Initial Public Offerings: An Introduction

Here's the deal:

- An initial public offering ("IPO") refers to the initial offering by a company of a class of its equity securities, usually with a contemporaneous listing of that class of securities on a national securities exchange.
- Although there is no perfect time to effect an IPO, a company should consider the overall market conditions, investor appetite for risk, its anticipated valuation, the needs of existing securityholders for liquidity, its preparedness to address the reporting and other responsibilities associated with being a public company and the specific benefits and drawbacks associated with completing an IPO.
- For discussion purposes, the IPO process can be divided into roughly three periods — the "pre-filing period," the "pre-effective period" and the "post-effective period" — each period is defined by the different tasks that the company will need to complete and the stages of review undertaken by the SEC.
- An IPO requires the involvement of a variety of parties, including that of underwriters, legal counsel to the company and the underwriters, accountants, an investor relations firm, a transfer agent, a financial printer and the equity research analysts associated with the investment banks that are acting as underwriters, each of which play a crucial role in the process of going public.

What's the Deal?

An "IPO" is the initial public offering by a company of a class of its equity securities, typically its common stock. An IPO is usually an offering that is registered under the Securities Act of 1933, as amended (the "Securities Act"), and the class of securities are often but not always listed on a national securities exchange, such as the New York Stock Exchange ("NYSE"), the NYSE American or one of the Nasdaq Stock Markets ("Nasdaq" together with the NYSE, the "exchanges"). In an IPO, the company may offer newly issued shares of its common stock and/or existing stockholders may offer their shares of common stock for resale (a "secondary" component). After completion of an IPO, a company becomes a "public company," subject to all of the rules and regulations applicable to public companies, including those of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and those of the exchange on which its securities are listed or quoted.

Considerations for a Company Contemplating an IPO

A company that is seeking greater access to capital, increased visibility and liquidity may decide to go "public." Although, there is no right answer or right time for a company to make the decision to go public, there is a market consensus that a "window" exists for certain types of companies to effect an IPO. Whether the window is "open" or "closed" usually depends on the overall economic conditions and investor appetite for risk. In addition to considering the overall receptivity of investor sentiment for an IPO, a company should also consider the advantages and disadvantages of an IPO, including, but not limited to, those summarized below.

Advantages

- An IPO allows a company to raise capital. Unlike a private offering, there are no restrictions imposed on a company with respect to the type or number of offerees or to the number of securities it may sell in an IPO. The net proceeds that are received from the securities sold in an IPO may be used for general corporate purposes, such as working capital, research and development, retiring existing indebtedness and acquiring other companies or businesses.
- Going public creates a market for a company's securities, allowing a company to have greater access to capital in the future. Once a public market for its securities exists, a company may be able to conduct follow-on equity offerings in the future to finance its growth. A company also may be able to use its stock to acquire other companies as part of an acquisition strategy.
- Companies achieve greater visibility after an IPO. That is because the media and research analysts will have greater economic incentive to cover a public company due to the number of investors seeking information about their investment.
- A public company may also use its equity to attract and retain management and key personnel. Once a company has gone public, a company's employees can share in its growth and success through stock options and other equity-based compensation structures that benefit from a more liquid stock with an independently determined market value. Similarly, existing stockholders may want a company to undertake an IPO in order to monetize all or part of their investment in the company.

Disadvantages

- The IPO process is expensive. The legal, accounting and printing costs are significant and these costs will have to be paid regardless of whether an IPO is successful.
- A company will incur higher ongoing costs as a public company, in order to comply with the requirements of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd Frank"). In addition, obtaining and maintaining directors' and officers' ("D&O") insurance adequate for a public company will be costly.

- Once a company is public, certain information must be disclosed to the public, including executive compensation, financial information and material agreements. Therefore, after an IPO, a company may also face increased public scrutiny.

Recent IPO Trends

Before choosing to undertake an IPO, a company will likely want to consider recent trends. During the dotcom boom of the late 1990s, many technology companies had no revenues or profits. Therefore, IPOs became an important capital raising tool that technology companies could implement to raise growth capital. However, regulatory developments and market dynamics have changed leading to an overall decline in the number of IPOs on a historical basis. This decline can be attributed not only to increased regulations relating to equity research, but also to enhanced corporate governance requirements for public companies, a decline in the liquidity of small and mid-capital stocks and other significant market structure and regulatory developments.

