What is the Best Exit Strategy for a Private Firm: IPO or Sale?

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Abstract

Investors in private companies eventually want to get out of their investments by either selling their stake once the firm goes public or by the private company selling itself. The Wall Street Journal reports several companies that for 2016 weighed a public IPO and a sale at the same time, referred to as a dual track. It is difficult to quantify why a private company would choose a sale over an IPO although The Wall Street Journal reports a larger proportion lately have chosen to sell. One issue investors in private firms face in an IPO is it can take several years to fully sell off their stake in the company. A sale of the firm on the other hand offers a less risky alternative to the stretched out IPO process. We examine investor returns for private companies that have exited their positions through either an IPO or a sale in order to compare which exit strategy gives investors the best return.

Key Words: Private firm, IPO, Acquisition, Private investment

1. Introduction

An issue individual investors are facing is a decline in the number of public companies in which they can invest. For example, the Wilshire 5000 measures performance of all U.S. equity securities with readily available price data. It was named for the nearly 5000 stocks it contained at launch. The peak number of firms in the Wilshire 5000 was 7562 firms on July 31, 1998. The low point was 3776 firms on December 31, 2013 and the Wilshire website reports 3818 firms now. Since private equity markets do not exist in isolation from public markets, private firm investors must eventually have their firm listed on public exchanges or be sold to another company to bring liquidity for private investors. Farrell and Jarzemsky (2016) report more private companies are choosing a sale over an IPO when private firm investors exit. They argue this is bad news for institutional and individual investors that want the chance to invest in companies that offer higher growth potential. For the 2016 IPOs, they report returns are up 16.7% whereas the S&P 500 return is only 6.3%. They go on to indicate the proportion of private firms that sell themselves rather than go public is growing.

CB Insights, a venture capital database and angel investment database, report in the first half of 2016, of the top 26 tech firm which exited, only 6 companies did so via an IPO. Billings (2016) notes that one factor may be that out of the almost 175 companies that made their IPO in 2015, more than 70% are now trading below their IPO prices. This study examines whether private firm investors are in fact getting a better return from the exited private company going public or selling itself.

2. IPO Exit

Private firms such as Uber Technologies and Airbnb have business models that are disrupting conventional markets and money has poured in. Eule (2016) states that in the first five months of 2016, only 31 companies have gone public in the U.S. That is down from 69 companies that went public in the first five months of 2015 and 115 companies in the first five months of 2014. He states the stock market crash of 2008-09 curbed investor enthusiasm for IPOs and new sources of liquidity have emerged for company founders and insiders. In addition, regulatory changes have made it easier to stay private and harder to be public. Eule cites work from Jay Ritter, a University of Florida professor who has studied the IPO market for 35 years, that from 1980 to 2000, an average of 310 companies went public every year but since then the average has fallen to 111. This decline of IPOs has forced mutual funds to look at private firms for growth opportunities. Although it represents only a small percentage of their investments, Fidelity Investments, T. Rowe Price Group and Wellington Management all have sizable stakes in private firms.

The IPO process has become a hassle that's best avoided for as long as possible. Congress passed the JOBS Act in 2012 to ease the IPO process and to make it easier for small companies to go public. Eule states the net effect of the JOBS Act has been to stall the market. A key provision of the JOBS Act makes it easier to stay private longer. The JOBs Act allows companies to accumulate up to 2000 private investors (previously it was 500) before being forced to disclose public company type information and the limit no longer includes employees granted stock as compensation. Due to the tech bubble in 2000, Congress passed the Sarbanes-Oxley Act in 2002 which raised the bar for public company disclosures. Thus, it became more expensive to be a public company and Eule argues that this extra cost forces companies to stay private longer as they grow in size.

3. Mergers and Acquisitions Exit

Even if more private companies would go public, Eule states U.S. IPOs are declining. Eule reports that while IPOs have faded, venture capital firms are cashing in through mergers and acquisitions (M&A). M&A for venture capital backed companies has held constant at about 120 per quarter for the past decade. Kathleen Smith, principal at Renaissance capital, says the IPO market has become more institutional, because most individual investors and their advisors are buying indexed products (Johnson 2016).

