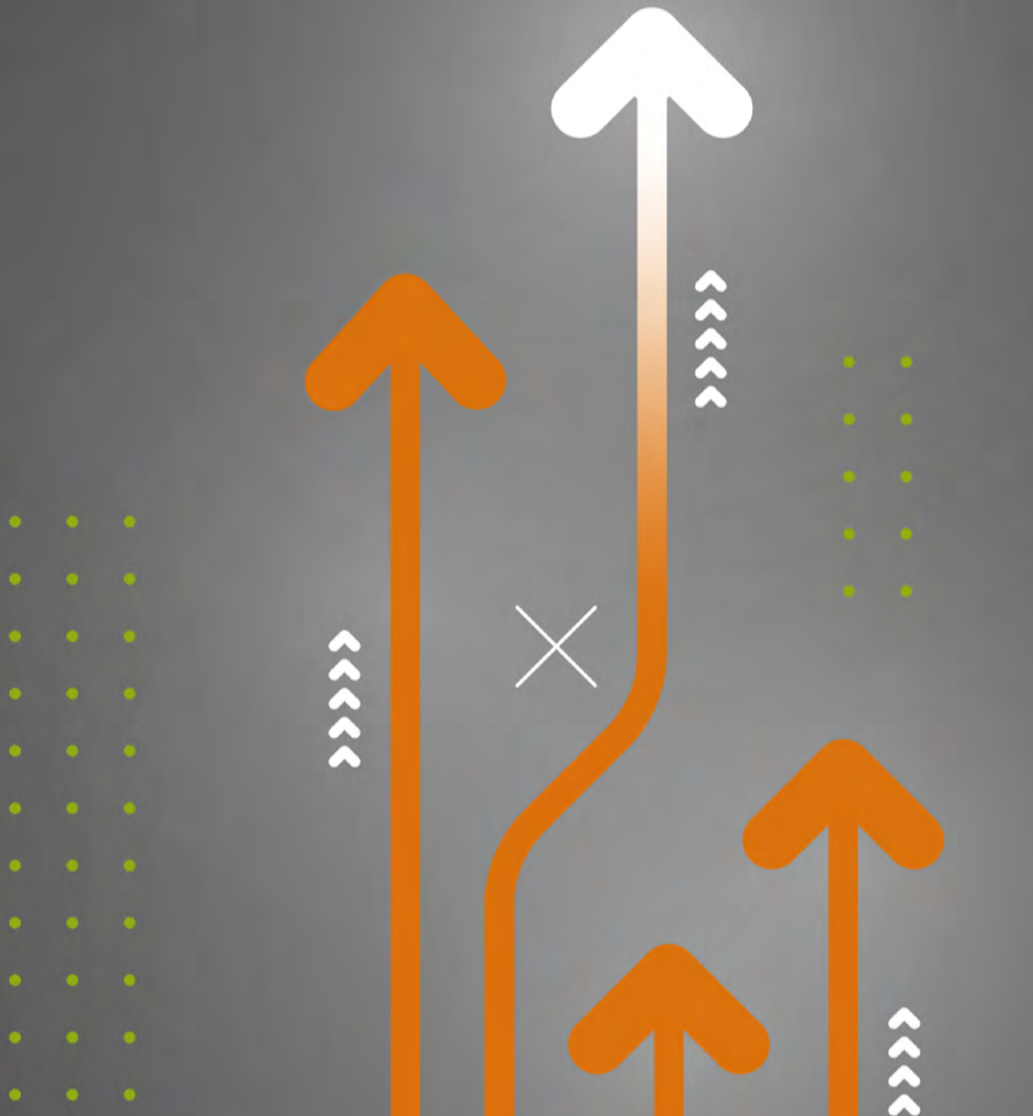
Choosing the Right Path to Liquidity: IPO, SPAC or M&A?

AN ARMANINO WHITE PAPER



Definition: Path to Liquidity

A path to liquidity is the route taken by a company to create liquidity for its owners or founders, enabling them to convert their ownership in the company to other means of currency or investments.

Introduction

Did you get a call from a potential buyer that seems too promising to ignore? Or perhaps you've decided that you're ready to retire sooner rather than later? Or maybe the current market situation is encouraging company executives to go public ASAP? Regardless of the reason, rushing down a path to liquidity without a plan is rarely a good idea.

Yet planning an exit is one of the most overlooked and underestimated aspects of formulating a business strategy. Choosing an exit strategy for your business can be one of the most difficult decisions you'll ever make, but if you don't plan how your company will transition to the next phase of its lifecycle, it may not change in a direction that you expect or want.

