

GOING PUBLIC: THEORY AND DECISION

Dr. Sali Bakare

University of the People, Business Administration Division

ABSTRACT

Going public means that a private company is becoming a publicly traded company. It is a transformational event for the firm. The decision to go public can be an important and challenging decision for that company. When a company is going public, it means that it is selling to the public for the first time, its shares that are formerly privately held. The general public then, has the opportunity to buy the company's shares for the first time.

Keywords: Going Public, IPO, Publicly traded company, outside equity

1. INTRODUCTION

Going public means that a private company is becoming a publicly traded company. It is a transformational event for the company. The decision to go public can be one of the most important and challenging decisions for that company. When a company goes public, it means that it is selling to the public for the first time its shares that were formerly privately held. The general public then, has the opportunity to buy the company's shares for the first time. The process of selling to the public is known as initial public offering (IPO). The level of commitment, which a firm's IPO team is willing to put into the process, will determine the success or failure of the IPO.

In the U.S. people view initial public offerings (IPOs) as a natural phase in the life cycle of a firm [6]. A lot of firms prefer issuing debt to equity so that management may continue to maintain a high control of the firm. Large firms such as Cargill and UPS remain private because privately held firms are not required to file their financial reports with the Securities Exchange Commission (SEC).

The number of companies that went public in the US has been fluctuating since 2001. In 1996, 675 firms sold their stocks via IPO; while in 2001, the number of IPOs declined to 84. In 2008 and 2009 together, the number of IPOs declined to less than 140 [4]. However, in 2014, there

was an increase in the number of IPOs to 275 from 128 in 2012; and then the number dropped to 170 in 2015; a decline of about 38% (see Appendices).

What are the deciding factors that trigger firms into favoring going public? The empirical literature on the reasons why firms go public is undeveloped and the available study results of the scanty foreign researchers may not be generalizable to the US economy. Firms that are not publicly traded are highly leveraged; which may make them unattractive investment to the public. Private firms have fewer growth opportunities and lower industry market-to-book value than the public companies [8]. Some private firms do not pay dividends; they retain profit for use in firm expansion or to fund the purchase of equipment.

There is a notion that going public is a stage in growth process; however, this notion is rendered void by [9] who noted that there are privately traded firms that are many times bigger than some publicly traded firms. According to [9], capital raised via IPO is not used to finance subsequent investment and growth but to pay debt. Therefore, going public is a choice rather than a stage in growth process.

2. DECISION TO GO PUBLIC

A company may raise external funds either by placing shares privately with a risk-averse venture capitalist (VC) or by selling shares publicly (IPO) [2]. A venture capitalist may (may not) undergo a costly evaluation of a firm before investing in it. If he did (because of his risk-aversion), then, the price he pays per share will depend on the result of his evaluation. A VC has three options; a) ignore the IPO and invest in a risk-free asset, b). invest in the IPO uninformed, and c). invest in IPO after undertaking a costly evaluation of the firm. The VC will choose the option that maximizes his time and money.

The decision to go public is affected by stock market valuation of firms in the same industry, size, and reputation of the firm intending to go public [9]. One of the factors that affect a company's decision to go public is its market-to-book ratio. Another factor is company size; large companies are more likely to go public than the small ones. There is a notion that for a company to go public, it has a stage in its growth process; however, [9] nullified this notion by noting that there are privately traded firms that are many times bigger than some publicly traded firms. According to [9], capital raised via IPO is used to pay debt rather than to finance subsequent investment and growth. Therefore, going public is a choice and not a stage in the growing process. Studies such as [3]; [5], and [9] showed that some post-IPO impacts are a reduction in profitability, investment, and financial leverage and an increase in turnover of the controlling shareholders.

3. REASONS FOR GOING PUBLIC

Companies go public for a variety of reasons. Publicly traded companies have free information available online; which facilitates decisions for individual investors to invest in the companies' stocks. This kind of investment in turn reduces companies' cost of capital [11] as cited by [6]. Companies without majority owners and with management that controls all of the voting power are more likely to go public [1] as cited by [6]. Also firms with a lot of equity stakes held by outsiders such as venture capitalists (VCs), are likely to go public using IPO as an exit strategy [6].

Prestige: Companies go public to enhance their reputation. There is added prestige and visibility with customers, suppliers, and the financial community. A company's reputation is enhanced by going public; going public is publicity in itself [12]. A firm's bargaining power increases after IPO [9]. When a company goes public, lenders and suppliers may perceive it as a safe credit risk; which will enhance opportunities for good financing terms. As noted by [12], public companies are more likely to receive the attention of newspapers, magazines and periodicals than private companies. A strong public relation campaign may enhance stock price, increase sales, revenue, and the number of investors.