Demos and Driebusch (2015) indicate that an increasing number of private firms are choosing to exit by selling themselves rather than going public. More than $2.3 trillion worth of M&A deals were announced in 2015 which is up 46% from the total volume of 2014. Demos and Driebusch quote Pete Lyon, co-head of Americas investment banking services at Goldman Sachs Group Inc., "When company owners sell, they take all the market risk off the table versus an IPO." In 2015, 18 companies stopped pursuing their IPO because they decided to be acquired instead. Petco Holdings sold itself for $4.6 billion after it had filed for an IPO seeking roughly a $4 billion value. Interactive Data Corp. and Ballast Point Brewing & Spirits Inc. were two other private firms that decided to sell themselves after filing for an IPO. Most of blame for companies backing out of their IPOs is put on unfavorable market conditions, in particular, high perceived volatility in the market. Another issue has been the poor performance of companies that have gone public which had led to investors asking for greater concessions from companies on price. They also report the shares of U.S. public companies announcing acquisition in deals over $1 billion have risen an average 2% the day after the announcement. To quote Chris Bartel, head of global equity research at Fidelity Investments, "We are in a low-revenue- growth environment for most companies, and M&A remains one of the best ways for them to grow earnings, especially if they can create synergies and cut cost through mergers."

Dinneen, Kutcher, Mahdavian, and Sprague (2015) did a study of 578 software and online services companies that surpassed $100 million in annual revenue and found acquisitions can be a powerful tool to accelerate revenue growth. Their research found that companies making more than two acquisitions a year had significantly higher growth than companies making one acquisition a year. In addition, the successful companies that acquired two or more acquisitions a year and had revenue of $1 billion were shown to enhance business momentum or growth, executed more deals and translated each deal into more revenue growth.

They also examined the fastest growing 10% of software and online services companies. All of these companies were acquiring two or more companies per year, they delivered the greatest average excess total return o shareholders and achieved annual revenue growth of more than 100%.

4. Private Shares Exit

Another arena where private share investors could get liquidity is through the trading of private shares on exchanges such as SharesPost and SecondMarket. Hope and Intindola (2014) report Nasdaq OMX Group Inc. received regulatory clearance to launch a market to trade shares of private companies. This was a joint venture with SharesPost Inc. to launch a market of private companies which was called the Nasdaq Private Market. Chernova (2015) reports that secondary transactions of private shares have increased tremendously through SecondMarket and the Nasdaq Private Market. Stynes and Hope (2015) reported the Nasdaq acquired SecondMarket and the Nasdaq bought out SharesPost stake in the Nasdaq Private Market. Nasdaq believes that longer relationships with private companies will lead to more of these private companies eventually going public on the Nasdaq. Unicorns currently trading private shares on the Nasdaq Private Market include Pinterest, DocuSign, Shazam, and Tango. The Nasdaq Private Market indicated transaction volume had reached $1.6 billion in 2015 which was higher than the volume in 2014. Geron (2016) states that in the first half of 2016, Nasdaq Private Market did $544 million in secondary deal volume which is up 136% from the same period in 2015. The Nasdaq Private Market states they want to help bring liquidity to private companies' employees and early-stage investors. However, at this time, selling shares on the private market will not bring the same level of liquidity that going public or sale will bring.

5. Results

The sample of exited private companies is obtained from the *CrunchBase Unicorn Leaderboard* (2016) and those listed in the *WSJ* (Austin, Canipe and Slobin 2015). Of the 201 unicorn companies listed in the *CrunchBase Unicorn Leaderboard* and the 149 venture capital unicorn companies listed in the *WSJ*, 29 firms have exited by going public and 21 firms have exited by being acquired. Unicorns is a term used to describe private startup firms valued at over $1 billion. Table 1 lists the unicorns that have exited by going public. Table 1 also includes an estimated annualized return for each firm using data from *FactSet Mergerstat* and *CrunchBase* and private valuations reported in the *WSJ* and the *CrunchBase*. To calculate the annualized return, the date and dollar amount of each investment round prior to the firm's public valuation is obtained from *FactSet Mergerstat* or *Crunchbase*. Using data from Jensen, Marshall, and Jahera [2014], it was estimated that when private companies went public, private investors who had funded rounds of financing, owned around 60% of the public company at the time of the IPO. The valuation of these companies was smaller (average valuation at IPO was $650 million) but the median rounds of funding, 5, is the same as the private companies listed in Table 1. PitchBook.com reports the percentage stake in a company investors are willing to take for a round of funding has been dropping. In the fourth quarter report in 2014, *4Q 2014 U.S. Venture Industry Report*, the median stake investors required for seed funding was 23% of the firm. The median for Series A was 28%, Series B was 23%, Series C was 17% and for Series D and beyond is was 12%. Using these figures and knowing the median rounds of funding was five for our sample listed in Table 1, investors should have around 69% of the company value after the financing rounds. Therefore, the value of the company after investors have provided funding will be estimated to be 60% for this study. Winkler (2015) interviewing Bill Gurley, who is a venture capitalist for Benchmark and is known as one of Silicon Valley's top technology deal makers, stated that when Benchmark talks to their limited partners about private companies, they discount the companies 40% as well.

