Issue N° 14
March 2015

Equity Solutions

EQUITY IN A NUTSHELL

LEVEL

The pros and cons of going public

According to the World Federation of Exchanges, end of 2014 there were around 44,500 listed companies – roughly 10,000 in the Americas (5,000 NYSE and NASDAQ), 10,000 in EMEA (1,000 Euronext) and 24,500 in Asia Pacific. At the end of 2014 the global market capitalisation was USD 67 trn. This compares to 35,500 listed companies and a global market capitalisation of USD 38 trn at the end of 2005. Companies disappeared from the stock market because they filed for bankruptcy, were acquired or were taken private. Contrary to that, every single year there are private companies that decide to go public. In 2014, according to Ernst & Young, 1,206 companies went public, raising USD 256.5 bn. Why do companies go public? What are the advantages? What are the disadvantages?

As family businesses grow, at one point in time, the company may be faced with a financing need. Indeed, growth can consume large amounts of money. As a company grows the working capital need may increase significantly. Growth may also require important investments in machinery, in buildings etc. Ultimately, private companies in this situation have three options. The first option is to keep the business as it is and not to grow. The second option is to seek additional debt financing. The third option is to raise capital. Of course one can try to raise funds internally, but the current shareholders do not always have the means or the desire to inject extra cash into the family business. Faced with this problem, the company can try to attract an external investor like a business angel or a private equity fund or it can decide to open up the capital to a plethora of investors and raise the necessary funds through an Initial Public Offering (IPO).

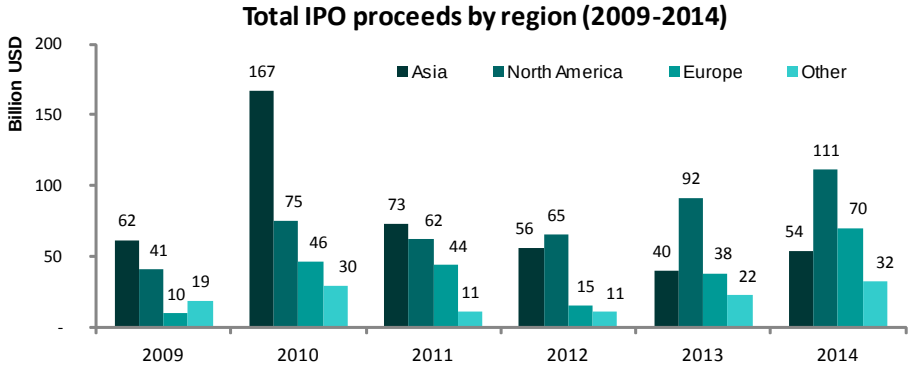
Hence, one of the most important reasons – if not the most important one – to take a private company public is raising capital. Moreover, that is not just a one off. Once a company's capital is (partly) publicly traded, in the future the company will have a quite easy access to capital markets whenever there is a need for cash, e.g. to finance an acquisition, as through the IPO the company's capital has been made liquid, i.e. easily tradable.

In some cases making the company's capital liquid is the principal driver behind the decision to take a private company public. That can be the case when one of the founding partners wants to leave the company and the other partner does not have the financial means to buy out the departing party. In that case, again a few options lie open, i.e. attracting an external investor or taking the company public and thus creating an exit for the selling partner. Older family businesses which have been passed on from generation to generation may decide to prune the family tree on a regular basis to prevent the business becoming too complex.

Of course, pruning the family tree leads to certain family members buying out other family members and thus requires cash which is not always readily available. Here too an IPO may be an elegant way to reorganise the ownership structure of the company.

Although often an IPO with the sole purpose of **creating an exit for existing shareholders** is negatively perceived, it is a perfectly sensible thing to do. Indeed, the (descendants of the) founding family not only has put a lot of effort in developing the company, more often than not the family business is by far the most important asset in the family fortune. Hence, by opting for an IPO whereby the existing shareholders monetise part of their participation not only allows them to cash in on the efforts of the previous years and generations, but also provides the means to diversify the family fortune.

Once a company is quoted on the stock market, at any time an objective valuation is readily available. This has a number of advantages. For starters, it simplifies the organisation of the **succession of the family fortune to the next generation and the shares can be easily used as collateral for a loan**. Secondly, in an effort to get the existing employees more involved and to attract talented people, **a publicly traded company can use its shares to compensate employees by granting options and/or issuing new shares.**



Sources: FactSet. SGPB

Thirdly, having an established value and liquid market for its shares allows the company to **use the shares as a currency for acquisitions.** The ability to use the company's shares to (partially) finance an acquisition significantly reduces the cash needs. The available cash can be used for investing in future organic growth.

