

Navigating the IPO process

From start to finish, the IPO process typically takes four to five months. The actual timing depends on several factors, such as market conditions and the availability of information required for the SEC registration statement.

The IPO process is rarely a smooth one. In all likelihood, you will face unforeseen obstacles and challenges along the way. Your team of trusted advisers can help you navigate through many of these roadblocks, but sometimes they may be just too difficult to overcome. In these situations, you might need to take a temporary hiatus from going public. In particular, it is usually prudent to suspend the IPO process when markets are volatile and then start anew when conditions improve.

Five main phases of the IPO process

Phases often overlap and need not be sequential.



Company valuation



Underwriter due diligence



SEC registration



Exchange listing



Marketing to investors

Company valuation

Even before kicking off the IPO process, an underwriter will begin estimating a company's value and determine the number of shares to offer in the public market.

Valuation is more an art than a science. Although underwriters follow rigorous procedures to arrive at a reasonable estimate of the company's worth, the market sets the ultimate price. The main steps in the process are outlined below.

Benchmarking against comparable companies

Typically, the underwriter will start by evaluating a company's historical results. In some cases, underwriters will adjust these figures for nonrecurring events such as a restructuring or a disposal of noncore operations.



The underwriter will use the adjusted figures to calculate key financial metrics, such as earnings before interest, taxes, depreciation and amortization (EBITDA), or revenues per customer. Multiples, derived from similar publicly traded companies (often referred to as “comparables”), will then be applied to these metrics to estimate the company’s value. For example, the underwriters may identify six publicly traded peer companies and determine their average ratio of price to EBITDA is 8-to-1. The company’s value may be estimated based on that same multiple, as applied to trailing or forecasted EBITDA.



Estimating a company’s value takes many steps and tremendous judgment.

Again, estimating the value of a company involves tremendous judgment. Accordingly, underwriters will also consider qualitative factors in arriving at a valuation, such as the quality of the management team, the market potential for the company’s product offerings and its operational excellence to date.

Because shares issued in an IPO do not have public trading history, they are typically priced at a discount — or “haircut” — versus shares of comparable companies, understanding that a motive of the underwriter is to increase the likelihood that the company’s shares will be sold at a profit.

Determining the percentage of the company to offer

Once there is an idea of the company’s estimated value, it is time to decide how much of the company to offer to the public.

The goal is to strike the right balance between raising the desired amount of capital versus relinquishing too much control and diluting existing ownership. One additional factor to consider is that a sufficient number of shares must be sold to provide public investors with trading liquidity.

Calculating the number of shares to sell

Generally, the greater the number of shares offered, the lower the price per share. The determination of the number of shares to offer typically depends on the type of investor most likely to buy the shares. Smaller, individual investors typically prefer a lower price per share, while institutional investors tend to favor a higher price per share. Sometimes, the company will have to execute a stock split, or a reverse stock split, prior to the public offering to arrive at a desired price per share.

Underwriter due diligence

The principal underwriter, as well as its counsel, will conduct due diligence over the company. The purpose of this process is to ensure the accuracy and completeness of all company information. Due diligence is essential because the underwriters will be purchasing the company stock (prior to its sale to the public) and making a market for it. In these sales, underwriters are liable under U.S. securities laws for misstatements or omissions in the offering documents. By demonstrating they performed proper due diligence, underwriters can limit their liability.



The company's senior officers, attorneys and independent accountants all play a role in the due diligence process, which ordinarily involves:

- Interviews with company directors and officers, as well as the company's independent accountants and attorneys, regarding company activities, its business, products, recent financial performance and future prospects. Directors and officers are also requested to complete written questionnaires about the company.
- Review of all significant corporate documents such as articles of incorporation, bylaws, board meeting minutes, major contracts, employment agreements and stock option plans.
- Request for comfort letters from the independent accountants regarding information that appears in the registration statement but not in the financial statements, and on events that occur after the accountants' report date. Ordinarily, comfort letters are issued to the underwriters on the effective date of the registration statement, followed by an updated letter as of the closing date. While underwriters typically want comfort on as much information as possible, there are limitations to the information on which the accountants will provide comfort (generally limited to amounts obtained or derived from accounting records that are subject to the company's internal control over financial reporting). In addition, underwriter requests for accountants to provide excessive levels of comfort can become costly for a company, which has to pay for the work the accountants will perform to issue that level of comfort. For this reason, it is important that the underwriters and independent accountants discuss and agree regarding the nature of comfort to be provided early in the registration process.

