IPO's Don't Provide Liquidity for Owners of Smaller Companies

IF NEAR TERM LIQUIDITY IS THE GOAL,

A SALE OR MERGER IS THE ONLY VIABLE ROUTE

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It seems that every week we read about another crop of multi-millionaires created by the latest IPO (initial public offering) of some recently minted dot com company. The truth, however is that these lucky entrepreneurs may be the King Midases of our age – they can read about their wealth in the newspapers, but they can't spend it – at least not for a while.

Contrary to the belief held by the general public, as well as a surprising number of entrepreneurs, an IPO is not an exit strategy for founders, management or early investors of even long established companies. If near term liquidity is the goal, a sale or merger is the only viable route.

The reason for a company to sell its shares in an IPO is to raise new capital to grow. In an IPO the underwriters (the stock brokers handling the registration and sale of the shares) almost always require that management and even early investors agree not to sell any of their stock for a period of time (a "lock-up period"), sometimes several years. The rationale is that they want existing management to remain in place with the same goal as the new investors, i.e. to enhance the value of everyone's shares.

So when can a public company's management and early investors reap their rewards?

If the company has done well since its IPO, it can usually go back to the public trough with a follow-on public offering a few years later. As in the IPO the primary purpose of the follow-on offering is to raise growth capital, but this time 20% to 25% of the shares offered might be those of management, founders or early investors. Even then, the shares seldom comprise more than 15 to 20% of any one individual's holdings.

Meanwhile there are some other options. After the lock-up period, Venture capital funds that invested in a company early might distribute their shares to their investment partners, who in turn may be able to sell them in the open market. In addition early investors and management can sell a relatively small number of shares (about 1% of the total outstanding every 90 days) under an exemption (rule 144) to the SEC's general rule prohibiting sale of shares publicly without a registration.

The hitch in 144 sales, however, is that any such sale by a director, officer or owner of 10% or more of the Company (so-called "insiders") becomes public information. At best

an explanation may be in order, or worse the market may not take it gracefully.

So why have an IPO? Again, the primary reason is to raise growth capital. An IPO is expensive and isn't always successful, and not every company has the prerequisite "investor appeal". However, it usually commands the best price for the equity sold (vs a private placement) and also can be highly rewarding for founders and managers in the long run. If all goes well, liquidity will be realized years down the road.

If near term liquidity is the objective, an IPO doesn't work. A sale or merger is the only viable route, but even this has its hurdles. Buyers almost always want immediate control, but usually insist on the sellers waiting for a portion of the purchase price, often making it contingent on future performance. In addition a buyer may require management to commit to stay on for several years. Time does pass quickly, however, and meanwhile at least you have some of their money.

To minimize such contingencies as well as obtain the optimum value in a sale or merger, preparations should be started years in advance. Such preparation covers a spectrum of issues that make a difference to potential buyers, such as consistent sales and profits, audited financials, professional management and outside advisors in place, an attractive public profile, and the absence of commingled personal and business expenses and assets.

In short, if the company has the public investor appeal, can effectively utilize growth capital and management is willing to wait for theirs until they've made it, an IPO is the ticket. If liquidity is the goal, a sale or merger is the answer.

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