Private, Pre-IPO Investments Continue To Gain Influence for Companies Looking To Go Public

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The continued growth and power of private financing alternatives have changed the dynamic of initial public offerings over time. Historically, an IPO was the ultimate goal for a company and its founders after raising initial venture capital and developing a story to sell to the public markets, and investors eagerly sought allocations in highly anticipated offerings. In recent years, however, the focus has shifted to late-stage private capital-raising, sometimes referred to as the "private IPO round" or the "final private offering," through which companies can attract significant funding from a broader group of investors in advance of or in conjunction with a traditional IPO. These private financings can have significant influence on a company's subsequent IPO, and, if properly structured and planned, can provide a strategic benefit for both issuers and investors.

IPO Market Developments

Many companies today are waiting longer to go public and have completed more, and larger, private financing rounds prior to their IPOs. In 1999, the average age of a newly public technology company reached a low of 4.5 years, which since has been creeping up. From 2017 through 2019, the median age of technology companies going public was more than 12 years old. (Data according to research published by Prof. Jay Ritter in *Initial Public Offerings: Updated Statistics*.)

In a speech at the Economic Club of New York in September 2019, Securities and Exchange Commission Chairman Jay Clayton said, "Twenty-five years ago, the public markets dominated the private markets in virtually every measure. Today, in many measures, the private markets outpace the public markets, including in aggregate size." In its most recent analysis, the SEC's Division of Economic and Risk Analysis reported that in 2017 registered offerings accounted for $1.5 trillion of new capital, compared to more than $3 trillion reported raised through all private channels.

A number of dramatic IPOs in 2019, including the highly anticipated offerings of Beyond Meat, Fiverr, Lyft, Pinterest, SmileDirect, Uber and XP, reflect the range of potential outcomes when pursuing financing in the public markets: Some of these offerings were great successes, while others experienced significant post-IPO stock price declines. Against this backdrop, a number of companies chose to delay or withdraw potential transactions.

The volatility in the 2019 IPO market highlighted the perceived misalignment between what may be valued by investors in private, pre-IPO rounds of financing and what public investors want to see post-IPO. Historically, many pre-IPO companies have successfully attracted private capital based on innovative or disruptive ideas, powerful mission statements, brand recognition and rapid growth, and the vision and reputation of charismatic leaders, even without profitability. On the other hand, public market investors increasingly are demanding a clearer path to profitability, fundamentals of long-term value and growth at a reasonable price.

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Combining IPOs and Private Financings

IPOs and private financings, however, need not be mutually exclusive. Properly structured and planned with a view toward a future or concurrent IPO, late-stage private rounds can provide a strategic benefit for both issuers and investors, from valuation, marketing and financing perspectives.

By staying private longer and having access to larger sources of private capital, companies have the opportunity to grow and mature beyond the venture capital stage and better prepare for an IPO. Prior to launching public offerings, companies can develop a track record with products, services and technology and show actual profitability and cash flow, or at least a specific path to deliver earnings to public investors. Increased flexibility to raise capital in either the private or public markets allows companies to determine which strategy and timing work best for them, irrespective of what competitors may be doing. A notable comparison of strategies is that of Impossible Foods, which to date has chosen to remain private, and its competitor Beyond Meat, which completed a successful IPO in 2019. Impossible Foods has raised a total of $777 million in private financings since 2011; Beyond Meat raised a total of approximately $193 million in the private markets, completed a $240 million IPO at $25 per share in May 2019 and two months later completed a subsequent follow-on public offering at $160 per share. (Data according to PitchBook.)

In addition, the number and types of investors willing to participate in private financings has increased over time. For example, large mutual funds and "crossover" investors, which have traditionally focused on public markets, are participating increasingly in pre-IPO private placements. Other key investors include hedge funds, family offices, sovereign wealth funds and special purpose vehicles through which sophisticated individuals invest. Also, the Securities and Exchange Commission has articulated parallel goals of enhancing the attractiveness of the public capital markets while also increasing the types and quality of opportunities for retail investors in private markets.

In particular, late-stage private financings by crossover or strategic investors, sometimes referred to as the "crossover round" before the public offering, can be a strategic step shortly before, or concurrent with, a company's public offering. These private placements can allow companies to raise additional capital to strengthen balance sheets or simplify capital structures before going public; they frequently offer common stock but can include debt securities or convertible securities as well. A company also may desire, as part of its IPO marketing or business strategy, to bring in strategic partners or anchor investors that make an actual investment instead of just providing a nonbinding indication of interest in participating in the IPO.

This structure has been common for some time in life sciences IPOs and has been expanding to other IPOs more generally. Recent examples include PayPal's purchase of $500 million of Uber shares in a private placement concurrent with Uber's IPO, as well as the extension of PayPal and Uber's global partnership arrangement; and the additional $100 million investment by affiliates of Technology Crossover Ventures, an existing Peloton stockholder, concurrent with Peloton's IPO. Having a well-known investor purchase shares in the company as part of a crossover round, particularly if the purchase is made at the public offering price, can help show confidence in the company, its business and its valuation. Private investors will require detailed information about a company and its management and perform significant due diligence before investing in it. In return, these investors have the opportunity to invest in an IPO-ready company and acquire a potentially larger stake than they would receive in an allocation in the IPO.

Planning for a Late-Stage Private Financing

Following the ups and downs of the 2019 IPO market, pre-IPO investors and companies may look more closely at what drives valuations in private funding rounds and how those valuations relate to the expected pricing if and when the company seeks to go public, whether through a traditional IPO or a direct listing. The "private IPO round," "crossover round" or "final private offering" before the initial public offering can provide strategic valuation, marketing and financing benefits to both investors and issuers. A company considering a late-stage private placement before, or concurrently with, its public offering should consult with counsel and the other parties in the offering process well in advance to ensure that both the public offering and the private placement are structured in accordance with applicable legal requirements and in a manner to successfully achieve the parties' objectives.