The estimated annualized firm return prior to the public valuation date is then calculated by using the dates and amounts of the equity funding from *FactSet Mergerstat* or *CrunchBase* with the valuation listed in the *WSJ* cut 40 percent. The calculation is done using the XIRR function of Microsoft Excel. The average annualized return for the investors in the private companies is 161.4% (median is 142.6%). The average valuation of the companies was $6.17 billion (median is $2.25 billion). These are estimated returns and do not reflect the differences in returns between seed investors and the different series investors. Seed investors in the firm would have annualized returns that would be higher than that reported since they are the first to invest and hold a better stake in the company than series investors. The same would be true of first series investors such as series A, if the firm has several rounds of funding. Keep in mind these returns reflect private companies that have made it through the startup phase. Gage [2012] reports research done by Shikhar Ghosh who finds 3 out of 4 startups fail. This failure rate is much higher than that reported by The National Venture Capital Association who estimate that 25% to 30% of venture backed businesses fail. Needless to say, the returns for the sample are high.

Table 1 shows the IPO date of the unicorns and the valuation of the companies at the IPO date. An annualized return based on the value of the firm at the IPO date is shown for each firm. The annualized average return at the IPO date is 106.4% (median is 79.5%). The value of the unicorns has increased from the private valuation to the public valuation and the annualized returns have gone down. The last column of Table 1 shows the growth (decline) of each unicorn's value from the private to public valuation. Seven out of the 29 unicorns have seen their value decline but overall the average growth from private to public valuation is 89.0% (median is 21.7%).

Table 2 lists the unicorns that have exited by being acquired. The same estimated annualized return for each firm acquired is calculated like Table 1. The average annualized return for the investors in the private companies is 778.6% (median is 77.1%). Unicorns that are acquired appear to be smaller, the average value is $1.98 billion (median is $1.20 billion), and the return appears to be less based on the median annualized return.

Table 2 also lists the date of acquisition and the price paid for the acquisition. The valuation at acquisition has gone up, the average value is $3.10 billion (median is $1.54 billion), but annualized returns have declined. The average annualized return based on the acquisition value is 169.4% (median is 75.7%). Seven out of the 21 unicorns that were acquired lost value between the private and acquisition value. WhatsApp has an increase in value between its private and acquisition value over 5000%. The average annualized growth in value is 326.6% (median is 26.4%). The growth in value for the acquired unicorns is slightly greater than the growth in value for the unicorns that went public.

Based on the articles listing the acquisition values, five of the 21 firms in Table 2 were in financial distress when they were sold, Better Place, Fab, Fisker Automotive, Gilt Groupe, and Good Technology. This may skew the comparison between unicorns that went public and those that were acquired. Table 3 excludes the five acquired unicorns that were in financial distress at the time of the sale. Comparing Table 1 to Table 3, shows the value of acquired unicorns is still lower than unicorns that go public. As Farrell and Jarzemsky (2016) stated, Table 3 shows unicorns that are acquired may be providing private investors with a better rate of return comparing the annualized return at the IPO date (average 106.4% median 79.5%) to the annualized return at the acquisition date (average 183.3% median 91.3%). In addition, the growth in valuation between the private and IPO date (average 89.0% median 21.7%) is lower than the growth in valuation between the private and acquisition date (average 471.5% median 87.6%).

6. Conclusion

Institutional and individual investors are looking to invest in companies with new growth potentials. One reason; The JOBS Act of 2012 was passed was to entice more companies to go public. The last few years have given rise to a number of unicorn companies. Investors in these private companies eventually seek liquidity by either the company going public or by a sale of the company. This paper examines whether private investors are obtaining a better return by the firm going public or selling itself.

Results from the sample of exited unicorns suggest private investors get a better payoff when the firm they have invested in sells itself. For institutional and individual investors seeking to invest in new growth opportunities, this is not a good sign. It would appear more needs to be done to encourage private companies to go public.

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Table 1. – Unicorns that have Exited by Going Public

The following table presents information regarding returns of unicorns that went public.