Company Value: Management believes that going public can generate more value for its company. The market value of a public company is usually greater than that of a private company in the same industry mainly because of liquidity [8]. Venture capitalist and other investors sometimes will require a company to go public before committing funds. Investors invest in public companies because investors know they have an exit strategy. Because of liquidity, shareholders who no longer wish to hold the shares can sell their stock to interested potential investors or other shareholders. Other reasons why companies go public are to raise capital needed for expanding their businesses, to diversify and reduce investor holdings, to attract and retain talented employees, and to provide liquidity for shareholders.

4. THEORY OF GOING PUBLIC

Going public means diversification for the firm as capital comes from numerous small investors rather than from one venture capitalist who maintains a lot of control over the company. As noted by [2], companies with high capital intensity or positive productivity will go public early. The act of shareholders monitoring management decreases after going public. In some economies such as Europe, the number of investment banks/financial analysts working with companies and providing information about them is limited compared to the US. Cost of evaluating companies will therefore be higher for investors in Europe than in the US. This will

make firms in Europe go public at a later age than in the US [2]. Because of technological advancement in certain industries, companies in those industries may go public at the same time. [2] identified four theories of the decision to go public.

Widespread Share Ownership (Diversification): In private companies, capital is generated from a venture capitalist or from a group of large investors such as banks. Thus, the VC or the group of investors has a large controlling power in the company. In a public company, ownership is diversified as shares are owned by numerous small investors.

Convincing Numerous Investors: A company going public has to convince numerous potential investors that its company is worth investing in. These potential investors will then investigate the company to ensure it is worthwhile to put their money into this company. (Information is not yet available about the company). The cost of researching this company is later covered by the company going public by offering the shares to these investors at lower share prices.

Capital Requirement: The larger the capital requirement, the more likely it is for a company to go public. It is easier to acquire funds from numerous investors when the fund needed is large. A company may desire to have a less-leveraged capital structure. If that be the case, the company may choose to go public. Also, if there is high technological uncertainty, the company will choose to go public.

Publicly Free and Available Share Prices: Companies go public after sufficient information about them is available publicly. When a company is going public, it is required to file some documents with the SEC to disclose certain financial information about the company. This means that information about these companies is available to potential investors free of charge. Share price of public companies is freely available. This free information reduces the cost of researching the company for potential investors.

There is an assumption that the deal between the company and investors is characterized by uneven information. If a company is financed privately, the VC has a huge bargaining power because he contributes a lot of the capital needed by the company. He (the VC) will then require a high return on his money. Cost of information acquisition to potential investors who intend to invest in private companies is high because little information is publicly available for these companies. On the other hand, if funds are gathered from numerous investors, each investor has a small stake in the company; and therefore has almost no bargaining power. Information is available publicly. Other companies in the industry that chose to go public can use the available information free of charge. However, investment bankers can require these new companies to share the information cost with the companies that went public before them.

Other theories are that the probability of going public increases if a company is big and well established. Another is that if and when the median industry market-to-book value is high, companies' likelihood of going public rises. Going public means that a company will publicly disclose important information about its research and development, marketing and pricing plans, etc. to competitors. Any company that objects to this will choose not to go public.

5. THE PROCESS OF GOING PUBLIC

The process of going public puts pressure on short-term growth, increases costs, imposes restrictions on the management, forces disclosure to the public, and results into former investors losing control of decision making. The process can on the other hand strengthen capital base, facilitate acquisitions, diversify ownership, and increase prestige for a company. The offering may be a primary offering whereby a firm sells its newly issued securities and receives all the proceeds as additional capital. When already existing securities are sold, it is called a secondary offering.

Before going public, a company must meet some eligibility criteria. Some of these criteria are that the company must meet financial audit requirements, be competitive in the industry, have a high growth prospects, and its product or service must be innovative. Sometimes a company going public may be required to have revenue of \$10-\$20 million per year, a profit of \$1 million, and a growth rate of 25% per year for 5-7 years consecutively.

Going public is a complicated and expensive process and may be full of pitfalls; however, having the right investment banking firm, investor climate, and timing can make a difference. [2] noted that it is better to go public when a bull market is booming as this is when new offerings enjoy popularity. A bull market is when securities' prices are rising or expected to rise.