Having a well-planned strategy and a well-prepared company can mean the difference between reaching your liquidity goals with ease or facing a stressful, risky transaction that could end in disappointing outcomes or worse. It pays to be well informed about the different liquidity options available today and what to expect when you choose one of these options.

This white paper can help you get started in evaluating your needs, understanding your choices and identifying what steps your company must take to be prepared on day one for the next phase of the business — whenever that next phase happens and whatever form it takes.

What Are the Options Available?

While some successful companies go on for decades as privately held entities, often passing from family member to family member, most will face a decision about the future of the business far sooner than that.

Maybe the founder would like to fund his or her retirement, or investors want to convert their ownership into cash. Perhaps the executive team feels that the company should go public as a path to liquidity for long-term shareholders and/or co-founders. Often private companies evaluate whether a public transaction or strategic sale can provide them with the capital infusion needed to fuel growth. Sometimes a business owner gets a call from a special purpose acquisition company (SPAC).

All of the above situations are potential paths to liquidity, and there are others as well. One of the many aspects that can make planning an exit strategy complex is that there are different routes your company can take, including a family succession, employee stock ownership plan (ESOP), management buyout, initial public offering (IPO), SPAC, strategic sale — which is a form of merger & acquisition (M&A) — and more.

In this paper, we'll focus on the IPO, SPAC and M&A options, as they can result in your private company going public and they often require a great deal of advance planning and preparation to be successful and meet your company's exit plan goals. These paths also generate the most liquidity for investors who sell while presenting a financing opportunity for the company to help it move into a new stage of growth.

Factors That Influence Which Path to Take

- The lifecycle stage of your company (growing, stable or declining revenues)
- The type of ownership (founder/individual, group of investors or private equity owned)
- The current marketplace, economy and regulations
- Interest and readiness for becoming a public company
- Liquidity goals such as potential vesting and earn out

The IPO Path: What You Should Know

When companies think about going public, an IPO is often what they envision. While successful IPOs generate substantial funding for capital investments to grow the business, this path is notoriously elusive because few private companies are ready for the rigors of taking a business public and selling shares on the stock market.

Not only that, but the vagaries of the IPO market are beyond the control of individual companies. Timing is everything, and the risk of failure can be high. Some companies are forced to pull out at the last minute while others may experience disappointing results or even significant losses after going public.

Before you choose this high risk/high reward path, here are a few facts to keep in mind:

- The process of going public takes an average of 18 to 36 months. While some companies have done it in 8 to 12 months, they were extremely well prepared before they began.
- Navigating the complexity of an IPO requires many stakeholders, from investment bankers to accountants, lawyers and regulators, to name a few.
- Cashing out is often delayed, with a lock-in period for founders and investors during which time they are unable to sell their shares.
- Regulatory requirements can be a major hurdle.
- Transaction and listing fees are high, as are the cost and effort to support roadshows that market the company to the public.

2021: A Record-Setting Year for IPOs

Despite the challenges of the IPO path, there were 480 IPOs in the U.S. in 2020, a new record.

By early November 2021, there were 914 IPOs on the U.S. stock markets, on track to double the previous year's tally.

Source: "All 2020 IPOs," "All 2021 IPOs," Stock Analysis, November 9, 2021

The SPAC Path: What You Should Know

Touted for its ability to fast-track the path to becoming a public company, SPAC mergers allow private companies to access capital and secure investors through private negotiations.

A SPAC is a blank-check corporation, which is essentially a shell company set up by investors with the sole purpose of raising money (through an IPO) to acquire another company. The acquired/target company will become the surviving publicly traded, operating company.

The target company merges with the shell company to access capital funding, market awareness, and liquidity for shareholders. This makes SPAC transactions mergers, not IPOs in the traditional sense, which means that the private company can directly negotiate with investors, resulting in clear, upfront terms, increased speed to market and a set valuation, which reduces risk. The merger of the SPAC and the target is called a "de-SPAC."

The SPAC market ran hot and cold in early 2021 and then heated up again at the end of the year, mostly due to concerns expressed by the Securities and Exchange Commission (SEC) around disclosures, conflicts of interest and share dilution. The agency has stated that it has plans to propose rule changes to make sure that investors get the transparency they need to make informed decisions.[1]

As you consider the SPAC option, here are some facts to keep in mind:

- SPAC targets are on a shorter path (six months or less) to going public than a traditional IPO, which can be a major disadvantage for companies that aren't prepared to become public entities.
- A SPAC typically has 18-24 months to acquire a company. If the SPAC merger is not completed within a specific timeframe, the SPAC has to de-list from the exchange, liquidate the funds held in trust and start the entire process over.
- Given the short timeframe typical of SPAC mergers, target companies need to carefully consider their readiness to go public in areas such as financial reporting, tax, legal and SEC reporting, executive expertise, human resources, technological processes and more.

