What Companies Should Know About Direct Listings

By Louis Lehot (February 26, 2020)

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With the wildly successful exits for shareholders at Spotify Technology SA and Slack Technologies Inc. via direct listings on the New York Stock Exchange, and with Asana Inc.'s direct listing now in process, stakeholders of late-stage companies need to ask themselves: Would a direct listing provide a better exit for your company than a traditional initial public offering?

Following is a summary of how a direct listing works, and why more companies are thinking beyond the conventional IPO to consider this method of going public.

What is a direct listing?

In a direct listing, a company's existing and outstanding shares are listed on a stock exchange with neither a primary nor secondary underwritten offering. The listing company raises no capital. There are no proceeds to the company.

Upon the effectiveness of a registration statement for the direct listing, the existing shareholders, whether investors or employees, become free to sell their shares without any obligation to do so.

Given there is no underwriter setting the price, there is the opportunity to offer greater transparency and to enable a more market-driven price discovery process for sellers. For companies that do not need to raise capital, this can be an attractive option to develop an active trading market for their securities.

How is a direct listing different than a traditional IPO?

In a traditional IPO, a company will offer a specified amount of new or existing shares to the public. For instance, if a company has 100 shares, it might create 20 more shares that it sells for cash. Underwriters or investment banks charge a commission to syndicate and sell the shares to their network of fundamental, retail and hedge fund investors.

The total number of shares thus becomes 120. Selling these new shares to investors helps raise additional capital for company operations and can fuel expansion. Secondary underwritten sales are typically limited to 20% to 50% of the aggregate proceeds in an IPO.

In a traditional IPO, underwriters, or banks that help sell shares of the company to fundamental, retail and hedge fund investors, have a crucial role in coordinating the transaction. Syndicate desks at the banks call dozens of investors in money centers around the country, and sometimes around the world, seeking one-on-one meetings and inviting investors to attend group presentations.

They also ensure investors get access to net roadshows, or electronic meetings and materials. The banks play a critical role in explaining to investors why they should buy shares in the company. But it costs typically a 7% commission. Add legal, auditing, financial printing, investor relations and other fees, and the cost of capital can exceed 10% in smaller deals.

Banks often price the IPO at a 12% to 25% discount to expected market value, which can create a pop on the first day of public trading as new investors buy a direct allocation of shares from the banks and then build a position in the market. In a direct listing, no new money is being raised, and no new shares are sold. Instead, existing investors and employees who hold shares can start selling them on the public exchange.

In a direct listing, an exchange works with a designated market maker and bankers to issue a reference price, which some investors view as a guide. The reference price is partly based on how the stock was valued in private markets.

The designated market maker and bankers provide input on the supply and demand, following which the exchange opens trading based on what the group believes will be a stable price. With a direct listing, a company can forego the 7% commission banks charge in a traditional IPO and the 12% to 25% discount that underwriting banks offer their direct customers.

While the company itself doesn’t raise any cash, at least not initially, the existing shareholders sell their shares directly and are not subject to lockup.

Banks do much less marketing with the direct approach. Many participating banks provide aid in a direct listing solely by committing to research coverage of the company.

What is the takeaway?

A direct listing is intended to provide liquidity for existing investors at a lower cost but is currently available only to companies that have enough expansion capital on hand to meet their needs. If you are profitable, cash flow positive, or sitting on a mountain of cash from previous rounds of private fundraising, with a well understood business model, then the direct approach can work.

You are not getting new money through the selling of fresh shares in the IPO, but you are also not spending as much on banks or giving away value to initial purchasers in the form of a discount.

Who are the winners in a direct listing?

To many venture capital investors, founders and employees, the direct listing is attractive because it avoids the 7% commission, avoids the 12% to 25% discount, there is no lockup and it monetizes immediately.

Employees, who take shares at the early stages of a company’s life, might prefer a direct listing so they can quickly sell shares. This is one way to compensate for the lower salaries that come with working at a startup.

In an IPO, early investors must wait until the lockup period is over — typically a 180-day period during which they cannot sell their shares. Employees may not prefer to wait, as markets could become too volatile, and they might realize less from the sale of their stock.

Direct listings benefit employees and the company benefits from avoiding banks’ charges for extensive marketing. Reportedly, Spotify saved $100 million through its direct listing.

What are the limitations?

As of this writing, U.S. securities laws do not allow for underwritten capital raisings via direct listings, although there is movement afoot at the NYSE Holdings LLC and the NASDAQ OMX Group Inc. to convince the U.S. Securities and Exchange Commission to blaze a trail. Lack of capital raising ability is thus a significant limitation.

Companies that are not already well capitalized should thus not look to this option.

Another limitation arises when companies do not have a shareholder base large and diverse enough to provide sufficient supply-side liquidity in the marketplace.

We have not yet seen a company attempt a direct listing that was not already a well-recognized brand name with an easily understood business model. Companies with new or disruptive business models, or that are not yet profitable should not look to the direct listing as an exit.

Finally, with only two completed direct listings to date, we have not experienced the full panoply of potential implications of the process, and much is to be learned.

Will direct listings become more common?

Since Spotify went public via the direct listing route in 2018, direct listings have been the talk of the town. Slack followed on in 2019 with a successful blockbuster transaction. It remains unclear whether direct listings will become more common, even if they can achieve liquidity at a lower price point than the traditional IPO, which often costs in excess of 10% of the deal proceeds.

At least for now, primary capital cannot be raised for a company via a direct listing. The direct listing process only offers liquidity for existing stockholders. There are a multitude of investment banks that can bring smaller companies public and raise capital for them via the traditional IPO process. Very few companies without brand recognition and cash flow will be able to successfully execute a direct listing.

Venture capitalists are very excited about the prospect of achieving liquidity at a lower cost of capital. Many are lobbying the SEC to set forth a regulatory framework that would allow direct listings for capital raising. With Asana’s direct listing coming to market soon, and Airbnb Inc. rumored to be exploring this route, time may soon tell.

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