Going public versus being public: The value of IPO readiness

By Aamir Husain

Accessing the initial public offering (IPO) market is driven by many and varying factors, and the decision to go public is unique to each organization and its strategic growth agenda. Confidence in the economy and a rising stock market greatly contribute to a company's ability to embark on the path to becoming a public company. Transitioning from a private entity to a public company presents many challenges: public companies not only have to meet numerous regulatory and reporting requirements, but they also must meet the expectations of their shareholders and the public.

A company with an IPO readiness plan in place at an early stage, however, has several advantages once it becomes a publicly traded entity. Preparing a well-conceived road map early helps guarantee a smooth transition and a company's ability to meet public-market requirements without overly disrupting its business.

Recently, the IPO market has benefited from investors' general sense of optimism. There were 64 IPOs in the first quarter of 2014, more than a 50 percent increase from the first quarter of 2013. Total IPO proceeds raised during the first quarter were $10.6 billion, compared with $7.6 billion in the first quarter of 2013.[1]

Although current conditions seem extremely favorable, companies considering becoming public organizations need to understand just how fast market conditions can change and the impacts on their businesses, and assess alternative growth solutions. KPMG has found that a company can best deal with economic uncertainty by focusing on items that are within its control, which can be supported with the development of its comprehensive IPO readiness plan, to experience strong post-IPO business results.

Keep your options open

At the end of 2012, the economy was beset with uncertainty, but just a few months later, the stock market was absolutely jubilant. In an IPO, traditionally, a minority stake of the organization is sold while retaining a controlling share in the company post-IPO. Even if a new IPO is an instant success in the marketplace, organizations may face future market risk: a tumultuous event in one country can hurt stock markets across the globe. Given market volatility, it is important for companies to consider multiple strategies to fulfill their growth agendas under the umbrella of their IPO readiness plan.

One such alternate strategy is mergers and acquisitions (M&A). Once the deal is consummated, cash is available in the bank, whereas in the IPO, the first tranche that's offered to the public in today's marketplace is typically 20 to 35 percent of the company; therefore,

[1] Renaissance Capital LLC, 1Q 2014 Quarterly Review

existing shareholders are still holding onto their investment. Even if the IPO goes very well because of market conditions, that share price can remain volatile. By holding onto shares, the holders are assuming market risk in the future.

However, an IPO can also allow for a permanent source of capital, especially for private equity funds, so they aren't constantly running on a fundraising treadmill. It can create liquidity for existing shareholders and allow for fund growth or company expansion when a previous lack of capital had been creating constraints on the organization. The IPO can drive shareholder wealth if it performs well, while potentially also driving currency that can be deployed for future strategic growth initiatives, such as M&A.

A high level of preparedness can allow a company to follow a dual-track strategy more easily, which allows for a flexible approach to pursuing both a sale and the public option simultaneously in order to attain the highest value. A company will know if an IPO is the logical next step when examining the potential for enterprise-wide value through an M&A transaction.

In addition, a company that has a dual-track strategy as part of a coherent IPO plan will substantially limit any surprises as it proceeds to becoming a public company. Even companies that are not completely committed to an IPO can greatly benefit from getting their houses in order. Almost all of the steps necessary to become public, especially those around financial reporting and corporate governance, should be undertaken by a company that is considering a sale. Both strategic and financial buyers will respond more favorably to a company where financial reporting and sound corporate governance meet their expectations, and where no "surprises" are revealed during due diligence.

Importance of planning ahead and steps to take

Once an organization has decided to go public, IPO readiness allows a company to quickly initiate an offering when market conditions are positive, and also gives companies the ability to start acting like a public company in advance of their IPO. However, regardless of market conditions, organizations should prepare well ahead and understand that the market will always react favorably to companies with a track record of growth and where growth projections appear strong. In addition, companies should understand just how time consuming the IPO process may be, and what will be required post-IPO.