After the dotcom bust, there was a slight increase in the number of IPOs, but that number quickly declined again after the economic downturn of the 2000s. During the same period, funding alternatives to public capital proliferated, as a number of developments affecting the private capital markets emerged. Additionally, broad pools of capital were created as new or additional investors entered the private capital markets, such as hedge funds, private equity funds, family offices, sovereign wealth funds and crossover funds. Even though significant changes to the IPO process have been implemented, such as those associated with the Jumpstart Our Business Startups ("JOBS") Act, there had been no significant sustained overall increase in the number of IPOs compared to the 1990 levels. However, the last two years have led to record-breaking amounts of capital being raised through IPOs.

The IPO market remained relatively stagnant until 2020. In 2020, there were 216 IPOs, which raised an aggregate $77.2 billion in proceeds. Despite the rippling effects of the COVID-19 pandemic, in 2021, an astounding 406 companies raised $139.3 billion of capital through IPOs. By comparison in 2019, there were 160 IPOs, which raised a total of $45.8 billion in offering proceeds. The median market capitalization for an IPO issuer was $928.1 million, with a median of $164.7 million per deal raised, in 2021. Life sciences and healthcare companies dominated the IPO market by number of deals in 2021 and life sciences, technology and financial services companies made up 69.8% of IPOs by number of deals.

Another recent trend in IPOs has been the recent surge of the special purpose acquisition company ("SPAC") IPO. A SPAC is a newly formed company that has no assets or operations and intends to effect an initial business combination with an operating company using the IPO proceeds. For a private target company, combining with and into a SPAC has become a popular alternative to a traditional IPO. This trend can be attributed to increased blue-chip investors sponsoring SPACs, and better sponsor-investor alignment structures. In 2020, U.S.-listed SPAC IPOs accounted for more than half of overall U.S.-listed IPOs. This trend continued into 2021, where there was a total of 613 SPAC IPOs and $162 billion of capital raised.

Types of Companies that Go Public

Generally speaking, and but for life sciences companies, revenue-generating companies or companies with a shorter path to profitability are more likely to have successful IPOs, compared to companies that are in a development stage or are pre-revenue. There are a variety of companies, which may seek to go public in order to pursue their strategic plans, including:

- **Research and development ("R&D")-based companies**, including pharmaceutical and technology companies, with strong valuations but little current revenue. These companies may decide to undertake IPOs to fund long-term, costly R&D. However, later-stage R&D companies and companies with near-term milestones may also decide to access the public markets through an IPO.
- **Real estate investment trusts ("REITs")**, including mortgage REITs, are formed to take advantage of opportunities to purchase distressed or undervalued mortgage-related securities, and equity REITs generally are formed to acquire specific kinds of real estate.
- **Special purpose acquisition companies**, a more recent type of blind pool offering, are shell or blank-check companies that have no operations but go public in order to identify and combine with an operating company, using the proceeds of the IPO, and subject to receipt of shareholder approval.
- **Business development companies ("BDCs")**, are entities that go public to raise capital and lend to smaller and medium-sized businesses.

The Effects of the JOBS Act on the IPO Process

After the accelerated passages of the Sarbanes-Oxley and Dodd-Frank Acts, business leaders and commentators observed that the regulatory requirements to be met in order to finance companies in the United States became overly burdensome and discourage entrepreneurship. In April 2012, the JOBS Act was enacted. The JOBS Act adopted the following provisions that affect capital formation:

- An "IPO on-ramp" for a new category of issuer, EGCs, that offers a number of benefits, including confidential SEC Staff review of draft IPO registration statements, scaled disclosure requirements, no restrictions on "test-the-waters" communications with qualified institutional buyers and institutional accredited investors before and after filing a registration statement, and fewer restrictions on research around the time of an offering.
- An amendment to the Securities Act (informally referred to as Regulation A+) permitting companies to conduct offerings to raise up to $50 million (now $75 million) in any 12-month period through a "mini-registration" process similar to that provided for under Regulation A.
- Higher securityholder triggering thresholds for reporting obligations under the Exchange Act.
- Removal of the prohibition against general solicitation and general advertising in certain private placements.
- A new exemption under the Securities Act for crowdfunding offerings.