	Firm	Date of Last Private Valuation	Last Private Valuation	Annualized Return based on Private	Date of IPO	Valuation at IPO (In Billions)	Annualized Return based on Public	Annualized Growth from Private to
1	Alibaba	9/1/2012	$42.00	69.4%	9/19/2014	$168.00	73.6%	96.7%
2	Atlassian	4/8/2014	$3.30	149.6%	12/10/2015	$4.40	94.3%	18.8%
3	Box	7/1/2014	$2.40	67.7%	1/23/2015	$1.67	42.6%	-47.7%
4	Coupa Software	6/1/2015	$1.00	58.9%	10/6/2016	$1.00	40.8%	0.0%
5	Coupons.com	6/1/2011	$1.00	50.8%	3/7/2014	$1.17	25.5%	5.8%
6	Facebook	1/21/2011	$50.00	204.8%	5/18/2012	$104.00	163.4%	73.9%
7	GoPro	12/20/2012	$2.25	383.9%	6/26/2014	$2.96	123.3%	19.8%
8	Groupon	4/18/2010	$4.75	318.3%	11/4/2011	$12.65	494.2%	88.3%
9	Hanhua Financial	5/1/2013	$1.30	na	6/19/2014	$1.60	na	20.1%
10	HomeAway	10/29/2010	$1.50	44.3%	6/27/2011	$2.20	50.1%	78.6%
11	Hortonworks	3/25/2014	$1.00	117.7%	12/11/2014	$0.67	37.6%	-42.9%
12	JD.com	11/13/2012	$11.70	202.5%	5/22/2014	$24.00	153.6%	60.4%
13	Lending Club	8/1/2014	$3.80	99.4%	12/11/2014	$8.50	117.7%	826.4%
14	LinkedIn	1/29/2007	$1.05	287.7%	5/19/2011	$4.30	105.8%	38.8%
15	Mobileye	7/1/2013	$1.90	54.4%	8/5/2015	$7.60	75.3%	258.9%
16	NantHealth	6/26/2015	$2.00	188.5%	6/2/2016	$1.70	53.9%	-15.9%
17	New Relic	4/28/2014	$1.10	78.3%	12/12/2014	$1.42	73.3%	50.5%
18	Nutanix	8/27/2014	$2.00	154.9%	9/30/2016	$1.90	51.1%	-2.4%
19	Pure Storage	4/22/2014	$3.23	191.2%	10/6/2015	$3.10	81.7%	-2.8%
20	Rocket Internet	8/7/2014	$5.80	142.6%	10/2/2014	$8.20	155.0%	855.4%
21	Shopify	12/1/2013	$1.00	347.6%	5/20/2015	$1.30	189.4%	19.6%
22	Square	3/2/2015	$6.00	122.3%	11/19/2015	$2.90	65.7%	-63.7%
23	Sunrun	5/16/2014	$1.30	16.9%	8/5/2015	$1.30	13.1%	0.0%
24	Twilio	7/29/2015	$1.03	64.0%	6/23/2016	$1.23	52.1%	21.7%
25	Twitter	9/1/2011	$8.00	249.3%	11/6/3013	$14.2	109.4%	30.1%
26	Ucar	9/1/2015	$3.40	na	7/26/2016	$6.00	na	87.8%
27	Wayfair	3/7/2014	$2.00	92.1%	10/2/2014	$2.65	79.5%	37.5%
28	Zalando	11/11/2013	$4.03	154.1%	10/1/2014	$7.25	138.5%	93.8%
29	Zynga	2/1/2011	$9.10	447.4%	12/16/2011	$7.00	212.4%	-26.0%
Average			$6.17	161.4%		$13.96	106.4%	89.0%
Median			$2.25	142.6%		$2.96	79.5%	21.7%

Table 2. – Unicorns that have Exited by being Acquired

The following table presents information regarding returns of unicorns that were acquired.

