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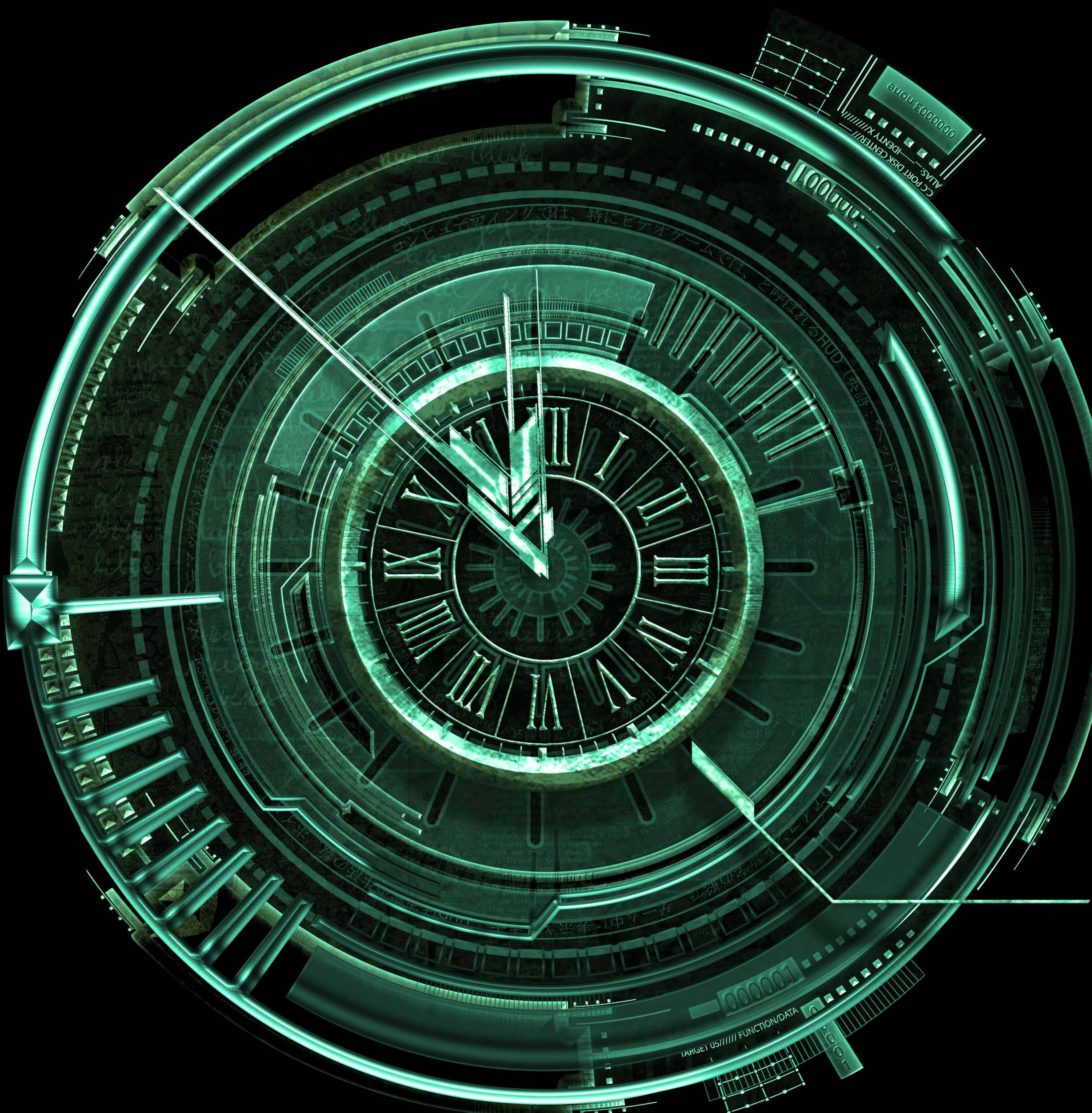


Private company IPOs: Is timing everything?

When to take the company public?

