Creating shareholder liquidity: A checklist before going public

BY ALLAN GRAFMAN

There is now a real investor desire, and even a need, for strong companies to be in the public markets. According to a May 2017 Ernst & Young report, the number of domestically incorporated U.S. listed companies dropped by more than 45% between 1996 and 2016. The amount of cash liquidity in the U.S. banking system is $2.2 trillion, according to Federal Reserve economic data (Dec. 7, 2017).

Going public can be the capstone accomplishment of a long and successful career.

What questions should family business owners be asking in 2018 to determine if they are ready to take their company public?

Question #1. Which has greater priority: maximizing wealth and liquidity or maintaining maximum control?

One will prevail over the other, and it is best to consider this question early in the process.

Illustrative of this is the recent Snap Inc. IPO. The founders retained control through a dual-class stock structure that gave them 89% of the voting power although they held only 44% of the equity. Because of the lack of voting rights, Snap Inc. shares were excluded from the relevant MSCI indices, suppressing the pool of prospective investors.

Question #2. Whose wealth is being maximized, current or future generations?

The more generations, the more important the question. Generational interests can easily diverge, as demonstrated by the separation of the Pritzker family's assets after years of discord.

Question #3. Who gets a vote on the upcoming direction and process?

This issue must be discussed and ideally settled before the owners consider going public.

Question #4. How will current service providers be handled?

Some of your legal, accounting, tax and estate advisers may be adversely affected. Others may see a windfall. Some will be displaced because of market needs, requirements or lack of qualifications. Long-time advisers may be displaced even if they are highly qualified, and long-term relationships may end up stressed or severed.

Question #5. How will current stakeholders — board, employees, customers, local community — be affected?

You should also consider what weight should be given to stakeholders who are not decision makers. Family employees and long-time executives and board members may be displaced. This issue is highly personal; no single approach is best for every family ownership group.

Question #6. Who should serve on the team that will decide the myriad questions that must be answered regarding which stock exchange to list on and which service providers — investment bank, accounting firm, investor relations firm — to engage?

These six questions are worth bearing in mind whenever a significant change in ownership is contemplated. They are even more important before beginning the process of creating liquidity via going public. Once the above items have been addressed, there is another set of considerations regarding alternatives. There are alternatives to going public via an IPO that may be a better solution for your company.

Liquidity alternatives for family businesses

- **Private equity firms** will often allow business owners far more control than they would have if they took the company public. Of course, terms are highly negotiated, and more than one family founder has been forced out

when the company struggled. Private equity and venture capital investors currently a have near-record amount of “dry powder” awaiting investment, estimated to be $638 billion, according to Pitchbook. When PE firms invest capital, they generally plan to grow the company and make it more successful for later sale. While this plan will ultimately require the family to relinquish all ownership, it will enable them to exit with greater wealth than they likely would have been able to realize without the PE partner.

• A sale to an **ESOP** (Employee Stock Ownership Plan) provides family owner/operators unique flexibility. The sale of all or some of a company’s stock to an ESOP provides liquidity for shareholders as well as incentives for management and employees. Participating employees receive company shares through the ESOP as a retirement benefit. Under Section 1042 of the Internal Revenue Code, shareholders can avoid capital gains taxes when selling to an ESOP if within 12 months of the sale they reinvest proceeds into “qualified replacement property,” such as stocks and bonds of U.S. companies. Within limits, the sponsoring company can deduct the principal and interest payments on the loan the ESOP used to purchase shares.

Have you considered all the personal and emotional ramifications of being part of a public company?

• **Merging into or selling to another public entity** has more certainty of closing a highly negotiated deal. While an IPO can be adversely affected by general market conditions that might make success — or even closing — impossible, a merger/sale is dependent on a very small group of decision makers. Even that risk can be mitigated with “break-up” fees paid should a closing not take place.

• A variation of the above is a special-purpose acquisition corporation, or **SPAC**. This entity raises a “blind pool” of public capital from investors with the sole purpose of finding a private company with which to merge. The private company management often retains full operational control and majority equity ownership of the now-public company. Promoters of a SPAC list these as advantages over traditional IPOs:

- The seller will know the price at the beginning of the process.
- Costs are lower, since the entity is already public.
- The deal structure is flexible.

• A newer potential vehicle for liquidity is a **Reg A+** public offering. This allows startups and later-stage pre-IPO companies to use equity crowdfunding platforms or traditional investment banks to raise as much as $50 million from both accredited and non-accredited investors. Unlike traditional S-1 public offerings, with a Reg A+ offering companies are allowed to test the waters with prospective investors during the approval process, eliminating the “quiet” period.

There are two tiers. Tier 1 allows the company to raise up to $20 million, while Tier 2 allows the company to raise up to $50 million. Larger Tier 2 capital raises require audited financials.

Going public: Which exchange?

Foreign exchanges come in and out of favor depending on that countries’ specific capital market dynamics. For an extended period the German market was booming as economic unification powered the German economy. More recently, the London Alternative Investment Market (AIM) and the Australian market have gained acceptance as viable, if not first-tier, markets.

NYSE and Nasdaq. If one decides to go the traditional IPO route there are two major markets to consider, the NYSE and the Nasdaq. Over-the-counter (OTC) networks are for small companies that can't meet exchange listing requirements.

NYSE and Nasdaq vary in their requirements for initial listings. Specific requirements for each exchange and the alternatives offered are available on their respective websites. Among the deciding criteria are the following: pre-tax income, market cap, total assets, market value of public float, stockholders’ equity, minimum price and operating history.

Reality check

Have you considered all the personal and emotional ramifications of being part of a public company? Employees, customers and owners will be affected. You will be required to report results every quarter. No meaningful problem or dispute will escape disclosure. There is a reason there are fewer public companies today, and that private companies controlled by private equity and venture capital are staying private much longer. FB

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