SEC registration

The SEC created the registration process to ensure that any company making a public securities offering fully discloses all important information to investors. The steps in the SEC registration process are as follows.

Preparing and filing the registration statement

The registration statement is essentially a biography of the company, replete with financial data. It contains such information as:

- Business description
- Risks associated with the business and the offering
- Use of proceeds from the offering
- Management's discussion and analysis — a narrative describing the company's operating performance, liquidity and capital resources
- Description of key members of the management team and major shareholders, as well as their financial relationships with the company
- Financial information, including audited historical financial statements and often unaudited interim financials as well

Preparing and filing the registration statement requires substantial time and effort from the management team and company's advisers.

The registration statement is filed with the SEC and reviewed by its staff. A portion of the registration statement becomes the prospectus — a disclosure document that is distributed to potential investors to help them decide whether to invest in the company.

Registration statements are typically made publicly available on the SEC’s Electronic Data Gathering, Analysis, and Retrieval (EDGAR) database¹ as they are filed.

However, under the Jumpstart Our Business Startups (JOBS) Act², emerging growth companies (EGCs) are permitted to make confidential submissions of draft registration statements to the SEC during the IPO process. In 2017, the SEC staff made this non-public review process available to any company undertaking an IPO.

The benefit of submitting draft registration statements to the SEC is that potentially sensitive information is not disclosed to the public until closer to the time that the company is ready to begin marketing its offering. Specifically, a company must make these draft registration statements public at least 15 days before it embarks on its marketing roadshow, but can keep such information non-public until that point.

Note that the label “draft” does not mean incomplete. The SEC staff will not commence review of a registration statement from an EGC, or any other filer, that is materially deficient — missing required contents, financial statements and/or disclosures.

In addition to filing a registration statement with the SEC, the securities being sold must be qualified under the “blue sky” laws of the states where the stock will be sold. In other words, the offering documents must comply not only with federal regulations, but with state legislation as well. For instance, some states require the prospectus to disclose the substantive merits and fairness of the offering, including the offering’s fee structure or the possibility for undue benefits to company insiders. This same type of disclosure is not prescribed specifically by SEC regulations.



A company must make registration statements public at least 15 days before its marketing roadshow

Review by SEC staff

The SEC staff reviews the registration statement to ensure that the company has complied with applicable disclosure and accounting requirements.³

After reviewing the initial registration statement — which takes around 30–35 days — the SEC staff typically issues a comment letter. It identifies specific items in the registration statement that the SEC staff believes should be clarified or revised.

Management and company counsel usually draft the company’s response to each comment and file a written response to the SEC, along with an amended registration statement. The independent accountants should also be involved in the review of responses, particularly for matters related to the financial statements and other financial information with which they are associated.

The SEC staff may accept the revised filing and have no further comments. Often, though, there will be multiple rounds of back and forth dialogue with the SEC staff. And, in some cases, a meeting or teleconference with the SEC staff may be necessary. Every SEC comment within each letter must be resolved before the registration statement can become effective. SEC comment letters, as well as management’s responses, eventually become publicly available on EDGAR.

¹ [“How do I use EDGAR.”](#) U.S. Securities and Exchange Commission, July 18, 2007.

² [See link](#) for an overview of JOBS Act, along with a link to the full text.

³ The SEC staff does not evaluate the investment merits of the IPO or risks associated with the proposed new issue.

Distribution of the red herring

Once all substantive SEC staff comments have been addressed, and draft registration statements publicly filed, the company distributes portions of the latest registration statement to potential investors. The booklet is referred to as a preliminary prospectus or “red herring” — a name derived from the red font used on the cover to flag the document as a draft. The red herring does not contain the date of the offering or its price.

Exchange listing

Early in the offering process, the company should decide where to list its stock. Listing on an exchange is the primary method for achieving shareholder liquidity and generally required by underwriters. The company’s attorneys can assist in preparing the exchange listing application and reserving the company’s proposed trading symbol. Each exchange requires that companies meet certain quantitative and corporate governance standards, although the specific requirements vary among the exchanges. Listing standards are frequently updated. The current listing requirements for two of the larger exchanges — the New York Stock Exchange and Nasdaq — are available online.

Marketing to investors

Convincing investors to purchase a company’s shares involves a coordinated effort from the deal team. There are a few major milestones that take place during the marketing process.

The roadshow

While a company waits for its registration statement to be declared effective by the SEC staff, investment bankers will organize a “roadshow” to build excitement around the offering. This is an opportunity for potential investors to learn more about the company and a chance for the investment bankers to gauge the level of interest among prospective buyers. The roadshow typically includes a series of intensive meetings over a two-week period, spanning several time zones.