As a major inflection point in the life of a growing, privately held business, an initial public offering (IPO) is a complex and challenging process. Yet for private company owners and executives the benefits of becoming publicly traded often outweigh the downsides.

Not surprisingly, a frequent question asked by owners and executives of such companies is when to take the company public? According to a recent Deloitte poll of nearly 3,000 private company executives across a variety of industries about one-third of companies view timing the market as the biggest concern when considering an IPO. Building the right team and business infrastructure for an IPO was a very close second leading concern.

Trying to time the IPO market is like trying to time a slump or spike in stock indexes. So what's a private company to do? Focus on factors you can control that will impact IPO success, like your financial reporting close process or risk management practices.

A poorly timed IPO can be difficult to overcome. If the markets are unfavorable at the anticipated time of issuance performance can suffer. At the same time, history shows that many—if not most—factors affecting IPO markets are beyond the control of the issuing company. Trying to time the IPO market is akin to timing a slump or spike in stock indexes.

So what is a private company to do? The simple answer is to focus on those factors that can be controlled:

- Develop a business model with sustainable growth potential
- Assemble a strong team for the IPO journey and beyond
- Build a solid business infrastructure and implement systems that facilitate financial planning and forecasting
- Prepare for a smooth financial reporting close process and develop appropriate risk management practices
- Allow adequate time to ramp up for the IPO

By understanding some of the vagaries of the IPO market and addressing those factors that are within a private company's grasp, owners and executives can smooth the IPO process and establish credibility for their company in the eyes of investors, both in advance of the IPO event and in subsequent fiscal quarters.

Past IPO market performance

Instructive but not an indicator of the future

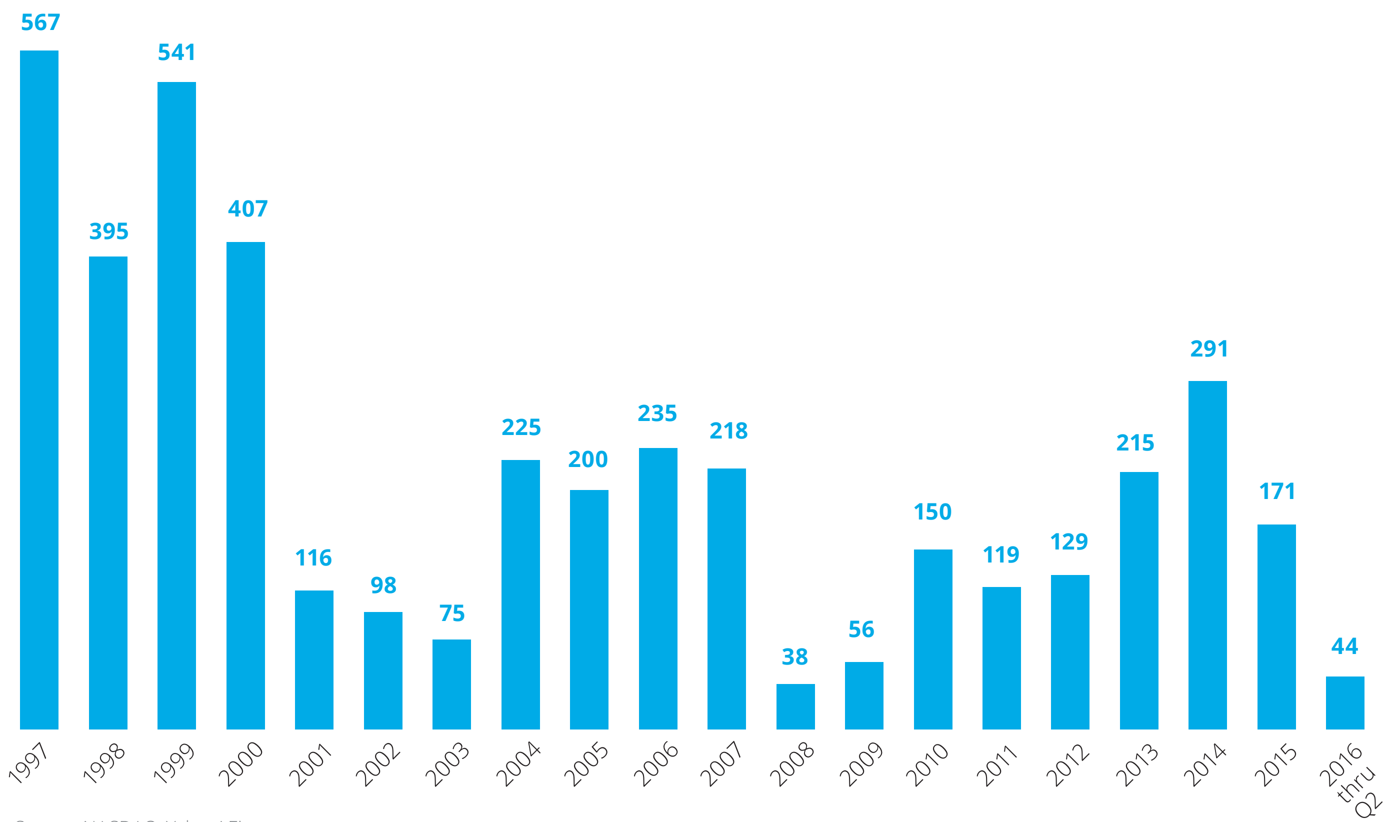
Over the past 20 years three cycles of healthy, robust US IPO activity have occurred (*figure 1*):

