2220 - Entrepreneurial Finance and Venture Capital

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Lecture #17

Why IPO?

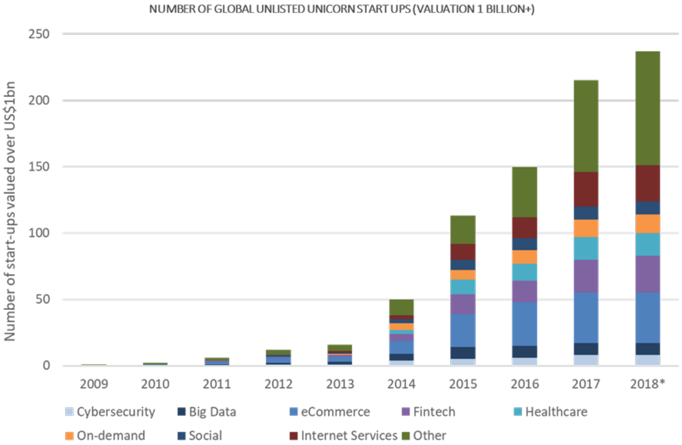
- Raise funding
- Achieve liquidity
- Enhance visibility and reputation

Exit trends

- Post-2000
  - Drop in number of IPOs, particularly small-cap
  - Larger fraction of VC-backed exits via acquisition
  - Rise of unicorns: startups remain private for longer

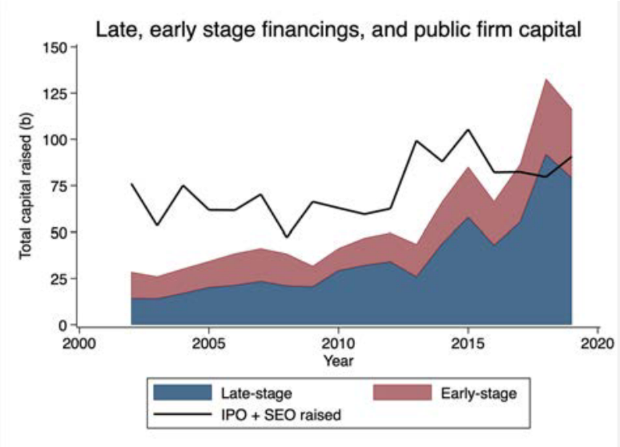
- Possible explanations
  - Increased cost of going/remaining public
  - More attractive M&A market
  - Growth in late stage finance

Rise of the unicorns



- 1200+ unicorns worth ≈$4.4 trillion in Jan 2025 (CB Insights)

Growth in late stage finance



Why are exits needed in the first place?

- No liquid private secondary market: adverse selection
- How do IPOs address this?
  - Due diligence
  - Underwriter's "firm commitment" to sell
  - Road show
  - SEC approval
  - 6 months lock-up for insiders
  - Greenshoe
  - Analyst coverage
  - Audits, disclosure, director liability and other regulations
- How do sales address this?
  - Due diligence
  - Change of control

Advantages of IPO vs sale

- Raise capital
- Entrepreneurs keep or regain control from VCs
- Prestige for founders/CEO
- High returns when IPO market is hot
- Often only path for most successful ventures

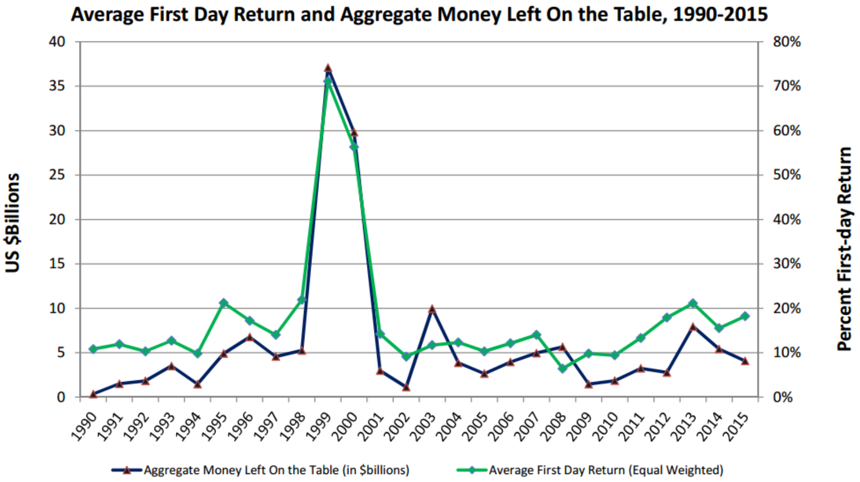
Disadvantages of IPO vs sale

- Legal, accounting, investment banking fees are often 10% of funds raised in offering
- 6-month lock-up for insiders (but sale may include vesting for key employees)
- Value to strategic buyer is often higher than standalone value (e.g. synergies)
- First day under-pricing

First-day under-pricing

- On average, stock price jumps on first day of trading
- As a result, issuing companies leave substantial value on the table
- Consistent pattern over time and across most developed capital markets
- Possible explanations
  - Generate positive sentiment and momentum
  - Banks use under-priced IPO allocations to attract informed investors to participate in pre-IPO price discovery
  - Banks use under-priced IPO allocations to attract/reward high-value clients

First-day under-pricing



Possible solutions to underpricing

- Auctions
  - Open bidding with shares allocated to highest bidders, not at bank's discretion
  - e.g. Google in 2004, Morningstar in 2005

- Direct listings
  - Stock is listed without raising capital
  - e.g. Spotify in 2018, Slack in 2019