The SEC restricts the information a company can release to the public during the IPO process. While the JOBS Act relaxed some of these rules for EGCs, it is important to work with securities counsel to understand what a company can and cannot communicate to the public during the roadshow and throughout the IPO process.

Syndication

The underwriter will organize a group of other investment banks to coordinate the distribution of stock to the investment community. This group is called the “syndicate,” and each member is responsible for selling a certain amount of stock. The lead investment bank will remain in contact with the other syndicate members to determine how much demand exists in the marketplace for the offering. If market sentiment changes following the roadshow, the offering price may be adjusted accordingly or, in some cases, the underwriters may recommend delaying the offering until market conditions improve.

The underwriting agreement

During the IPO process, the company and its investment bankers will negotiate an underwriting agreement. It will specify the offering price of the stock and outline commissions, discounts and other expenses incurred during the underwriting process.

The underwriting agreement also specifies the terms of any underwriters’ over-allotment option, or “green shoe.” In a green shoe, the company grants the underwriters the option to purchase up to 15% of additional company shares over the original offering size at the offering price. This provides the underwriters the right to sell additional shares if demand for the securities is in excess of the original amount offered.

In addition, the underwriting agreement carefully lays out each party’s responsibilities during the offering process and after the underwriting agreement is signed. The underwriting agreement is signed on the day the registration statement is declared effective.

Pricing the stock

While the underwriters perform a preliminary company valuation at the beginning of the IPO process, the actual pricing of the stock offering is not established until immediately before the sale is about to take place. This will occur following the roadshow and after the SEC staff declares the final registration statement effective. The share price will be based on the marketplace's degree of interest in the offering.

Once the price is determined, the company files a final prospectus with the SEC, which will include the final agreed-upon issuance price, replacing any preliminary estimates that were made in earlier filings. Any related disclosures will also be updated, including those around the amount of proceeds that will be obtained from the offering.

Typically, the final pricing decision is made in the evening before the initial stock sale will take place, meaning that the updates to the preliminary prospectus must be made through the night and filed with the SEC the next morning before trading commences. Usually, all parties — management, underwriters, attorneys and independent accountants — meet at the financial printers to process these updates and check the changes in real time. It's a fitting end to an intensive process.

Aftermarket trading and finally...closing

Trading begins when the deal is priced. The lead manager of the underwriting syndicate allocates the stock among the members who, in turn, sell shares to their clients. The allocation and initial stock sales are based on interest expressed by the syndicate members' clients after reading the red herring or attending the roadshow.

As part of the closing process, underwriters will want to ensure that the officers, directors and large shareholders of the company do not sell their shares shortly after completion of the IPO. The underwriters will request that these parties enter into a "lock-up agreement" that prohibits the sale of shares for a period following the offering. Lock-up agreements typically span 180 days.

Once the company receives the proceeds of the offering, it is required to report to the SEC how the proceeds are used, among other things. It will do so in subsequent Securities Exchange Act of 1934⁴ quarterly or annual reports and continue to disclose this information until all the proceeds are consumed. In addition, the company must disclose any differences between the expected "Use of Proceeds" described in the prospectus and the currently intended use of the funds.

A journey with significant rewards

The journey from private to public company requires significant effort from you and your entire team of advisers, but the end of the IPO process can bring significant rewards and position your organization to reap the benefits of being a public company.

⁴ [See link](#) for a description of the Exchange Act.



An IPO glossary of insider terms

- **Blue sky laws** – State-level securities laws that govern the sale of securities, designed to protect the public from fraudulent sales practices and activities.
- **Comfort letters** – Letter issued by accountants to underwriters regarding procedures performed and results of such procedures in relation to financial statements and related information contained in a registration statement.
- **Comparables** – Publicly traded companies similar to the entity undertaking the IPO; usually competitors operating in the same industry.
- **Green shoe** – An over-allotment option that grants an underwriter the right to sell investors more shares than the issuer initially planned if demand for a securities issue is high.
- **Haircut** – A term describing a discounted price for shares, such as for shares in an IPO that have no public trading history.
- **Lock-up agreement** – In an IPO, a contract that prohibits company insiders such as officers, directors, large shareholders, employees and their families from selling shares for a set period of time.
- **Red herring** – A preliminary prospectus filed with the SEC in connection with a company's IPO; the name is derived from the red font used on the cover to flag the document as a draft.
- **Roadshow** – A term describing presentations given to potential investors to build excitement around an IPO.
- **Syndicate** – A group of investment banks coordinating the distribution of stock to the investment community.

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