- From 1997 to 1999, the advent of the dot-com era created a path for many companies to go public.
- The next period, from 2004 to 2007, saw IPO activity accelerate across a number of industry sectors.
- The most recent period, from 2010 to 2015, included two years of moderately healthy activity, followed by three high-activity years.

The end of the two earlier periods can be tied to specific macro events that drove significant decreases in IPO activity. In 2000 it was the dot-com crash, followed by a two-and-a-half-year recalibration. The financial crisis put the brakes on the IPO market in 2008 and 2009 leading to another recalibration of between a year and 18 months.

On the other hand, a slowdown in the first half of 2016, after three years of heightened activity, does not lead back to any single event in particular. Yes, there is significant uncertainty, even angst, in the world, but no specific macro event has led to the slower IPO market. Rather, a number of factors may be driving the slowdown.

Figure 1. US IPOs, 1997-2016



Source: NASDAQ, Yahoo! Finance

The lesson from the past 20 years is that trying to time the IPO market can be a risky proposition. Certain indicators can help companies gauge the overall market, but there is no one foolproof measure on which to bet the outcome of the IPO event.

First, there is a disconnect between valuations in the public and private markets. Second, there is significant growth in private market financing. Ten years ago, if a company wanted to raise $100 million an IPO was the primary option. But now anything up to $1 billion can be raised with private investments such as hedge funds, mutual funds, and international sovereign wealth funds. Finally, the slowdown could be due, in part, to an unpredictable Volatility Index (VIX) – discussed in the next section – which ended 2015 at around 21, then dipped to 13 or so in March 2013, then rose to 18 in June 2016. Other broader issues, such as a tepid global economy, the US presidential election cycle, the UK's exit from the European Union, and an escalating global war on terrorism could be impacting IPO activity as well, making any efforts at timing the market very challenging.

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Market volatility

A better indicator

The volatility of the IPO market can have a significant impact on a company's initiation of stock trading. A key measure of volatility is the VIX, which reflects the expectations of investors about how fast market prices of the S&P 500 will move. Stated another way, it tries to predict investor confidence in the next 30 to 60 days in the stock market.

Along with other broad market indicators, the VIX can give stock traders a better understanding of investor sentiment and even a sense of possible reversals in the market. But how does it translate for companies seeking to launch an IPO? With a low VIX, more IPOs actually "go effective" or trade, and those IPOs typically have lower discounts to their offering price. In more volatile markets, valuations tend to be based more on profitability than revenue growth and that condition can often make it much more challenging for earlier-stage companies to go public (i.e., ones that may be more focused on revenue growth than on profitability and cash flow).

