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Direct Listing vs. Traditional IPO Case Study

Zachary V. Skaff
University of Tennessee, Knoxville, zskaff@vols.utk.edu

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Zachary Skaff

Advisor: Dr. Eric Kelley

Chancellor’s Honors Program Thesis

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What is an IPO?

An initial public offering (IPO) refers the process by which a private company first issues its stocks in the form of a new offering to the public. This issuance gives companies the opportunity to raise capital from the public. The capital is typically used to pay off debt, fund the growth of the company, place the public's attention on the company, or give current shareholders the opportunity to divest some or all of their shares in the company. This process gives initial investors a chance to realize a return on their investment, while also gives public investors the opportunity to participate and buy shares of the company.

Once a company decides to "go public," they choose a lead underwriter to help guide them through registration of their security and assume responsible of distributing the shares to the public. The lead underwriter forms a group of investment banks, called the underwriting syndicate, that are then responsible for the sale of shares to both individual and institutional investors. Following the IPO, the stock begins to trade on public exchanges, such as the New York Stock Exchange (NYSE) or Nasdaq

Primary Offering vs. Secondary Offering

There are distinct differences between the sale, the process, and the significance of a primary offering and a secondary offering. A primary offering represents the first issuance of a stock to the public from a private company and is another name for an IPO. The primary offering represents a private company's transition to being publicly traded and able to raise equity capital to grow the company's operations, opposed to solely debt. As a result of a primary offering, new money begins to come into the firm.

A secondary offering is when a large number of shares of a public company are sold on the secondary market [1]. A secondary offering is essentially transferring the ownership of existing shares and it does not dilute the shares that current shareholders own. This occurs when private shareholder, executives or other company investors, sell their shares. The issuing company does not directly benefit from the sale of these shares, but rather, the liquidity of their shares increases. In general, an IPO may have a primary component and a secondary component.

Overview

The two primary ways companies choose to list their shares on the public exchange today are the traditional IPO and a direct listing. In a traditional IPO, new shares of the company are created, underwritten, and then sold to the public. Conversely, some companies opt to use a direct listing to take their company public. In a direct listing, no new shares are created, and only existing, outstanding shares are sold directly from the company without the use of an underwriter.

Advantages / Disadvantages

Traditional IPO:

The greatest advantage to issuing an IPO is the capital the issuing company raises. The median IPO raised $108 million in 2019, with Uber generating the most capital for the year, $8.1 billion (Ritter). An IPO also allows investors to have an opportunity to see a large return from their investment and provide them with an opportunity to liquify their capital that was currently vested in the company. An IPO also provides extensive exposure to the public and can thrust the company into the spotlight and generate positive exposure and credibility for them. An IPO can

[1] Follow-on offerings, also called dilutive secondary offerings, occurs when the issuing company creates and releases new shares onto the market. As a result, the number of available shares in the market become diluted. A follow-on offering occurs when the company's board of directors makes the decision to increase share count to sell more equity. Thus, the earnings per share become diluted from the increase in outstanding shares. Additionally, the share price usually decreases from the additional shares becoming available. The offering generates additional cash for the company, which can be used for various future operations or paying down debt.

also decrease the overall cost of capital for a company. Becoming a public company can lessen the high interest rates many young private companies face. An IPO can lessen the difficult of obtaining large amounts of additional capital, additional reduces the risk of investment in the bank's eyes, resulting in lower interest rates. An IPO also give a company the opportunity to use stock a means of payment. While private companies can use stock as a means of payment, it is often viewed a less valuable. A public company's shares is extremely valuable because it is liquid and can be bought and sold at a market price at any moment with no restrictions. Another benefit of opting for an IPO is the underwriter has several large institutional investors, which can ensure the success of the listing. Lastly, the overall liquidity of the company's assets increase exponentially, as a result of the IPO and the public's ability to trade the company's share.