The first step in the IPO process is to decide if the company wants to issue stocks or bonds. To make this decision, a company has to consider the pros and cons of both alternatives. The next step in the process is finding an investment banker with the best deal because the IPO process is expensive. Firms such as Goldman Sachs (Golden Slacks), Morgan Stanley or Wells Fargo specialize in initialing IPOs. To go public, a company will contact an investment bank with the number of shares and the price at which it wants the shares issued. The investment bank then becomes the underwriter or owner of the shares and takes legal responsibility for the shares. The goal of the underwriter is to sell the shares to the public at a price higher than what was paid to the original owners of the company.

The investment banker will let the company know how much money it will raise from the IPO, the type of securities to be issued, and all the details in the underwriting agreement. The firm

then needs to get approval from the Securities and Exchange Commission (SEC). The investment banker will help the company with all the filings with the SEC.

A company that wishes to issue stocks publicly must file a formal registration statement with the Securities and Exchange Commission (SEC), providing details of the company's financial history, current condition, the proposed public offer, and projections. The company will prepare and submit a registration statement (SEC Form S-1) to the SEC for approval [5]. This takes about 30 days. Once approval is granted, the company can sell its securities both in the primary and secondary markets. The number of shares that a company may issue is determined by the company's shareholders and varies according to the company's size.

The SEC will investigate the company to ensure that all information submitted is correct and that all relevant financial data has been disclosed. If everything goes well, the SEC will work with the company to set an IPO date. The underwriter will put together a prospectus. The underwriter will then present the prospectus to potential investors. If the investors are interested, they will buy shares at a set price before the stock goes on the exchange. The price at which the stock is sold on the exchange depends on the company and the current market conditions.

A publicly traded company is subject to other SEC reporting requirements including filing annual reports on Form 10-K, Quarterly reports on Form 10-Q and current reports on Form -K. Regulation S-K is the forefront of the document. It specifies the disclosure requirements of the non-financial statement part of filings with the SEC. Regulation S-X states clearly the financial statements that a firm should include in the filings with the SEC; it also states the rules and guidance on the format and content.

Publicly-held companies are required to comply with Sarbanes Oxley (2002) (SOX). Once a firm becomes a publicly traded company, the way it does business changes; its detailed financial information then becomes a public document.

6. ADVANTAGES OF GOING PUBLIC

Some of the advantages of going public are:

Access to Capital: A public company has access to more and greater sources of capital than a private company. Being a public company gives investors more confidence to invest in the company. A public company may give investors a discount from the public trading price (if investors are willing to hold the stock for one year).

Liquidity: Investors in a public company may be able to buy or sell their stock quickly than private company stocks; hence, publicly traded stock provides greater liquidity. Liquidity is one of the reasons why public companies are typically valued more than a private company [12].

Valuation: Public companies are typically valued more than private companies [12]. The market **value** of a public company is usually higher than that of a private company in the same industry. Chamber of Commerce research results indicated that sellers of private companies may receive 4 to 6 times their net earnings while public companies sell at an average of 20-25 times their net earnings. Increased valuation increases opportunities for mergers and acquisitions. Securities and Exchange Commission's disclosure requirements offer the public more confidence. Market stock price depicts more accurately a firm's value than that obtained from a venture capitalist [6].

Prestige: There is added prestige and visibility with customers, suppliers, as well as the financial community and the public.

Acquisition: Acquisition and mergers are easier for publicly traded companies because they can issue their liquid stocks for the acquisitions. It is often difficult for private companies to issue their stocks in acquisitions as the stocks are illiquid.

Awareness: Going public is publicity, which brings the public's awareness about the company. This awareness may not happen if a firm remains private.

Wealth: Shareholders of publicly-traded stock can use their stocks as collateral or as a currency to acquire assets. They can also sell their shares to realize immediate profits.

Risk premium payment: If a firm decides to be private, it has to pay the venture capitalist (VC) a risk premium because the VC has his money tied up in the firm (no diversification). If the VC is the sole supplier of fund, he has a huge bargaining power. Going public enables a firm to avoid this experience. The bigger the risk premium requested by the VC and the more capital intensive a firm is, the greater the chances of a firm going public.

Other advantages of going public are:

- 1). The trading price of a public company's stock serves as a benchmark for the offer price of other securities.
- 2). Raising capital later is typically easier for a public company because the stock has a market value and is tradable; a private company can only raise money from friends and family.
- 3). Public companies offer stock options and stock incentives to attract employees. This is a benefit to employees.

7. DISADVANTAGES OF GOING PUBLIC

Despite all the advantages, going public is not always the right or possible answer to additional capital needed. As investment bankers want the securities they underwrite to be successful, they always look for companies that have outperformed their industries' average.

