the transaction, there was no offering of the shares by a group of financial specialists as is usually done in an IPO. Instead, there was a Distribution section in the resale registration statement which described the process of the distribution of the shares

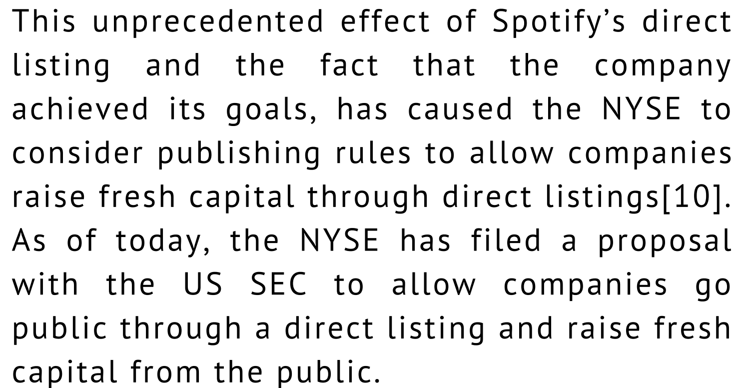
5. Financial Advisors

Again, due to the absence of underwriters, Spotify appointed financial advisers (Goldman Sachs & Co. LLC, Morgan Stanley & Co. LLC, and Allen & Company LLC) who had specific roles during the direct listing process such as market markers, public communication and advising on how to prepare the registration statement.

THE SUCCESS STORY

On 3 April 2018, the NYSE published to the market pre-trading that Spotify shares were going to sell at $132.50 per share. The opening prices of the shares were actually $165.90 and 30,526,500 shares were traded with 178,112,840 shares outstanding on the first day. The exchange closed on the first day with shares of Spotify trading at the price of $149.01 per share. As at April 2020, Spotify shares were trading at $156.57 per share and the lowest share price the company has experienced on the NYSE is $109.18 according to the NYSE.

[8] "Anonymous company" Another name for a company with its liability limited by shares. Usually used in jurisdictions that operate civil law.
[9] Spotify Case Study: Structuring and Executing a Direct Listing Posted by Marc D. Jaffe, Greg Rodgers, and Horacio Gutierrez, Latham & Watkins LLP, on Thursday, July 5, 2018 on the Harvard Law School Forum on Corporate Governance.



This unprecedented effect of Spotify's direct listing and the fact that the company achieved its goals, has caused the NYSE to consider publishing rules to allow companies raise fresh capital through direct listings[10]. As of today, the NYSE has filed a proposal with the US SEC to allow companies go public through a direct listing and raise fresh capital from the public.

The Nigerian Stock Exchange and Direct Listings

According to the Nigerian Stock Exchange Greenbook (the "NSE"), there are five ways of listing on the NSE[11]. The types of listings that are similar to direct listings are Listing by Introduction and Direct/Dual Listings.

Listing by Introduction

In a Listing by Introduction, the company's shares are listed without an IPO. The company must meet the listing requirements set by the NSE such as a minimum number of public shareholders and a minimum public float (number of shares to be held by the public). The company should have raised capital prior to the listing.

Direct/Dual Listing

For a Direct/Dual Listing, a company must be listed on another stock exchange before listing on the NSE or the company will list on the NSE and another stock exchange but the latter will be its primary listing. The company need not have an office in Nigeria or even conduct business in Nigeria but it must have an operating track record of two years, and the jurisdiction it has been listed in or wishes to be listed in must have shareholder protection equivalent to Nigeria.

Perhaps, the Nigerian Stock Exchange could combine the principles of the two methods aforementioned and create direct listings for entities that have complied with the listing requirements spelt out in the NSE Greenbook. This means that a private company that has an:

- operating track record of at least two years;

[10]Ari Levy "NYSE proposes allowing companies to raise fresh capital in direct listings" https://www.cnbc.com/2019/11/26/nyse-proposes-allowing-companies-to-raise-capital-in-direct-listings.html.
[11] Initial Public Offerings (IPOs), Listing by Introduction, Reverse Mergers/Reverse Takeovers, Direct/Dual Listings and Depositary Receipts.

- has met the minimum requirements of the NSE and has been screened by the Nigerian Securities and Exchange Commission and its sector-specific regulator; and

- has a minimum private float that will be determined by the NSE;

can go public without an IPO, by listing on the Nigerian Exchange through a direct listing, allowing its shareholders sell their shares to the general public through brokers and also allow the company sell its outstanding shares.

CONCLUSION

A direct listing is a viable path for tech companies that wish to go public but it is not for everyone. Companies must consider factors like capital requirements, shareholder composition and the goals and objectives of going public. Tech companies that wish to go public by this means must also ensure that they have a shareholder base comprising of high net-worth Individuals and the company's valuation is close to "Unicorn status"[12].

One thing is certain, direct listings are here to stay and Nigeria with its large tech ecosystem needs to consider the new alternative for tech companies who wish to go public.

[12] A unicorn is a privately held start-up company valued at over $1 billion according to Venture Capitalist, Aileen Lee.

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