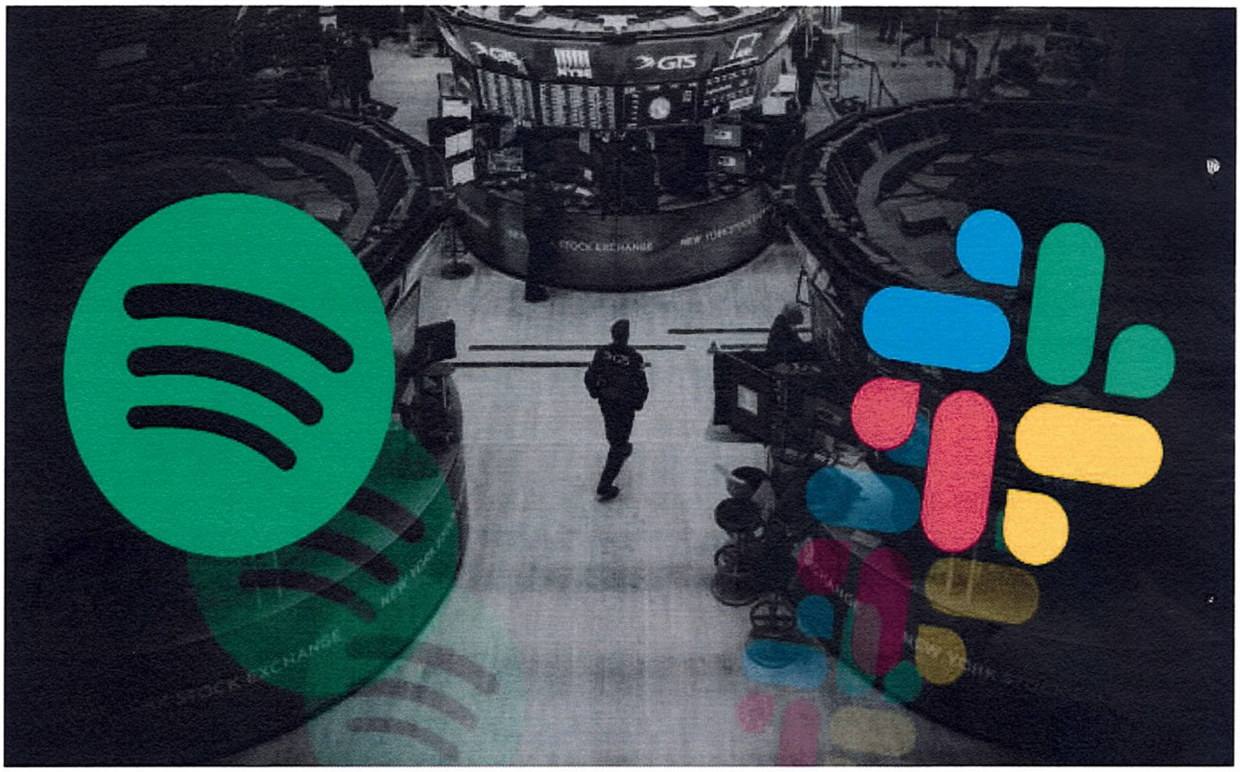
IPOs

Slack and Spotify debuts tempt companies to cut out the middlemen

Successful 'direct listings' cast doubt over the traditional route of an IPO



Richard Henderson in New York JULY 10 2019

US stock-market listings have roared back to life after a slow start to the year, but a new way of offering shares to the public has left top executives and venture capitalists wondering about following suit.

Last month, messaging service Slack bypassed convention with a "direct listing," where shares become tradable on an exchange, but no money is raised. In doing so, it cut out many of the ways in which investment banks traditionally drum up interest among fund managers. Since then, its shares are up about 35 per cent.

The deal followed Spotify, the music streaming service, which used a similar method in April 2018. At the time, the company's chief financial officer decried the traditional share-listing model as broken, expensive and outdated, relying too much on enriching underwriters via a first-day "pop" in the stock.

Critics countered that the technique would leave the shares thinly followed and, without "lock-ups" which restrict sales in the early months, vulnerable to falls. But they have since risen more than 10 per cent.

Analysts note that while the duo represents a small slice of the market, their success is likely to attract copycats, squeezing the fees paid to investment banks and shattering the club-like system behind initial public offerings, where big groups of banks band together to build investor appetite for the stock.

"The days of the 7 per cent fee for a large IPO are long gone," said Jeffrey Harte, a banks analyst at Sandler O'Neill. "Direct listings are another incremental step in the pricing pressure for the larger IPOs."

Slack paid about $22m in fees for its direct listing to Goldman Sachs, Morgan Stanley and Allen & Co — the same trio behind the Spotify listing. Uber, by contrast, whose $72bn market capitalisation is four times Slack's, paid $106m to 29 banks for a regular IPO.