Planning for an IPO is complex and should begin with the entity having a clear and complete understanding of its core business functions. Companies need to understand the legal, regulatory, financial, and operational requirements they will face once they become public, and take the steps to meet those requirements. IPO readiness also means meeting the challenges of a public company immediately before, during, and after its official filing, lessening any unexpected issues.

Ideally, this type of readiness assessment should take place at least 9 to 12 months before the company plans to go public. This assessment should include, but not be limited to, an analysis of key performance indicators (KPIs), gaps in financial reporting, management reporting, corporate governance, and systems and processes. The company's management team should review the existing corporate structure and focus on tax planning. Additionally, it is important to develop an investor-relations function and anticipate how to communicate with the financial community and Wall Street analysts.

It is also critical to select the right team members to support the IPO readiness process. An underwriter should possess industry knowledge and expertise, and have a demonstrated track record of keeping commitments on price, coverage, execution, and support. Lawyers should be trusted to protect management and shareholder interests, keep underwriter counsel focused, perform diligence on management's forecasts and projections, and move the IPO along. Accountants should have the breadth and depth of technical resources to address the U.S. Securities and Exchange Commission (SEC) review in a timely manner.

Additionally, there are important items CFOs and their accountants should consider during the planning process, now that new rules have been implemented under the JOBS Act. This includes the significance of audited financial statements that will be presented in the S-1; under the Jumpstart Our Business Startups (JOBS) Act, companies will need to prepare two years of audited and summary statements. Auditor attestation under Sarbanes-Oxley Act, Section 404 can be deferred for five years, and filings can be done confidentially, with the veil broken just three weeks prior to the road show.

Other leading practices that should be implemented as part of the IPO readiness planning process include reorganizing and memorializing related-party arrangements; putting employment agreements and equity-oriented arrangements in place; having auditors subject financial statements to the public company review process; affirming or renewing key customer and supplier arrangements; evaluating corporate structure changes and taxation implications; formalizing general counsel and external legal review process; regularly preparing Management's Discussion & Analysis (MD&A); and organizing IPO communications and road shows, among other key steps.

Being a public company, and associated risks

Once the IPO has been announced, the road shows completed, and the company is finally public, its effectiveness as a public company in today's environment will require the ability to balance growth, risk-taking, and compliance.

One of the most challenging tasks for a newly public company is to develop a corporate governance function. Corporate governance is an important and demanding issue for a newly public company. While many companies understand the need to have board members with financial expertise, companies should also consider that one of the most important roles for board members is to set a tone for ethics and compliance. One simple way to determine board readiness is to ask: "Is the board we have today equipped to handle the issues that will arise when we are a public company?" If the answer is no, companies should add any missing expertise to the ranks of their boards.