[1] "SPAC Issuance Jumps to the Highest Since March as Deals Rush to Market Before Year-End," Yun Li, CNBC, November 3, 2021

The SPAC Roller Coaster

SPACs represented almost 71% of all IPOs by volume in the first quarter of 2021. They dropped to 23% in the second quarter after the SEC announced in April 2021 it was considering new guidance on SPAC IPOs. While not the only contributing factor, the SEC announcement clearly led to cooling. Then, staging a comeback in October 2021, SPACs hit an eight-month high.

Sources:
"U.S. IPO Market: Fewer IPOs in the Second Quarter as SPACs Drop Off," Sara Potter, FactSet Insight, September 1, 2021
"SPAC Issuance Jumps to the Highest Since March as Deals Rush to Market Before Year-End," Yun Li, CNBC, November 3, 2021

The M&A Path: What You Should Know

M&A is the most common route among the three mechanisms discussed in this paper, representing 88% of all exits.[2] In fact, sales to strategic and financial buyers are more common than ever because of low interest rates and enormous amounts of cash raised by private equity firms that seek growth investments.

In a merger, two entities come together as one. In an acquisition, parts of the selling company's assets are transferred to the buyer, with retention of key personnel, including the founder, typically built into the deal structure. Often the acquiring company is already a public entity, which means the target company will also become public when acquired or merged.

Finally, M&As fall into two categories from the buyer perspective. Strategic buyers are other companies, often direct competitors or companies operating in adjacent industries, such that the target company would fit in nicely with the acquirer's core business. Financial buyers are institutional buyers, such as private equity firms, that are looking to own but not directly operate the acquisition target. The type of buyer will dictate many aspects of the post-M&A future for the acquired company.

While most exits are some form of M&A, here are a few things to keep in mind before choosing this path:

- The M&A process can take from six months to a year or more to complete, with structuring of the deal often the most complex step in the process.
- If the acquiring company is a public company, then the selling/merging company will need to be ready for public company requirements on the timing of information for financial reporting, tax, legal and internal controls.
- M&As are all about creating synergies between the companies. Finding a good cultural fit will be key to post-deal success.

[2] "How to Prepare for M&A, Your Most Likely Exit Avenue," Ben Boissevain, TechCrunch, July 26, 2021

Cheat Sheet: Overview of Paths to Liquidity

Path to Liquidity	IPO	SPAC	M&A
Timeframe from decision to closing the transaction	18-36 months	6 months or less	6-12 months
Timing to receive proceeds	Lock-in periods of 180 days are common	Typically subject to lock-up/resale restrictions for 1 year from de-SPAC transaction	Typically 100% or substantially all of proceeds at time of closing
Underwriting/ banking costs & fees	~5-7% of IPO gross proceeds	~5-6% of SPAC IPO gross proceeds	~1.5-8% depending on company value
Post-transaction control	Owners retain control	Owners lose control	Owners lose some or all control
Seller's role post-sale	No change from pre-IPO	Negotiable, but typically includes staying on for a predetermined amount of time	Negotiable, from a complete exit to staying on for a predetermined amount of time

Thinking About an Exit Strategy: Questions to Consider

Choosing a path to liquidity is a complex, difficult decision with many implications for owners, their heirs, employees and investors. Many different factors come into play that impact exit options and outcomes.

Working with a trusted advisor can help you navigate the complexities and formulate a well-informed plan. While an experienced advisor team will bring knowledge and best practices to the exercise, there will be many questions about your business and your goals that you should be prepared to answer. Your responses will guide the direction of the exit strategy and inform the specifics of the plan.

Keeping the Company Private

For companies not prepared to go public, another exit option is "secondaries" or a "liquidity round." This is where founders, employees and/or investors sell their (partial) stake in the business to another investor. The new investor could be an existing investor or growth or private equity firms. Secondaries are a popular choice because they allow companies to stay private longer.