	Firm	**Date of Last Private Valuation**	**Last Private Valuation**	**Annualized Return based on Private**	**Date of Acquisition**	**Valuation at Acquisition (In**	**Annualized Return based on Acquisition**	**Annualized Growth from Private to**
1	Airwatch	5/16/2013	$1.00	11,560.1%	1/22/2014	$1.54	390.4%	87.4%
2	Beats Electronics	9/27/2013	$1.10	-25.5%	5/28/2014	$3.00	60.0%	351.3%
3	Better Place	11/2/2012	$1.60	16.3%	7/12/2013	$0.01	na	-99.9%
4	Blue Coat Inc	5/26/2015	$2.40	-42.6%	6/12/2016	$4.65	-11.0%	87.8%
5	Fab	8/1/2013	$1.15	147.4%	3/3/2015	$0.02	na	-93.5%
6	Fisker Automotive	5/1/2011	$1.20	0.0%	2/18/2014	$0.15	na	-52.4%
7	Gilt Groupe	2/16/2015	$1.15	24.6%	1/7/2016	$0.25	na	-82.0%
8	Good Technology	9/30/2014	$1.20	30.2%	9/4/2015	$0.43	16.4%	-67.3%
9	Jasper Technologies	4/16/2014	$1.35	47.9%	2/3/2016	$1.40	33.8%	2.0%
10	Jet.com	11/24/2015	$1.35	111.1%	8/7/2016	$3.00	160.0%	210.8%
11	Lashou,.com	3/23/2011	$1.10	na	10/23/2014	na	na	Na
12	Lazada Group	4/1/2016	$1.50	na	4/12/2016	$1.00	na	-100.0%
13	Legendary Entertainment	10/3/2014	$3.00	101.2%	1/12/2016	$3.50	54.0%	12.8%
14	Lynda.com	1/1/2015	$1.00	96.0%	4/10/2015	$1.50	123.0%	345.9%
15	Nest Labs	12/31/2013	$1.20	na	1/17/2014	$3.20	na	188.4%
16	Powa Technologies	11/1/2014	$2.70	77.1%	4/18/2016	na	na	Na
17	Renaissance Learning	2/19/2014	$1.04	11.3%	3/13/2014	$1.10	13.7%	153.6%
18	Stem CentRx	9/9/2015	$5.00	184.3%	4/27/2016	$5.80	152.6%	26.4%
19	Uber China	1/13/2016	$9.00	na	8/1/2016	$7.00	na	-36.6%
20	WhatsApp	7/1/2013	$1.50	623.6%	2/19/2014	$19.00	948.1%	5237.6%
21	Zulily	11/15/2012	$1.09	272.7%	8/17/2015	$2.40	91.3%	33.2%
Mean			$1.98	778.6%		$3.10	169.4%	326.6%
Median			$1.20	77.1%		$1.54	75.7%	26.4%

Table 3. – Unicorns that have Exited by being Acquired Excluding Unicorns in Financial Distress

The following table presents information regarding returns of unicorns that were acquired.

	Firm	Date of Last Private Valuation	Last Private Valuation	Annualized Return based on Private	Date of Acquisition	Valuation at Acquisition (In	Annualized Return based on Acquisition	Annualized Growth from Private to
1	Airwatch	5/16/2013	$1.00	11,560.1%	1/22/2014	$1.54	390.4%	87.4%
2	Beats Electronics	9/27/2013	$1.10	-25.5%	5/28/2014	$3.00	60.0%	351.3%
4	Blue Coat Inc	5/26/2015	$2.40	-42.6%	6/12/2016	$4.65	-11.0%	87.8%
9	Jasper Technologies	4/16/2014	$1.35	47.9%	2/3/2016	$1.40	33.8%	2.0%
10	Jet.com	11/24/2015	$1.35	111.1%	8/7/2016	$3.00	160.0%	210.8%
11	Lashou,.com	3/23/2011	$1.10	na	10/23/2014	na	na	Na
12	Lazada Group	4/1/2016	$1.50	na	4/12/2016	$1.00	na	-100.0%
13	Legendary Entertainment	10/3/2014	$3.00	101.2%	1/12/2016	$3.50	54.0%	12.8%
14	Lynda.com	1/1/2015	$1.00	96.0%	4/10/2015	$1.50	123.0%	345.9%
15	Nest Labs	12/31/2013	$1.20	na	1/17/2014	$3.20	na	188.4%
16	Powa Technologies	11/1/2014	$2.70	77.1%	4/18/2016	na	na	Na
17	Renaissance Learning	2/19/2014	$1.04	11.3%	3/13/2014	$1.10	13.7%	153.6%
18	Stem CentRx	9/9/2015	$5.00	184.3%	4/27/2016	$5.80	152.6%	26.4%
19	Uber China	1/13/2016	$9.00	na	8/1/2016	$7.00	na	-36.6%
20	WhatsApp	7/1/2013	$1.50	623.6%	2/19/2014	$19.00	948.1%	5237.6%
21	Zulily	11/15/2012	$1.09	272.7%	8/17/2015	$2.40	91.3%	33.2%
Mean			$2.21	1084.8%		$4.15	183.3%	471.5%
Median			$1.35	98.6%		$3.00	91.3%	87.6%