Although there are many advantages to opting for an IPO, there are some disadvantages. Becoming a public company forces the company to file their financial statements with the Securities and Exchange Commission (SEC) every year. These financial statements must follow the principles that are laid out by the United States Generally Accepted Accounting Principles (GAAP). This process is both costly and time consuming, as the company must have financials reported in a specific fashion quarterly and annually, hire and audit firm, and complete a multitude of responsibilities to satisfy the SEC's requirements, which cost the company millions of dollars and thousands of hours per year. Becoming a public company also places a tremendous amount of pressure on the company as they as the executives must turn their focus from the long term vision to focusing on the present and meeting quarterly earnings targets for shareholders. Another disadvantage of using an IPO is the transaction costs associated with it. IPOs are extremely expensive. The largest cost associated with the IPO is underwriter fees, who usually charge 5% to 7% of the gross proceeds, which equates to up to $7 million on an average IPO.

Additionally, companies must anticipate $1.5 – $2 million in legal fees, $1 million on auditor fees, and $500,000 on registration and printing fees. Lastly, the amount of time spent working on the IPO and its requirements for the SEC takes away from time the company could be spending on operations.

Direct Listing:

The direct listing also has several benefits that companies can opt for. The first being the highly reduced costs to become a public company. By using a direct listing, companies do not have to pay the hefty fees for associated with an underwriter. Another large benefit is the liquidity provided to shareholders, as every shareholder has the opportunity to sell their shares and receive a return for their investment. Another advantage of opting for a direct listing is that the stock price is determined by market demand, which ideally negates the likelihood of underpricing, as traditional IPO commonly has. In addition, there is no dilution of shares because no new shares are being create, and earnings per share remain steady. Lastly, there is no lock-up period: In a traditional IPO, existing shareholders agree to not sell, hedge, distribute their shares for a given period, usually 180 days.

The biggest disadvantage to using a direct listing is the company cannot raise any new capital. As a result, they must rely on a final round of funding. Additionally, a direct listing has a higher volatility of stock price. Because the stock price is determined by the market and its release price is chosen by the market maker, there is no exact way of predicting what price the stock will initially be valued or where it will move to. Without the assistance of an underwriter, the company cannot guarantee the sale of shares because no large investors are in place to back the sale because a direct listing enters the public market immediately. Lastly, there is no overallotment option to help guarantee the success and price stability of the stock (Appendix I).

Traditional IPO Process

For years, any corporation that made the decision to go public followed a standard process for listing their IPO. The traditional process for an IPO starts with one of the most important step, to select the investment bank (underwriter), with which the company would be working with timelessly through the process. Once the underwriter is established the due diligence process and regulatory filings work begins.

Following this selection, the two parties begin to construct their commitment to one another. There are two primary types of underwriting that can be agreed upon, firm commitment and best efforts agreement. A firm commitment is an agreement in which the underwriter will purchase all the shares of the offer and sell them back to the general public. Through this agreement the investment bank guarantees the firm a set amount of money from their offering. The second type of underwriting is a best efforts agreement. Unlike a firm commitment, no set returns are guaranteed, but the underwriter still acquires all the shares and resells them to the public. Lastly, the two parties can work through a syndicate of the underwriters. Through this process, one investment bank acts as the lead (book-running) underwriter and sells the majority of the company's shares. In addition, to mitigate some potential risks associated with an IPO listing, other investment banks join the process as follow-ons and sell a smaller portion of the shares. After the two parties agree on a type of underwriting, the issuing company signs the engagement letter, which binds them to reimburse the investment bank for all expenses they incur during their time providing services or work for the company. Additionally, the document includes the gross spread, which shows the profits from the transaction by the difference of the price sold to public and the price the underwriter paid.