- 1). **Time Pressure:** There is increased time pressure on public companies for reporting to SEC compared to a privately held company
- 2). **Costs:** Underwriting costs, legal fees, filing fees, printing costs, compliance costs, and advisors' fees are expensive. And the costs are not deductible on the statement. There is also a lot of paperwork.
- 3). **Loss of control:** When and if more than 50% of the firm's shares is publicly traded, the firm's founders lose control. IPO exposes firm to unsolicited acquisition threats.
- 4). **Pressure for performance:** Shareholders expect sales, profits, market share, and product innovation to continue growing no matter what. This may create a lot of pressure for the company management.
- 5). **No turning back:** Once a company goes public, it may have to stay public as going back to being private is difficult and expensive.
- 6). **Availability of Valuable information:** Valuable information about a firm going public is available to competitors.
Companies that go public later are able to use free of charge the information generated by firm's that went public before them. Investment banks can however, force firms going public next (later on) to share the costs of information.
- 7). **Evaluation Cost:** Because the source of capital is single, the evaluation cost is low with private placement. Going public means a lot of investors will evaluate the firm; and this in turn increases evaluation costs. The older a firm, the more track record of performance it has available and the lower the evaluation cost.

Transparency: Publicly held firms are required to file quarterly financial reports with SEC. In the report, they have to disclose key officers' salaries, stock, and option holdings.

Because of the disclosures required by SEC, competitors will have information about public companies' pricing, margins, profitability and financial structure. Analysts expect publicly traded companies to quarterly forecast performance and meet that forecast [4]. Analysts may publish their own forecasts, which may negatively affect the market for publicly held firms.

Decreased Profitability: [9] indicated that profitability decreases tremendously and permanently after IPO. This fall may be due to the fact that the original owners' equity fell because of the IPO. When a firm is owned by a few entrepreneurs, the entrepreneurs work restlessly to see that the firm succeeds. Once it becomes public, there is so much the managers can do. Agency costs may also be a good explanation of the decline in profits.

Litigation risk: - Being a public company makes a company prone to shareholder lawsuits, Well-experienced and skilled management team is crucial for optimal corporate governance structure. Ownership by management indicates to investors that the management has a vested interest in the company's future. The company must endeavor to maintain credibility and investor confidence after the IPO.

8. CONCLUSION

The decision to go public is an important transformational and challenging event for a company. However, there is very little empirical research that addresses going public [2; 5]. The older a company, the more information is available about it for evaluation. In 1996, 675 firms sold their stocks via IPO. However, in 2008 and 2009 the number of IPOs declined to less than 140 [4]. A lot of firms prefer to issue debt rather than equity so that the management may continue to maintain a high controlling power in their companies. Companies go public for the reasons of diversification, prestige, increase in valuation, and the ease to acquire other firms. If a company decides to go public, it is better to go when a bull market is booming as this is when new offerings enjoy popularity.

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APPENDIX

Table 1. Number of IPOs in the United States from 1999 to 2015

Year	Number of IPOs	% Change
1999	486	
2000	406	-0.16
2001	84	-79.31
2002	70	-16.6
2003	71	0.14
2004	226	218.3
2005	206	-0.09
2007	213	0.34
2008	31	-85.44
2009	63	103.23
2010	154	144.44
2011	125	-0.188
2012	128	0.024
2013	222	0.73
2014	275	0.24
2015	170	-0.38

Data Source: Statista.com

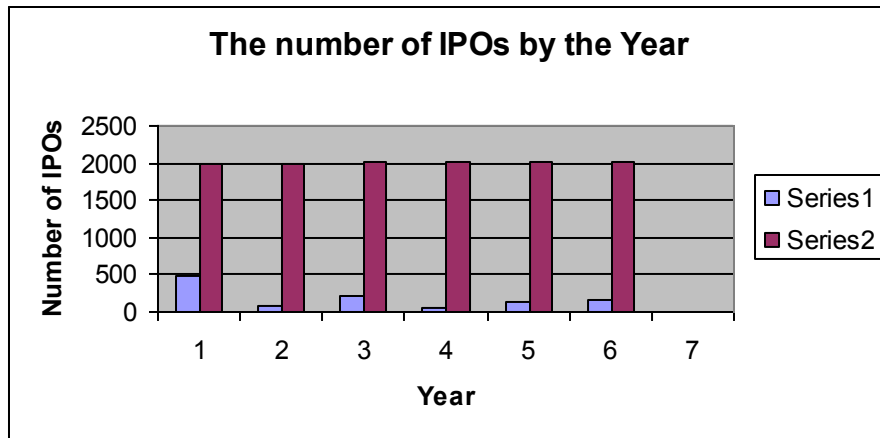


Figure 1. Data Source: Statista.com