The fourth quarter of 2015 saw no technology company IPOs. Not coincidentally, the VIX was at its highest level since Q1 2012.

Private companies have one chance for a successful IPO, and an important objective is to produce the best possible returns for their investors and employees and set the valuation foundation for life as a successful public company. The VIX is a valuable indicator, yet it—like broader IPO market conditions—is unpredictable, and it fluctuates continuously. So while keeping an eye on volatility is important it is at least as important that private companies address the other factors that are more within their control.

So when is a good time to ramp up for an IPO?

Market conditions aside, a valid question is when to begin preparations for an IPO? Many companies start between 18 and 36 months before the anticipated IPO date, with an average time being 24 months in advance.

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However, two other important factors that may influence that decision are the current size of the company and the pace of its trajectory toward an envisioned IPO state (i.e., the projected size of the company at the point of the IPO). An important step is to benchmark comparable companies in the same industry or adjacent industries that have gone through the IPO process to determine their path. Were they at $50 million in annual revenue or $100 million when they went public? What was their headcount?

If, based on the benchmarking, the decision is made to target a "run rate" or future performance of, for example, $100 million in revenue as the optimal time to launch the IPO, then the next question is when will the company achieve that target? Is that three years or four years from now? A reasonable plan would be to begin IPO preparations approximately two years before the company is forecasted to hit that target run rate.

IPO readiness—important considerations

It should be no surprise that publicly traded companies are held to a high standard, particularly when it comes to financial disclosure and other regulatory reporting.

Given that some earlier stage, privately held companies use less formal processes an important part of preparing for an IPO is assessing key systems and processes and addressing any gaps between their current state and the level of performance that will be required by both internal and external stakeholders. It is important to take a measured approach to this assessment process because the company may have limited people and resources—and in a high-growth company they may already be stretched to the limit.

IT systems

A company might want to upgrade its financial systems in advance of an IPO to address the more stringent requirements for data accuracy in support of financial reporting and create more flexibility in analyzing financial and non-financial data. Reducing the use of spreadsheets and automating currently manual processes are other potential areas to address.

For example, in smaller, high-growth companies revenue generation is often the domain of a relatively small, tight-knit group of managers and salespeople who communicate with each other directly and while in motion. As growth accelerates and sales grow, management may begin to involve others in the organization such as accounting, finance, legal, and logistics. In the ramp-up to an IPO, the introduction of technology and the creation of a "deal desk" process could help enhance communication and collaboration between sales, finance, and legal teams. It could also introduce beneficial workflow processes, track contracts through their lifecycle, and feed sales data to the financial systems. These are types of processes that are more common in larger, publicly held companies.

Such processes also dovetail into enhancing the sales forecasting process. In smaller, privately held companies that function often resides in the sales department and generally relies on informal processes. As a company prepares to go public the process for forecasting revenue and profits should be formalized and begin to have meaningful oversight from the financial side of the house, since that information will figure heavily in the guidance the CFO offers to Wall Street just before and certainly after the IPO.

Another vital capability of a publicly traded company is the monthly, quarterly, and annual "closing of the books" for financial statement purposes. The accuracy and timeliness of this process is imperative for a public company and its senior executives, who must attest to the accuracy and completeness of financial statements. Smaller privately held companies often use very simple financial applications. As the business scales and prepares for an IPO that approach may no longer be efficient enough or adequate from an internal controls perspective. More sophisticated financial systems and processes may be required.

Internal controls and processes. Provisions of the JOBS Act offer accommodations to qualifying companies regarding compliance with internal controls requirements of the Sarbanes-Oxley Act of 2002, including (see "A boon for the IPO market"):

- Section 404(a), which requires management of a publicly traded company to certify that the internal controls are appropriate.
- Section 404(b), which requires the company's external auditors to certify and attest that the internal controls are working as management has asserted.

Under "emerging growth company" provisions of the JOBS Act qualifying companies may be exempted from Section 404(a) compliance for one year after an IPO and from Section 404(b) compliance for up to five years after the IPO.