The JOBS Act offers an issuer new possibilities for structuring its capital raise.

Requirements for a Company to Maintain EGC Status

The JOBS Act established a new category of company, emerging growth companies ("EGCs"). EGCs are issuers (including a foreign private issuer) with total annual gross revenues of less than $1.07 billion (subject to inflationary adjustment by the Securities and Exchange Commission ("SEC") every five years) during its most recently completed fiscal year. If a company loses its status as an emerging growth company, the status cannot be reestablished. Status as an EGC is maintained until the earliest of:

- The last day of the fiscal year in which the issuer's total annual gross revenues are $1 billion or more;
- The last day of the issuer's fiscal year following the fifth anniversary of the date of the first sale of common equity securities of the issuer pursuant to an effective registration statement under the Securities Act (for a debt-only issuer that never sells common equity pursuant to a Securities Act registration statement, this five-year period will not run);
- Any date on which the issuer has, during the prior three-year period, issued more than $1 billion in non-convertible debt; or
- The date on which the issuer becomes a "Large Accelerated Filer," as defined under the SEC's rules.

With regard to the $1 billion debt issuance test, the SEC Staff has clarified that such three-year period covers any rolling three-year period and is not limited to completed calendar or fiscal years.

An Overview of the IPO Process

As noted above, the public offering process may be divided into three periods:

- **Pre-filing Period.** The pre-filing period is the period from the determination to proceed with a public offering to the filing of a registration statement with the SEC. This is also generally called the "quiet period," and a company is usually subject to limitations on its public communications. For more information, please refer to "What's the Deal? IPOs – Pre-Filing."
- **Pre-effective Period.** The waiting or pre-effective period is the period from the date of the filing of the registration statement to its "effective date." During this period, a company may make oral offers and certain written offers, but may not enter binding agreements to sell the offered security. For more information, please refer to "What's the Deal? IPOs –Filing and Post-Filing."
- **Pricing and post-effective.** The post-effective period is the period from the date the registration statement has been "declared effective" by the SEC to the completion of the offering. For more information, please refer to "What's the Deal? IPOs –Filing and Post-Filing."

The Primary Parties Involved in an IPO and Their Roles

Going public requires putting together a team of external advisors. An IPO team will include a lead underwriter (possibly co-managing underwriters), an independent audit firm with significant public company experience, external legal counsel, a transfer agent and a financial printer. Before completing an

IPO, a company is advised to hire an investor relations firm. A company will also need to have an internal IPO team in place, which will include the company's president, CEO, CFO, general counsel, controller and an investor relations or public relations manager. The role of each of the parties involved in the IPO team are further described below.

Underwriter and Co-Managers

For an IPO, a company will first identify one or more lead underwriters that will be responsible for the offering process. A company chooses an underwriter based on, among other factors, its industry expertise, including the knowledge and following of its research analysts, the breadth of its distribution capacity, and its overall reputation. Before choosing an underwriter for the offering, a company will need to keep in mind that the underwriter will have at least two conflicting responsibilities—to sell the IPO shares on behalf of the company and to recommend to potential investors that the purchase of the IPO shares is a suitable and worthy investment. Further, the company should also consider the following questions:

- Does the investment bank have strong research in its industry?
- Is its distribution network mainly institutional or retail?
- Is its strength domestic or does it have foreign distribution capacity?

The underwriter's primary roles will include—marketing the IPO shares, setting the price at which the shares will be offered to the public (after consulting with the company) and, in a "firm commitment" underwriting, purchasing the shares from the company and re-selling them to investors. Following the offering, the underwriter generally will make a market in the stock and facilitate transactions in the company's securities.

Depending on the size of the offering, a company may want to include a number of co-managers in order to balance the lead underwriters' respective strengths and weaknesses. Co-managers are underwriters who agree to purchase a substantial portion of a company's shares and who are involved in drafting the prospectus and marketing the offering. Companies typically choose co-managers that have distribution capabilities or analyst coverage that is complimentary to those of the managing underwriter.

In-house and Outside Legal Counsel

A company's in-house and outside legal counsel play important roles in completing the IPO. A company's counsel will:

- Prepare the registration statement, prospectus, and stock exchange application;
- Communicate with the SEC and the stock exchanges on a company's behalf, responding to any comments they may have;
- Negotiate an underwriting agreement with the underwriters and their counsel; and
- Prepare various other documents, including stock option plans, a company's post-IPO certificate of incorporation and bylaws, committee charters, board minutes relating to the IPO and any required consents, waivers and legal opinions.

