Saying No to an IPO

Are Tech Companies Better Off Private?

Written by Nicholas Kuchtaruk

As the market recovers from the uncertainty of the recent recession, investors are desperate to snatch a piece of the booming technology industry – so desperate, in fact, that comparisons are being made with the hysteria of the 1990s internet bubble. Rumored IPOs by LinkedIn, Groupon and Skype have investors salivating. Players who have not yet filed to go public, such as Twitter and Zynga, are also garnering interest. Facebook, arguably the most sought-after prize in the tech space, has many wondering if it is ready to 'friend' the stock market.

A decade ago, investors would have eagerly awaited an IPO to partake in the success of these tech firms. The IPO system favoured investors since tech companies seeking growth had few alternatives to public financing. However, a recent deal between Goldman Sachs (GS) and Facebook suggests that investments in technology are taking a new form.

The Future of Financing

Many in the media have targeted Facebook as the next 'sure thing' IPO. Cue the underwriters? Not necessarily. Times are changing and Facebook CEO Mark Zuckerberg has repeatedly delayed a public offering.

In January of 2011, Zuckerberg entered a multi-party financing with GS for US$450 million, Russian investment firm Digital Sky Technologies for $50 million and an elite list of GS clients for an additional $1 billion via a Special Purpose Vehicle (SPV). The SPV is a legal entity that enables a collection of GS clients to be considered a single investor. The SPV structure effectively prevents Facebook from surpassing 500 investors – at which point they must disclose financial statements, as per SEC rules.

Investors are becoming increasingly accepting of the risk associated with opaque private companies. The benchmark for disclosure and liquidity is being lowered each minute these companies stay private. Large investors certainly have appreciable access to management but the individual investors that provide capital through structured vehicles do not necessarily have the same quality of information. Several investment banks are even creating SPVs to allow clients to invest in the most popular companies. For example, JPMorgan's Digital Growth fund is designed specifically for clients interested in private social media investments. Despite

SEC scrutiny, these financings are poised to become more common, increasing the capital available to private tech companies.

Shifting landscape

Surely tech companies are watching the GS–Facebook deal carefully. The GS valuation has accomplished two important things for tech companies: first, it has given them valuation credibility based on the reputation of the investment bank. Second, it has provided a template for future financing. Facebook received a sizeable capital injection and did not need to go public to do so.

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One has to wonder, are IPOs still necessary for tech firms? With funding available via SPVs, going public is no longer a requirement of tech companies' financing plans. The capital required to take on new projects and incentivize talent is now available to private firms. However, SPVs alone do not satisfy the need to create liquidity for founding members. Entrepreneurs have thus created secondary markets for trading private shares.

Secondary Markets

SharesPost and SecondMarket are secondary market trading platforms for private company shares. These online markets allow shareholders – employees and current investors, in private companies – to conveniently trade their shares. Since June 2009, SharesPost has grown to 45,000 members managing $125 billion in capital. Transaction volume in Q4 2010 was $1 billion for 150 of the hottest start-ups.

> "One dynamic that is changing is all the activity in the secondary market where founders can get a little bit of liquidity from existing investors or incoming investors. Sometimes that can allow them to take a few chips off the table yet still take a risk by staying in the company as opposed to exiting in a liquidity event."
>
> - John Simon
> General Catalyst Partners

Secondary markets for private shares also offer more attractive returns for current investors: an IPO typically prices at a discount to fair value because institutional buyers need an incentive to take a large position. SharesPost and SecondMarket, on the other hand, offer very attractive valuations. The combination of limited disclosure requirements and media hype around private companies helps build investor optimism and drive share prices higher. In Facebook's case, this optimism took the form of a 50% premium: the social media company was valued at $75 billion on SecondMarket at the end of February 2010, just two months after a $50 billion valuation through the SPV deal.

With the liquidity available through SecondMarket and SharesPost, investors can more easily trade shares of private companies. This allows early investors to sell a portion of their shares, locking in some return without having to relinquish their entire stake. With the number of transactions through secondary markets growing quickly, both shareholders and investors clearly value these services.

Not a Good Fit for Tech

The nature of the tech industry makes going public unappealing, since the focus of Wall Street is at odds with the goals of budding tech enterprises. The long time horizon, nontraditional founders and culture of innovation that are the backbone of many successful tech firms tend to clash with the desires of traditional investors.