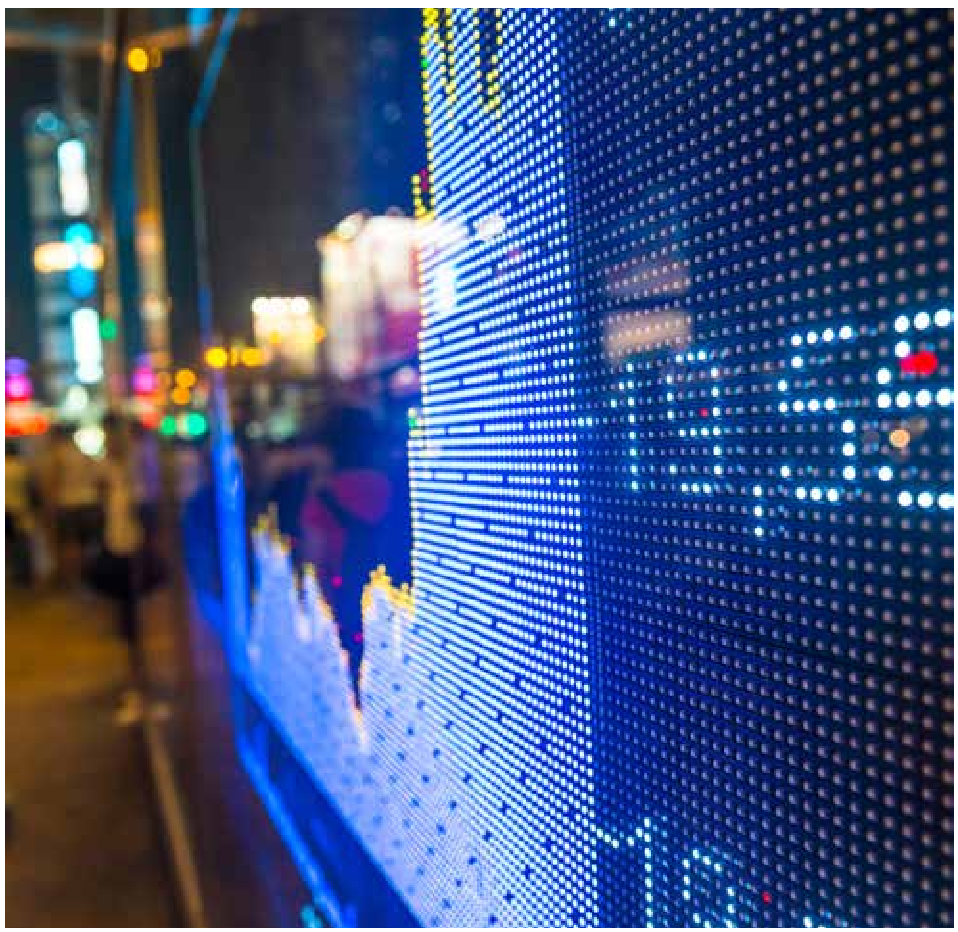
Another challenging task under the corporate governance umbrella can be managing the expectations of the organizations' shareholders. Some shareholders invest in a stock to receive dividends; others look to capital gains from a sale of their shares for a profit. Regardless of the type of investor, prospective and current shareholders are looking for security of their capital. In order to provide that security, an effective corporate governance structure needs to be in place to increase transparency and ensure that stakeholders can rest assured that the right controls are in place and are being followed by the organization.

Accurate revenue and profit projections are particularly important for a newly public company. Therefore, a public company should have a robust business planning and analysis function to formalize the process and increase its chances of accuracy. Management should also create diligence files to make sure that each assertion is justified and regularly update its MD&A so that it accurately reflects ongoing operations.

It's important for organizations to understand the potential risks associated with becoming a public company that result from insufficient planning. As soon as the company becomes public, there will be less time to deal with complex accounting policies or issues, potentially causing headaches once public.

Private companies are obliged to make public a financial statement once a year. As a publicly traded entity, quarterly statements are required with accounting income, balance sheet, cash flow, footnotes, and MD&A, that is filed with the SEC between 40 and 45 days (based on the organization's size) after the quarter's end. If a robust process is not in place, there is the risk of filing the Form 10-Q late. As a result, the company is not looked upon favorably by investors or the SEC, and the company's share price risks a decrease in value.

Additionally, from a controls perspective, the CFO/CEO of the newly public company will be charged with making a certification in the first SEC filing after the S-1 is effective, communicating that to the best of their knowledge, the financial statements are accurate and that the control environment exists and is operating effectively. In order to have a basis for this certification, it's recommended to identify and document, as well as test, key controls. This can mostly be done post-IPO, but at a minimum, these controls should be identified in the planning stages.



Conclusion

Companies seeking to go public need to spend a significant amount of time planning and executing their IPOs. While it is clear that legal and regulatory requirements must be met, adopting leading practices can make the process run more smoothly. Companies are advised to start early and consider planning even during a downturn. Their readiness assessment should include an analysis of their KPIs including financial reporting, management reporting, corporate governance, and systems and processes. They should implement infrastructure changes that will help them meet SEC filing requirements, and financial statements should meet public company standards before a planned filing. These and other practices will help make the IPO process less disruptive and help the newly public company to run more smoothly.

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