Nevertheless, a company's CEO and CFO are still directly responsible for the accuracy, documentation, and submission of the company's financial reports under Section 302 of Sarbanes-Oxley, which rely on an effective internal controls structure. So it is imperative that those internal controls receive adequate attention in the ramp-up to an IPO, along with an effective and timely financial close process, as previously described. Areas of particular focus often include the processes for gathering, analyzing, and preparing data for financial statements, revenue recognition processes, controls related to business combinations, and even common stock and equity-based compensation arrangements.

The CEO and CFO are directly responsible for the accuracy, documentation, and submission of the company's financial reports under Section 302 of Sarbanes-Oxley. Since these rely on an effective internal controls structure, it's imperative to pay attention to those internal controls in the ramp-up to an IPO.

Business and legal matters. Other important factors for consideration in the ramp-up to an IPO include:

- A formal business strategy that tells the company story, articulates key goals, and maps a path toward those goals.
- Corporate governance that approaches the levels of other publicly traded companies in the same or related industries. This includes policies, procedures, and controls that are clearly documented and articulated in the way investors have come to expect.
- Adequate liquidity or financing to address contingencies or delays in the IPO process.

On the legal side, it is important to prepare an inventory of material agreements (contracts) and assess whether they use terms and conditions and are properly executed. Any major "handshake" or otherwise undocumented arrangements should be formalized. Related-party arrangements should be identified and their potential impacts on the IPO should be considered.

An effective CFO and finance team. One factor that cannot be overemphasized is having an effective CFO and finance team with skill sets that are appropriate in the context of a publicly traded business. Companies preparing for an IPO often focus on hiring a CFO who has previous IPO experience. That experience is certainly a plus, but two other qualities are even more important:

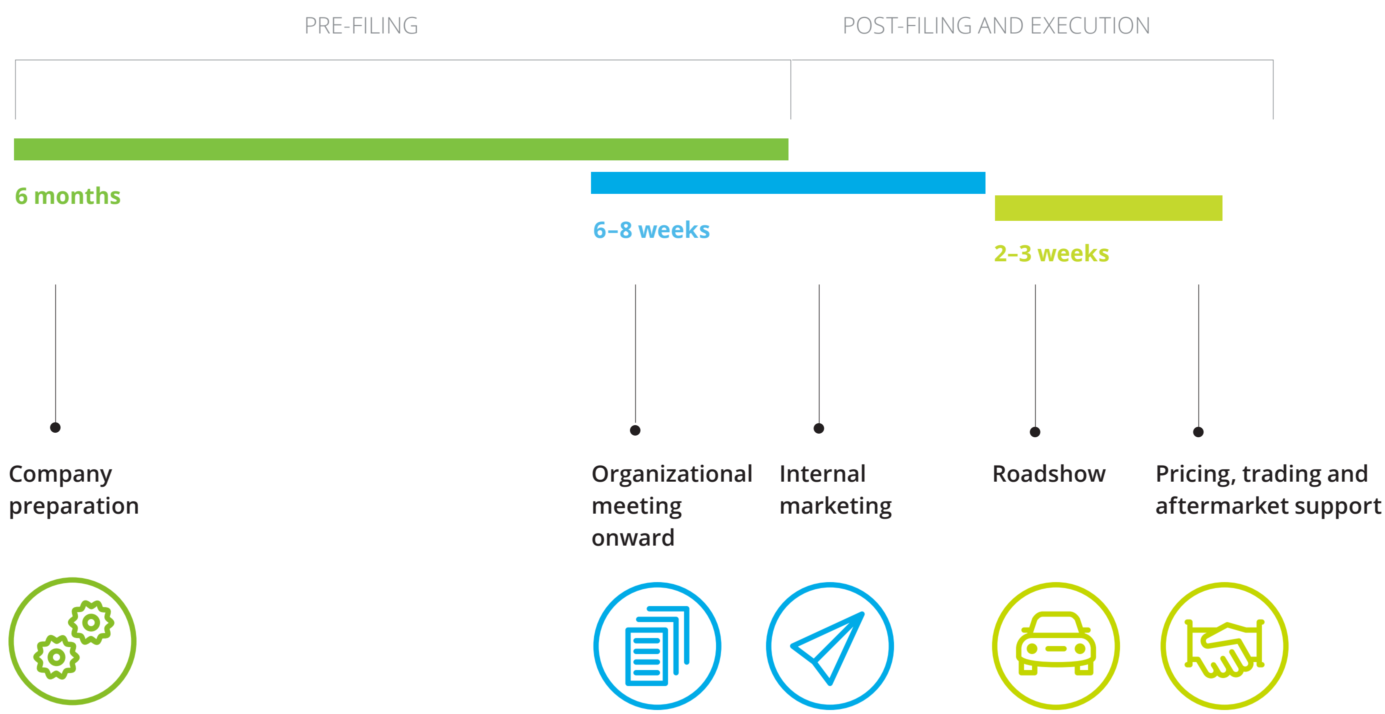
- *Leadership and team-building skills*—the ability to "see where the puck is going" in terms of the company's business plan and strategies and to build a finance and accounting team that has the skills necessary to carry the company toward its goals.
- *Domain expertise in either financial planning and analysis (FP&A), controllership function including technical accounting skills, or capital markets-related experience* that come from having held a corporate controller position or a senior FP&A role, a position with a public accounting firm, or investment banking-like experience. That kind of hands-on experience with the FP&A and closing the books for financial reporting purposes is imperative as the company goes public.