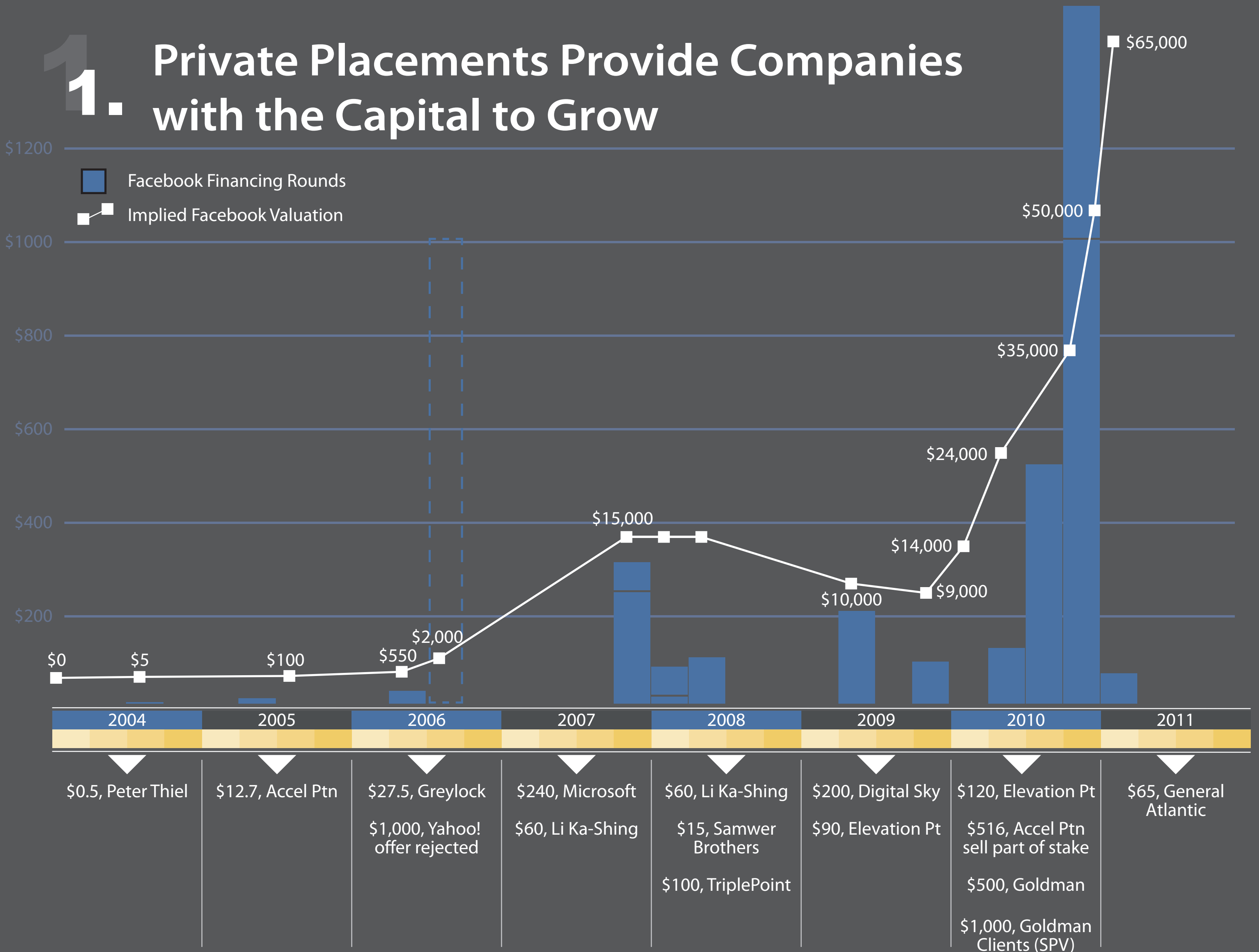
Conversely, growing tech companies focus on increasing their user base rather than profiting immediately. A company that prioritizes developing their technology or increasing their user loyalty could be forced to make unappealing tradeoffs to satisfy shareholders' expectations regarding profit. For example, companies such as Facebook and Twitter have emphasized that increasing their subscribership is more important than user monetization. Would this long-term perspective be possible if they were public? Analyst scrutiny and the pressure to meet quarterly EPS figures would surely weaken long-term focus. With access to alternative financing readily available, companies can continue to delay profitability in an attempt to grow.

