

IN FOCUS

CORPORATE GOVERNANCE

Want to join IPO revival? A few tips for directors

Boards should take note of changes in market and industry conditions.

By Dane A. Holbrook
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This year marks the resurgence of the U.S. market for initial public offerings (IPOs)—even despite the market turmoil sparked by the credit crisis. In fact, the number of IPOs conducted during the first three quarters of 2007 were at levels not seen since 2000. Privately held companies—many of which were acquired by private equity firms, or commenced operations, in the aftermath of a bursting Internet bubble—have reached a level of operational maturity necessary to conduct a successful IPO. And they are flocking to the capital markets.

This mini-boom in the IPO market is welcome news to directors of privately held companies. But are they prepared for the IPO process or, for that matter, for their companies to be publicly traded? This article discusses the myriad of issues to be explored by the board prior to launching an IPO.

Dane A. Holbrook is an associate in the Reston, Va., office of Cooley Godward Kronish. He is a member of the firm's public securities, public offerings and mergers and acquisitions practice groups.

Conditions in the Market and Industry

The board should begin by carefully assessing the capital markets climate to ensure that the company is prepared when the window of opportunity opens. Fortunately, market conditions today evidence an IPO revival that began in late 2006. See e.g., Pricewaterhouse Coopers, [US IPO Watch: 2006 analysis and trends 4 \(2007\)](#), (stating that the IPO market in the fourth quarter of 2006 was the strongest of the decade); Jessica Guynn, *Recent*

Tech companies are leading the recent IPO resurgence.

IPOs Raise Hopes '07 Could Be Better Year, San Francisco Chronicle, Dec. 26, 2006, at F-1. There were 186 IPOs completed during the first three quarters of 2007, an increase of 20% from the same period in 2006, and a 178% increase from the same period in 2001. IPO Vital Signs, *IPO Offerings database*, available to subscribers at www.ipovital signs.com (includes real estate investment trusts and blank-check companies without current operating businesses).

The number of IPO filings is also rising, with 288 in the first three quarters of 2007,

an increase of 12% over the same period in 2006. *Id.*, *IPO Filings database*. Moreover, the aggregate IPO offering amount was \$41.5 billion during the first three quarters of 2007, the highest since 2000. *Id.*, *Offer Amount database*. This resurgence may suggest that investors' confidence in the public capital markets has been appreciably restored since the disquieting corporate scandals in the early part of the decade.

The potential success of an IPO also depends upon whether the company's industry is in vogue with the financial community. Industries rise and fall with investor preferences. During the IPO boom in 1999, for example, 66% of the total IPO volume was attributable to the technology sector. *Id.*, *Offer Amount database* (www.ipohome.com). In comparison, the volume of IPO activity during the first three quarters of 2007 was spread among several different sectors, including health care/biotech (18%), energy (17%), financial services (16%) and technology (16%). *Id.* See also PwC IPO Watch, *supra*, at 5 (2007) (citing financial services, technology, health care and energy sectors as the largest by IPO volume in 2006).

Of particular note, technology companies are helping to lead the IPO surge. Michelle Kessler, *Tech Firms Scoot Into IPOs Again*, USA Today, July 9, 2007, at 1B (stating that tech firms are "embracing initial public stock offerings again"); Todd Wallack, *Waltham Biotech Adnexus Looks to Join IPO Parade*, Boston Globe, Aug.

27, 2007 (“Biotech companies are riding the IPO wave”). In the third quarter of 2007, technology IPOs accounted for nearly one-quarter of the total deal flow. [IPOhome.com](#), *Renaissance Capital’s 2007 Third Quarter IPO Review*. There were 29 technology IPOs completed as of Oct. 14, compared to 31 during all of 2006 and 29 during all of 2005. *Id.*, *IPO Industry History*, *supra*.