Here are some examples of the questions you may be asked:

Areas of Consideration	Questions to Answer
Business maturity	• Have you assessed whether your company is ready to become a public company? • If it is not yet ready, do you know what needs to happen and how long it will take to become ready? • Would it be better to stay private for a longer period of time to reach optimal readiness?
Control	• How will the owner, management team and employees be impacted in terms of control over operations and strategic direction? • If a deal is already on the table, do you understand the new investors' desired direction and focus, and is it aligned with the current focus of your business? • Can you and your team adapt to that desired direction? • Could there be a conflict?
Personal goals	• What do you want from the liquidity event? • Beyond cash, are you ready to leave or do you want to stay on? • Is it important to continue your legacy?
Company performance/financial condition	• Is the business still growing? • What is the outlook for future growth? • How stable are your financials? • Have you gone through an audit before?
Management depth	• If you don't want to stay on, is your management team competent enough to step into your place? • If they aren't, are you prepared to stay until that changes?

Preparing for Day One

For any exit path that results in a private company going public, most businesses will need to begin preparing far in advance.

It typically takes years to develop the capabilities for functioning as a public company, requiring cross-functional preparation that addresses the people, processes and technology you'll need in place on day one as a public company. Equally as important is the focus on operational effectiveness from day two onwards.

The following broad categories of topics introduce some of the top challenges that your company will need to address ahead of going public.

Accounting
The accounting team will need to prepare your financial statements to meet the stringent Public Company Accounting Oversight Board (PCAOB) audit standards. This includes formalization of the monthly and quarterly close process to ensure timeliness for external reporting needs, documentation of policies and procedures and confirmation that technical accounting documentation is sufficiently robust.

Tax
The tax team is responsible for more than compliance, including handling quarterly tax provisions as well as additional needs such as Section 382 studies to determine treatment of net operating losses and credits, sales and use tax studies, and required footnote disclosures for financial statements.

Controls and SOX compliance
You'll need to have the proper internal controls to comply with Sarbanes-Oxley Act (SOX) requirements that mandate certain practices in financial recordkeeping and reporting for public entities. Internal controls should be reviewed by management for compliance readiness, and your external auditors will seek to understand your control environment for the pre-filing PCAOB audits. An accounting team prepares your financials for both of those audits.

Audit

It's not uncommon for private companies to have staffing gaps in finance, so this is the time to bring in a reliable accounting team to make sure your books meet PCAOB public company audit standards and you have proper audit internal controls.

Financial planning & analysis (FP&A)

Budgeting and forecasting can no longer be a once-a-year activity. Your company must be prepared to go public with guidance going forward, including additional operational analyses and drivers for purposes of conveying company performance to analysts and investors.

Technology

Depending on the maturity of the company, the technology on which you currently run the business — such as your enterprise resource planning (ERP) system — may not be robust enough to support the needs of a public entity. Assessing the current state of your technology stack and comparing it to what you'll need to operate efficiently and effectively as a public company will help you identify gaps in technology and the skills and resources you'll need to upgrade it.

Areas to consider include:

- Is your company dependent on spreadsheets instead of working within technology platforms that enable drilling down deeper into the data?
- Do you need to upgrade from a basic system such as QuickBooks to a robust ERP/financial system that can support internal control activities and greater automation?
- Do you have the technology in place to support external reporting with the SEC EDGAR platform?
- What software do you use to manage your current equity plan, and is it robust enough for future administrative tasks in the public markets?

Investor relations

Managing a successful IPO requires a strong investor relations (IR) team that can assemble relevant and timely information and insights to guide investors and manage perceptions that create demand for the stock. The IR team works alongside the C-suite to tell a compelling and credible story to Wall Street and shape expectations of the company's future performance.

Legal

Your legal team will take the lead role in liaising with regulatory authorities, formalizing agreements, documenting compliance and governance, due diligence and more. The team will be critical in handling and documenting agreements, licenses, equity awards and other key company records in addition to orchestrating the filing of S-1s and registration documents.

Equity plans

You should prepare to allocate time and resources to compensation-related issues ahead of an IPO. Your pre-IPO equity plan will likely need to undergo significant change and be restated in its entirety at the time of IPO. Given the complex accounting and tax implications around equity compensation, your company might be better served by upgrading your technology and/or outsourcing plan administration.

Conclusion

It's never too soon to start thinking about a future exit strategy given the extent of preparation needed to make any path to liquidity as successful as possible. As we've highlighted here, those strategies that involve private companies becoming public — whether through an IPO, SPAC or M&A — require extensive planning and many months of effort to achieve.

The process can be overwhelming. To make it easier and ensure you're aligning your personal and business goals with the right path to liquidity, turn to a team of trusted advisors who can help you work through any business, accounting, tax, legal and human resources issues to create an exit strategy that works for you and your stakeholders.

Armanino offers a full range of advisory services to help you assess your readiness and create and execute an exit strategy that fulfills your objectives. Contact the Armanino Advisory team to learn how we can help you get started making the next phase of your business a reality.

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