The founders of many tech companies are not the typical CEOs of the past. Young entrepreneurs tend to be uninterested in relinquishing control of their projects and thus avoid diluting ownership. Being the face of a public company also leads to increased personal scrutiny. Founders may shy away from the limelight and choose to remain private. Google's Larry Page and Sergey Brin were uninterested in being the face of Google, and thus relinquished their chief executive roles for board positions, which many feel was the beginning of a negative cultural shift in the organization. Does it make sense for young founders to step aside simply because the typical face of a large company is an older individual with a traditional business background? Certainly, CEOs that have built enterprises from basements and dorm rooms into global titans are not thrilled with the idea of passing the reins to a more 'established' executive, as shown by Page's return to Google.

Innovation is also central to these companies. In an environment in which a first mover advantage is often critical to achieving success, companies cannot risk falling behind. The publicity and reporting standards associated with being public increases the likelihood of competitors catching wind of potential innovation, not to

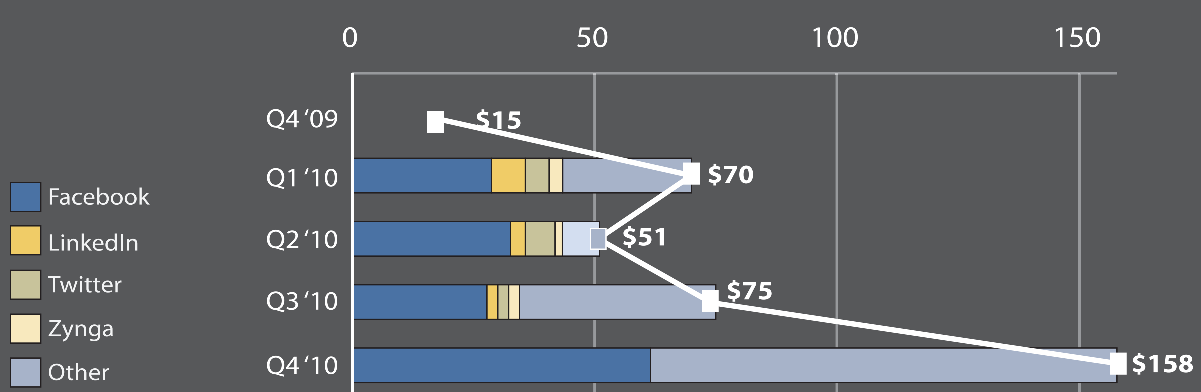
Why Can Companies Stay Private?

1. Private Placements Provide Companies with the Capital to Grow



Facebook investments and resultant valuations ($US billions)

2. Secondary Markets Provide Employees and Early Investors with Liquidity



Total Value of SecondMarket Transactions per Quarter ($US millions), % of Transactions by Company mention the increased regulation when public. Are the resources being directed toward appeasing SEC legislation truly helping the company achieve its end goals? There are significant benefits to focusing capital and manager energy on continuous innovation – in the minds of some young tech builders, a public listing could be viewed as a distraction rather than a benefit.

Firms across many industries would benefit from remaining private – hence the rise of private forms of capital. However, the use of SPVs and secondary markets seems exclusive to tech firms at this point. The tech industry generates significant buzz by virtue of new products' impacts on consumers, contributing to investor appetite for tech financing. Also, the overwhelming majority of trading volume on secondary markets is in tech stocks, so the liquidity does not exist to support other industries. Finally, many other industries require high capital investment from their founding – they need to raise money consistently, and an IPO is the most tried-and-true way to accomplish that. Tech companies like Facebook and Twitter, on the other hand, require little capital investment to succeed.

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In The Future

Going forward, many speculate the SEC will grow more active in scrutinizing private financing. With significant capital and a sizeable number of investors involved, increased regulation is expected. It is unclear how the SEC's role will develop to protect investors on the private markets, and how any changes will restrict private financing moving forward.

On the corporate side, without the pressure from shareholders to monetize the business concept and a strong business track record, some tech visionaries may not optimally translate users into profitability. Yet with such significant investor interest, many investors do seem to believe in some of these nontraditional business leaders. Mark Zuckerberg, in particular, seems to have discovered how to take advantage of the recent financing trend.

Facebook is undisputedly today's tech darling. When Zuckerberg states that he will not take his company public until at least April 30, 2012, and others suggest he will delay indefinitely, people wonder why. It seems he has realized that tech companies today are playing in a far different environment than in years past. Young entrepreneurs should pay attention. With the emergence of new financing alternatives and secondary markets for private stock, growing tech companies are no longer forced to IPO, and pay the steep price associated with being public. For the sake of innovation, the entrepreneurs of tomorrow should take advantage of this opportunity to stay private.

Facebook Special Purpose Vehicle Structure