The Legal Intelligencer

Where Have All of the Initial Public Offerings Gone?

Katayun I. Jaffari and Kimberly W. Klayman, *The Legal Intelligencer*

August 8, 2017

On June 29, the Securities and Exchange Commission (SEC) announced that it is permitting all companies to file the paperwork for an initial public offering (an IPO) without immediately disclosing the IPO to the public. Further, companies will be permitted to immediately withdraw an IPO filing. Previously, this "nonpublic review process," known as the "stealth IPO rules," was only available to emerging growth companies. As of July 10, when the so-called "stealth IPO rules" went into effect, all companies, including those that would not be classified as emerging growth companies, have been able to take advantage of a confidential IPO process.

The stealth IPO rules permit companies to submit a draft of their initial registration statements and related revisions on a nonpublic basis, provided that the company confirms in a cover letter to the nonpublic draft submission that it will publicly file its registration statement and nonpublic draft submissions at least 15 days prior to any road show or, in the absence of a road show, at least 15 days prior to the requested effective date of the registration statement.

The stealth IPO rules, which have been available to emerging growth companies under the Jumpstart Our Small Business Act (the JOBS Act) since 2012, have been popular with emerging growth companies. According to Renaissance Capital, roughly 70 to 80 percent of all IPOs in the United States that priced in 2016 began as confidential filings. Companies that have or are taking advantage of the stealth IPO rules include headliners such as GoPro, Chegg and Twitter.

The expansion of the availability of the stealth IPO rules has been viewed by many pundits as an attempt to "grease the way for more IPOs," as the number of IPOs has generally been declining year over year since the recession in 2007-2008. Though some held out hope that 2017 would usher in a resurgence of IPOs, the number of IPOs has remained subdued as compared to the pre-recession years. According to Dealogic, the U.S. equity capital markets revenue for banks is lower than it has been in more than 20 years and the largest component of this statistic is a decline in the number of IPOs. In 2016, there were only 105 U.S. IPOs, which was a record low since 2008, and the average base deal value was $214 million, which was the same as 2015 and the lowest since 2005. This decline in the number and base value of IPOs is in spite of a 40 percent decrease in SEC comments to Form S-1s since 2013 and a greater market acceptance of less financial information from emerging growth companies, which have had an easier path to the public markets (including the ability to use the stealth IPO rules) since 2012.

Some attribute the low number, and low base values, of IPOs in 2015 and 2016 to uncertainty in the markets caused by the geopolitical upheavals of the U.S. presidential election. Based on this logic, many expected 2017 to be a huge comeback year for IPOs. In the second quarter of 2017, there were 33 IPOs, which represented the highest monthly total since 2000. While there has been

positive growth in the number of IPOs in the first and second quarters of 2017, many are unconvinced that the rest of 2017 will be enough to revive the U.S. IPO market.

There are a few reasons that the number of IPOs has dropped precipitously over the past decade, and may continue to decrease over time, including companies have been availing themselves of cheaper, easier paths to fundraising (including private offerings, initial coin offerings or block trades) and companies are just not prepared to meet the financial and regulatory burdens of being public companies.

The availability of cheaper financing sources is the greatest threat to the IPO market. The primary source of alternative financing is private offerings. Over the past decade investors have been increasingly willing to fund companies through private offerings. Year over year since 2014, there have been record breaking investments made through private placements and surveys suggest that investor demand for private placements continues to exceed supply. One commentator has explained this trend by arguing that nonpublic companies have an information advantage over public companies that investors are increasingly viewing as a benefit.

In addition to traditional private offerings, in 2016 alone, startups and entrepreneurs raised more than $1 billion by selling custom-made virtual currencies to investors in what are known as an "initial coin offerings." Initial coin offerings, which are a (currently) unregulated means by which funds can be raised, are so popular that the SEC issued a warning in July in an attempt to curb this trend. The SEC warned companies that at least some virtual currencies being sold to investors should be categorized as securities and needed to follow federal securities laws. Though the price of virtual coins recently sold to investors dropped sharply after the SEC's announcement, this source of alternative financing may continue to be a threat to traditional IPOs.

Block trades have also impacted the IPO market. Block trades are follow-on offerings typically led by banks looking to purchase a large block of public company stock for purposes of reselling the stock in the market at a higher price. Block trades enable public companies to obtain financing through a follow-on offering, rather than a public offering. According to Dealogic, block trades accounted for roughly 44 percent of the U.S. equity capital markets volume in 2016, which is the largest share to date.

In addition to finding alternative financing sources, companies have also been much more amenable to strategic exits as an alternative to IPOs. For example, in 2016, Playa Hotels & Resorts BV, which had filed for an IPO in September, opted instead to be bought by a private equity firm for $500,000 in December.

Another reason IPOs are on the decline is that companies are neither prepared for, nor able to keep up with, the financial and regulatory burdens of being a public company. Evidence that companies are neither prepared nor able to withstand the burdens of undergoing an IPO and being a public company is the rising number unsuccessful IPOs. Many companies that have filed IPOs in the past few years, especially in the life sciences sector, have done so prematurely and have failed to become profitable post-IPO. From 2013 to 2015, the percentage of profitable IPO companies declined by over 15 percent. One reason for this statistic is that there has been an uptick in the number of IPOs in the life science sector and life science companies tend to have a longer path to profitability. Notwithstanding the rise in life science companies undergoing IPOs, the public market cap has become increasingly consolidated indicating that fewer companies are up to the task of complying

with public company requirements. All IPO candidates have to be prepared to comply with the accounting, corporate governance, financial and disclosure controls and procedures, external communications, legal and regulatory requirements and other corporate housekeeping requirements that burden public companies. On top of the compliance obstacles, shareholder activism and shareholder advisers have been an increasing source of pressure for public companies, particularly with respect to proxy access and corporate governance matters. As a result, companies that successfully file an IPO are not always prepared to meet the demands of maintaining public company status.

While commentators cite a number of other reasons to explain the decline in IPOs in the past few years, including a volatile market, regulatory uncertainty and consolidation in certain industries, the common theme has been the disappearing IPO as the numbers have steadily declined for over a decade. This trend has persisted despite periods of economic growth and it is likely to continue into the foreseeable future. •

Katayun I. Jaffari *is a partner in Ballard Spahr's business and finance department and a member of the securities, life sciences/technology, energy and project finance, and mergers and acquisitions/private equity practice groups. She has experience counseling public and private companies in the areas of corporate governance and securities law and compliance, including reporting requirements under NYSE and Nasdaq regulations. She can be reached at jaffarik@ballardspahr.com or 215-864-8475.*

Kimberly W. Klayman *is an associate at the firm. She counsels publicly traded and privately held companies on mergers and acquisitions, securities offerings, regulatory compliance, corporate governance, corporate formation, contract review, and other business and financing matters. She can be reached at klaymank@ballardspahr.com or 215-864-8792.*