Also, if any finance or accounting functions have been outsourced while the company was in growth mode pre-IPO an important consideration is to transition vital information—"knowledge capital"—relating to the private company from the service provider to the new finance and accounting function, ideally pre-IPO or soon after going public. Absent that transition, an information gap can form that creates challenges for the smooth operation of the company's finance function and compromise the company's ability to function as an effective public company.

Once a privately held company is prepared to go public, the formal process typically takes six months.

That six months is a highly choreographed and stage-managed process involving many different people, including investment bankers, attorneys, and accountants, whose job it is to help the private company and its management to navigate the IPO. The preparations made in the 24 months leading up to this six-month process are a key determinant of how smoothly the IPO goes *(Figure 2)*.

Figure 2. IPO Roadmap



The bottom line:
Diligent preparation trumps timing

With a legislative environment that continues to favor IPOs – and has for more than three years – the 2016 lull in the market may or may not be a temporary phenomenon. The VIX offers one measure for consideration, but many other economic, political, and global factors could come into play to offset even the most positive investor sentiment. As a result, it is especially important for private company owners and executives who are considering an IPO to understand and address the elements of the issuance process that they have greatest control over: the IPO strategy, the preparations made during a 24-month ramp-up, and the team assembled to navigate the roughly 6-month process leading up to the issuance.

A boon for the IPO market

The JOBS Act, signed into law in April 2012, is a likely contributor to higher IPO activity in 2013 and 2014. A key objective of the act is to encourage the IPOs of emerging growth companies (EGCs), defined as companies with less than $1 billion in revenue in their most recent fiscal year, and to ease their transition from privately held to publicly traded. EGC status affords a company several key benefits, including:

- The ability to file its IPO confidentially. Under the JOBS Act, as long as a company meets certain criteria, it can file its IPO documents confidentially and remain so until up to 15 days before the IPO "road show" begins. This allows the company to "test the waters" in terms of investor appetite and also choose the timing of the entrance into the markets.
- A requirement for only two years of audited financial statements rather than the previous three years. For an early-stage company that may not have had an audit performed since its inception, the one-year reduction can reduce the cost and effort required for an IPO.
- Temporary exemption from Sarbanes-Oxley Act compliance requirements, including the external audit of internal controls requirement under Section 404(b) of Sarbanes-Oxley. This exemption gives a company more time to establish internal controls that are sufficient to meet Securities and Exchange Commission requirements, and it can save a company significant expenses during the ramp-up to the IPO.

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