Taking a company public increases the company's visibility. **Usually IPOs attract a lot of media attention, creating a halo effect for the company as a whole, increasing its recognition in the market.** While of course this is very subjective and by no means 'science proof', suppliers, customers and financial institutions often hold quoted companies in higher esteem than non-quoted ones. This prestige may also allow the company to attract more highly-qualified personnel.

Several academic studies have already demonstrated that listed family businesses are strong performers and that, over a longer period of time, they usually perform better than listed non-family businesses. Moreover, although this is a topic that needs further investigation**, there are indications that quoted family businesses outperform non-quoted ones and that the opening up of the capital to either a private investor or to the public has a significant positive effect on the performance of the company.** The underlying logic here is that the new shareholders entering the capital, will push for a clear strategy, a focused execution of that strategy, increased efficiency, a compliance with the corporate governance rules etc.

Despite the advantages mentioned above, the decision to go public is not one to be taken lightly as there are some clear disadvantages and serious hurdles to be taken too. Hence, it is not surprising that there are huge, well-known companies that are still 100% family held, having no intention whatsoever to do an IPO any time soon. If a financing need arises, some companies will prefer the entry of a private equity fund over going public. The most obvious evidence that a stock market listing does not bring universal happiness is that from time to time publicly traded companies are taken private again.

A significant hurdle that family shareholders are sometimes unable to take is the loss of control.

Even if only a small percentage of the shares are on the market, opening up the capital to non-family members means that unknown people will not only be looking over the management's shoulder, but that they will also have their say. Indeed, listed companies are required to have independent directors on the board. This implies that important decisions, e.g. on executive compensation, on strategy, on shareholder remuneration etc., which were previously autonomously taken by the family shareholders, will henceforth be taken by other people, who are not necessarily experienced with the company's operations. The entry of non-family shareholders may even lead to a complete overhaul of the strategy. Decisions will have to be accounted for. Especially for businesses where management is in the hands of the founders or members of the family, this change in corporate governance structure will require a lot of flexibility.

A French adage goes: "Pour vivre heureux, vivons cachés" (in order to live happily, live hidden). **To live hidden is impossible for a public company. On the contrary, in the obligatory IPO prospectus, the company has to present itself in detail**, commenting on strategy, giving detailed information on operations, revealing the risk factors, publishing detailed financial figures not only on a global level but also on a segment level, indentifying important customers and suppliers, detailing executive compensation etc. It does not stop there. Public companies are required to publish results and reports on a regular basis to inform all shareholders and, by extension, all stakeholders. For a private company this can be very intrusive. Market observers, analysts and journalists will be commenting on the company's results and will be writing positively or negatively on management decisions, sometimes pushing ideas themselves. While here one could still argue that the best coaches are in the sands, one must not forget that competitors will be eagerly reading the company and analyst reports too. **Family businesses must be ready to share this kind of information with the world and be strong enough to cope with the negative press they could get.** Sometimes the publication requirements may even lead to hiring additional staff and changing the IT environment to be able to assemble the necessary information for the reports. Moreover, the whole process of information gathering and sharing is a very time consuming activity.

The company's and the stock market investors' time frames are generally very different. **Family businesses focus on the long term.**

As usually the founders intend to pass the business on from generation to generation and as some even aspire to build an industrial empire, sometimes short-term gains are sacrificed for long-term gains. **Stock market investors generally have a much shorter time frame.** Ad-hoc press releases and quarterly earnings reports will be unravelled and depending on their judgement the stock price will fluctuate. This may entice management to adopt a more short-term view too, certainly if management remuneration is in one way or the other dependent on the company's share price or on certain short-term performance indicators.

In that respect it is also important to be aware that all public companies are takeover targets. If the share price falls, the risk of a hostile bid increases. A successful takeover, particularly a hostile takeover, could result in the company's founders being removed from management positions.

Finally, one must consider the price tag of an IPO and a public listing. **Going public and being publicly traded is an expensive endeavour.**

Conclusion

Going public requires far-reaching changes in the company's structures and management. A high degree of openness is a prerequisite. Moreover, an IPO and a stock market listing do not come cheap.

Yet, an IPO and having the company's shares publicly traded have some undeniable benefits. It allows to raise capital, it makes the company's capital liquid, it creates an exit for existing shareholders, it leads to an objective valuation (facilitating the succession, enabling to use shares as compensation and payment method), it adds to the company's prestige and it tends to boost performance.

Going public should be a conscious choice. Other options should also be explored.