Market and industry conditions can dictate the timing, valuation and, ultimately, the success of the IPO. To that end, the board should bear in mind that conditions in the market may change significantly between the time that a company decides to undertake its IPO and the time it actually conducts its IPO. For example, although the financial services sector, led by private-equity giant Blackstone Group LP, was hot in the second quarter, this sector “was hit hard in the third quarter [and] isn’t expected to fare well going forward.” Lynn Cowan, *IPOs Weather Stormy Market*, *Wall St. J.*, Oct. 1, 2007, at C6. Directors and officers should consult with investment banking firms—preferably those that are experienced in the industry and/or representing comparable public companies—for perspective on market and industry conditions and their effect on the company’s potential IPO.

IPO costs have risen and may well prove prohibitive.

Conditions the Company Controls

Surging capital markets notwithstanding, a company’s IPO prospects are only as good as the company itself. During the time leading up to an IPO, the board should continually evaluate the company’s financial condition and operating results; the adequacy of its internal financial reporting and accounting controls; its corporate governance policies and infrastructure; and the quality, experience and dedication of its management team. Directors should assess the impact of these

considerations on the viability and timing of an offering, as well as the potential valuation of the company. See Steven E. Bochner et al., *Guide to the Initial Public Offering 3-4* (6th ed. 2006).

The board is generally responsible for ensuring that the company meets the IPO criteria of underwriters and the market. It is no surprise that the criteria required by equity markets and investors have changed since the late 1990s era of exciting stories backed by unproven business models. See *Species of Blue-Green Algae Announces IPO*, *The Onion*, Nov. 17, 1999, Issue 35-42 (quipping that a Lake Erie-based algae, *Anabaena*, with \$0 in 1999 revenues, would be conducting a \$9.8 billion IPO). Investors today are focusing on more traditional factors such as a history of (or clear path to) profitability, proven business models, growth prospects, an experienced and dedicated management team and board, differentiated products or innovative technologies, and significant entry barriers for potential competitors. In terms of pure operating results, 71% of the companies that went public during 2005 and 2006 were profitable. Quentin Hardy, *Exuberance*, *Forbes.com*, April 9, 2007, [www.forbes.com](#). However, this year there has also been “a dramatic rise in the share of money-losing companies” going public. *Id.*

The board and management should be the first to call for help from investment bankers, auditors and attorneys. For a company making its debut into the capital markets, having the right professional advisers can make all the difference.

Understanding the Benefits of an IPO

Before embarking on the expensive and protracted process of preparing for an IPO, the board should decide whether the benefits of going public outweigh the costs. In doing so, directors ought to be mindful of the private alternatives to a public offering. An IPO may not be the best option for a company to realize its immediate and long-term objectives. The best interests of stockholders may be better served by a sale or merger, a private equity or debt financing, or a joint venture.

Of course, the most straight-forward benefit to a company conducting an IPO is the amount of capital raised in the offering. And so far, 2007 is seeing the largest offerings since 2003. Of the 186 IPOs completed as of Sept. 30, 2007, the median deal size has been \$115 million and the average deal size has been \$223 million. IPO Vital Signs, *Offer Amount database*, *supra*.

An IPO can generate significant offering proceeds that can be used to finance the immediate and long-term growth of the company’s business. A recent survey of 438 chief financial officers (CFOs) found that the most important benefit of an IPO is that it can be a vehicle for funding company growth. James C. Brau, et al., *Initial Public Offerings: CFO Perceptions*, 41 *The Financial Rev.* 483, 495 (2006). This capital can be used to fund the expansion of the company’s operations or infrastructure, to accelerate the company’s growth by adding personnel, or to subsidize significant expenses such as research and development, acquiring new technology or product marketing. See Patrick Schultheis at al., *The Initial Public Offering 4* (2d ed. 2004).

The IPO process culminates in the creation of an active trading market for the company’s stock. Aftermarket trading results in greater liquidity for founders, early stage investors, managers and employees—although there are often limitations on liquidity, including restrictions preventing trading until the expiration of a six-month “lock-up” agreement with the underwriters. See Robert Heim, *Going Public in Good Times and Bad 19-20* (2002). Liquidity need not be viewed simply as an immediate exit strategy, however. More importantly, liquidity allows company stock to be used as a currency to acquire complementary businesses and technologies, to dilute the ownership control of large investors and to fund expansion. See, e.g., Schultheis, *supra*, at 6 (“[S]tock provides an acquisition currency that enables the target company stockholders to participate in the anticipated upside of the combined company”).