Underwriters' counsel will undertake legal due diligence during the offering process and will review the registration statement and prospectus with the company, its counsel and the underwriters. Underwriters' counsel will also:

- Negotiate the underwriting agreement with a company and its counsel;
- Discuss the "comfort letter" with a company's accountants; and
- Submit the underwriting agreement, registration statement and other offering documents for review to the Financial Industry Regulatory Authority.

Eventually company's counsel and underwriters' counsel will then coordinate the closing of the transaction.

Auditors and Accountants

Accountants prepare and audit the financial statements of a company or other entities or properties that must be included in an IPO registration statement. Other services provided by the accountants during the offering process include assisting a company in preparing the other financial portions of the prospectus, such as the summary financial information, selected financial information, capitalization and dilution tables, and any required pro forma financial statements. Additionally, the auditor will work with the company to identify any problems associated with providing the required financial statements in order to seek necessary accommodation from the SEC. The accountants will ultimately provide a "comfort letter" to the underwriters.

Other Professionals

- **Transfer Agent.** A company's transfer agent coordinates the issuance and tracking of the company's stock certificates, maintaining a list of the individuals and entities to whom the shares are issued.
- **Financial Printer.** A company's financial printer will print and distribute drafts of the prospectus to the working group as well as provide copies of the prospectus to the underwriters for distribution to investors. The printer will also file (or confidentially submit) the registration statement and prospectus with the SEC through its Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system.
- **Research Analysts.** To increase the company's visibility, a research analyst will cover the company once it becomes public. Depending on the size and type of business of the company, there may be anywhere from two to ten analysts covering the company's stock. Smaller companies, however, may not have any analyst coverage. Research analysts will regularly publish recommendations with respect to the company based on their analyses of the company's financial condition and results of operations. Analyst coverage and publicity may result in introducing the company to potential customers and business partners, as well as reinforcing the company's advertising and product-branding initiatives.
- **Investor Relations Firm.** A company may hire an investor relations firm for the IPO. The firm will help to ensure that the company's communications with the general public, as well as its target

market during the offering period, are consistent with the SEC's rules, while continuing to generate interest in the company and its business.

Listing on an Exchange

Listing stock on an exchange is one of the most important steps a company can take to achieving liquidity, as part of an IPO. Certain kinds of investors may only invest in exchange-listed issuers. Liquidity and an active market should help establish a widely recognized value for the company's stock, which will help the company use its stock instead of cash for acquisitions and other significant transactions. Listing on an exchange cannot guarantee liquidity or investor interest and there are many companies that have liquid markets even though they are traded in the over-the-counter markets. Exchange listing requirements may be generally described as "quantitative requirements" and "qualitative requirements." Quantitative requirements are financial criteria for listing and include a minimum number of shareholders of the company, a minimum market capitalization, a minimum share price and financial tests. Qualitative requirements are standards relating to the company's business and corporate governance, including the nature of the company's business, the market for its products, its regulatory history, as well as the election and composition of the board of directors and audit committee, issuance of earning statements and the company's shareholder approval requirements.

To list its securities on an exchange, a company must meet the quantitative and qualitative requirements and submit an application to the exchange. In order for shares to be listed on the exchange, in addition to filing a registration statement for the IPO itself under the Securities Act, the issuer must also file a registration statement under the Exchange Act that acts as the continuing registration statement for the company after the IPO is completed. The exchange will review the application and supporting documentation, and once the listing is approved, the shares will be admitted for trading after the Exchange Act and, if applicable, Securities Act registration statements have been declared effective by the SEC, and the shares have been offered and sold if there is a concurrent IPO. As listing is often critical to the success of an IPO, it is best practice to get such approval before the preliminary prospectus has been printed.

Checklist of Key Questions

- Do the benefits of an IPO outweigh the risks of going public for the company?
- Has the company considered the current market and recent trends before considering an IPO?
- Does the company fall into one of the categories of companies that are typically successful in IPOs?
- Is the company an EGC?
- Has the company considered the exchange on which it will list its shares in connection with the IPO?