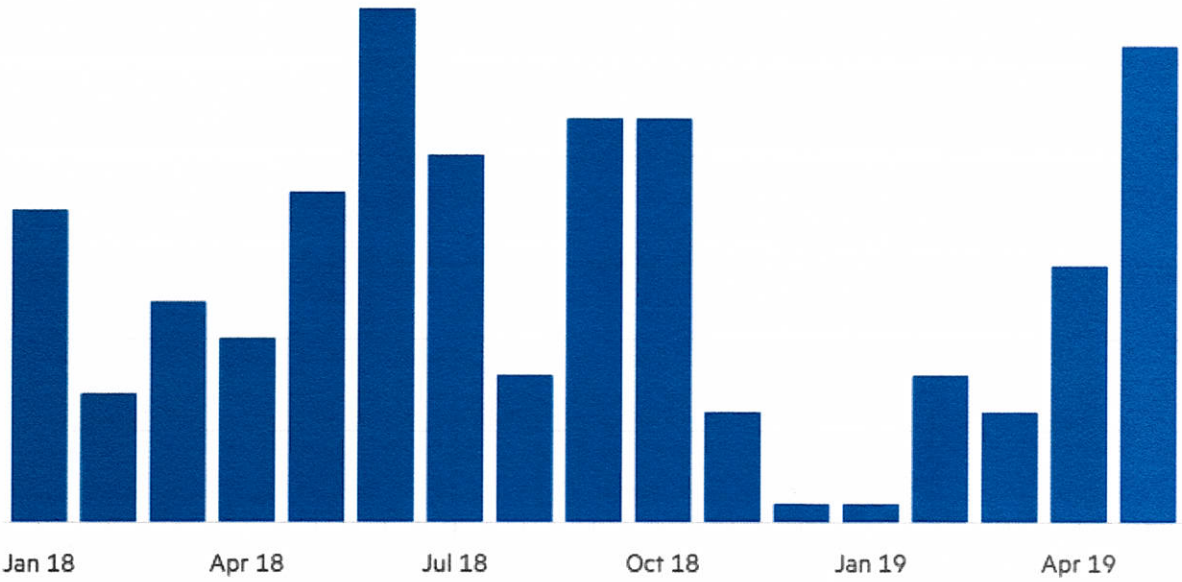
"More direct listings will dramatically change the number of underwriters in these deals and the idea of a syndicate," said Scott Kupor, managing partner at Andreessen Horowitz, the Menlo Park, California-based venture capital firm that owns a stake in Slack.

For now, direct listings are rare. Spotify and Slack stand against 226 companies that have listed via an IPO in the past 18 months in the US, raising $77.3bn, according to data from Ipreo. Yet the option may be attractive — especially for companies in Silicon Valley, one of the most fertile regions for exchanges' listings business. Airbnb, for example, is reckoned to be considering a direct listing.

"The number . . . will continue to grow," said Colin Stewart, global head of technology capital markets at Morgan Stanley, who worked on both deals. "I think it leans toward technology companies because they are high-growth and more attractive equity stories, but over time it will broaden out."

US enjoys bumper IPO crop

226 listings raise $77.3bn since start of 2018 (number of IPOs by month)



Monthly totals of US IPOs January 2018 to May 2019
Source: Ipreo

Typically, syndicate banks host investor roadshows in the months before an IPO, stirring up interest by chaperoning executives from the listing company to conferences with institutional investors and portfolio managers from fund groups like BlackRock and T Rowe Price. The banks then apportion stock to large investors through the IPO.

A direct listing circumvents this process. Without an allocation locked in, institutions stand on equal footing with retail investors. "A direct listing allows investors to buy a bigger chunk of the company, if they choose, and not be held back by allocations as in an IPO," said William Connolly, Goldman's head of technology equity capital markets.

"The people who don't like direct listings are the hedge funds and other short-term investors that want to flip in and out of the IPOs," added Mr Kupor. But for fund managers with a longer-term focus, "direct listings offer higher valuations with lower volatility," he said.

Another reason tech companies may consider a direct listing: high demand among investors for tech stocks, which have delivered a solid decade of outperformance over the broader US stock market.

Prospects of a US recession, meanwhile, could spur equity investors to buy up stocks in defensive sectors such as consumer products, but also high-growth companies whose performance is less tethered to the economy.

The pioneering efforts of Spotify and Slack echo one former tech start-up that decided to sidestep the typical IPO process 15 years ago.

Instead, it listed its shares via a "Dutch auction" where investors logged their interest online, allowing a piece of software to set the share price by weighing supply and demand. Shares in that company, Google, have since gone up about 2,000 per cent.

But advisers caution that breaking the mould is not for everyone. Spotify, Slack and Google were all big businesses with brand-name recognition that resonated with retail investors — vital elements required to build investor interest outside of the IPO industry's hype machine.

"If you don't have those factors going for you, it's like selling your own house without a real-estate agent," said Mr Harte of Sandler O'Neill. "You can do it, but it's hard."