A company’s IPO can facilitate future financing. That the company is publicly traded has meaning—a public company

has undergone extensive due diligence, its business plan has often been thoroughly vetted and proven, its financial records have been audited for an extended period of time and it may be followed by independent analysts. Compared to a similar private company, these factors make a public company a more attractive candidate for debt and equity financing.

Measuring the Costs of Going Public

The board may determine that the significant costs of going public militate against conducting an IPO. Direct costs associated with the IPO process have grown noticeably since 2002. For example, a comparison of the average legal, accounting, printing and transfer-agent expenses incurred by the 186 companies that completed IPOs during the first three quarters of 2007 with those of the 65 companies that completed IPOs in all of 2002 reveals the following: Legal fees rose from \$1,136,457 in all to \$1,322,175 in 2007; accounting fees rose from \$682,578 to \$946,354; printer fees decreased from \$468,882 to \$299,201; and transfer-agent fees rose from \$13,201 to \$22,697. See IPO Vital Signs, *supra*, *IPO Legal Fees*, *IPO Accounting Fees*, *IPO Printer Fees and IPO Transfer Fees databases*.

Other direct offering costs are based on the size of the IPO, including filing fees of the U.S. Securities and Exchange Commission (SEC) and the Financial Industry Regulatory Authority, as well as fees associated with listing on exchanges such as the New York Stock Exchange Inc. (NYSE) or NASDAQ Stock Market (NASDAQ).

The largest IPO-related cost is the payment of discounts, commissions and financial advisory fees to the underwriters. Typically, the underwriters will receive a fee equal to 7% of the gross offering proceeds for their services in coordinating the syndicate, conducting due diligence review of the company, and generally marketing the offering. Costly underwriting fees, according to a recent survey of CFOs, are the most significant disadvantage associated with conducting an IPO. Brau, *supra*, at 502 (59.6% of CFOs agreed that a

disadvantage of conducting an IPO is costly underwriting fees).

One major indirect cost inherent in the IPO process is that it requires 14 to 18 weeks (and sometimes more) of dedicated attention from key members of the company's management. Company executives will spend a significant amount of time working with investment bankers, attorneys and accountants preparing the registration statement and prospectus. This distraction from the day-to-day operations of the company can aggravate executives and disrupt company operations, especially if the company is not adequately prepared for the IPO process.

Costs of maintaining a public company must be considered.

Evaluating the Costs of Being Public

The board's decision calculus should also include a realistic appraisal of the costs of maintaining a public company. Unlike the costs of going public, the considerable expenses related to maintaining a public company are ongoing and directly affect the company's operating results. The expenses accompanying public-company status include costs associated with compliance with rules and regulations, including the Sarbanes-Oxley Act of 2002 and the stringent listing standards of NYSE, NASDAQ, or other exchanges, developing or increasing compliance and accounting personnel, fees for professional advisers, and directors and officers insurance premiums.

A public company lives in a fish bowl, as the federal securities laws impose significant disclosure requirements on it. Once publicly traded, the company will, to a large degree, lose the ability to maintain the confidentiality of sensitive information it may otherwise wish to keep hidden from its competitors. According to a recent survey of CFOs, this loss of confidentiality

was the most significant indirect cost of an IPO. Brau, *supra*, at 502-03 (63.4% of CFOs agreed that a disadvantage of conducting an IPO is the loss of confidentiality).

Finally, the company and its directors and officers will face an increased risk of securities liability for public statements or omissions following an IPO. Public companies are frequent targets of securities class and derivative actions from an active plaintiffs' bar and institutional shareholders, and may be subject to enforcement actions by the SEC.

Conclusion

Taking advantage of this IPO mini-boom is an exciting prospect for many privately held companies. However, the process and costs of going public and then maintaining a public company that are discussed in this article should be carefully weighed before launch. **NLJ**