The next step in the IPO process is the letter of intent. This document is a commitment from the investment bank to proceed with all necessary actions to issue the company's initial public offering to the public. Additionally, it creates an obligation of the issuing company to not withhold any information from the underwriter during the process. Lastly, the two parties agree on terms that subject the issuing company to offer underwriter an overallotment option of up to 15%. The overallotment option, also called the greenshoe option, allows the underwriter to issue any amount of the 15% of shares they have the option for. This overallotment can be used as a strategy to stabilize the price of the IPO when the demand for the company's shares are rising or falling. Typically, when the market price of the stock falls below the price at issuance, the underwriters incur a loss, and they have the opportunity to buy shares at a lower price to stabilize the market price. As a result, the buyback reduces the supply of the shares on the secondary market, resulting in increased demand and an increase in price. An increase in demand can cause a spike in the market price of the stock. If the market price were to rise above the offer price, the underwriter cannot buy back the shares at the current market price since doing so would result in a loss. This is where the underwriter has the opportunity to utilize the greenshoe option. The underwriter can exercise their greenshoe option to buy additional shares at the original offer price without incurring a cost. The difference between the issue price and the current market prices assists in compensating the underwriter for any loss incurred when the shares traded below the offer price.

A primary aspect of an IPO is the underwriting agreement. This is an agreement and contractual obligation on the price that security will be sold to the underwriter from both the investment bank and the corporation.

The registration is filed with the U.S. Securities and Exchange Commission (SEC) and supplies them with information on the IPO for approval, including financials, managerial information, insider holders, current and potential legal issues, and the ticker symbol to be used. Attached to the registration statement is the prospectus, which is brief summation document that is provided to any investor that purchases or is interested in purchasing the newly issued security. Also attached is the company's private filings. This gives the SEC historical information on the company that is not available to the public.

Prior to the issuance of the IPO, the underwriter is tasked with constructing a red herring document for the company. This document is a reiteration of the initial prospectus that the underwriter uses while the SEC is reviewing the filing. The underwriter and the company's management team partake in a road show, in which they travel to potential investors to gain interest and gage demand level from institutional investors.

Once the SEC approves the IPO, the process begins to move forward again. The first step is deciding on an effective date, at which the security will be issued to the public. On the day prior to the effective date, the underwriter and the company review the information they have collected and decide on a price and a specific number of shares to be sold. This price determines the set amount of capital the issuing company will gain from their IPO. The factors that are used to determine the price of the IPO are the feedback and results of the roadshow, future expectations for the company, and the current state of the market. Unfortunately, most IPO pricings result in an underpricing of the IPO and lost capital for company.

Following the issuance of the stock, the underwriter holds the responsibility of providing analyst recommendations, performing after-market stabilization, and driving up the demand for the stock. In addition, the SEC mandates a twenty-five day quiet period for the stock to nationally transition into the market. Then market information is used for the valuation of the security.

Direct Listing Process

Company's looking to release their stock to the public now have the option of electing not to use a traditional IPO and instead opt for a direct listing process, in which they go straight to the market with no middle-man. The process is initiated once the company files the S-1 with the SEC to inform them they plan to issue a public offering. Following this submission, the company hosts an investor day, in which they invite prospective investors to come hear details and information on the historical financial state of the business. This day usually falls five weeks before the list date. The process is designed to draw interest from potential investors through one-on-one meetings. Once the S-1 is approved by the SEC, the issuing company releases its future outlook of the company, giving potential investors the opportunity to value the company and determine the price they are willing to pay.

Before trading commences, current shareholders of the company create a valuation of the price they are willing to sell their shares at. This is due to the fact that the company itself is not doing the issuing, but rather the shareholders of the company are selling their own personal stock. As a result, there is no primary offering being conducted, and rather, the direct listing involves the registration of a completely secondary offering of the company's shares (Gibson Dunn). This is one of the biggest differences between a direct list and a traditional IPO. Existing shareholders are given the opportunity to sell their shares on the secondary market if they choose to do so. This gives the holder flexibility and value, while also creating liquidity of the company's shares on the open market.

The day before the issue date, the company releases an reference price. This price is a guide point that informs the public that a recent transaction has occurred on the private market. The reference price does not serve a material purpose or affect pricing and is just a reflection of secondary market pricing.

On the first day of trading, the supply and demand for the security is created through auction until the chosen market maker feels the conditions are appropriate to release the stock to the public at an agreed upon price. It is recommended to use do a secondary exchange to determine the price point, but they cannot serve the role of determining the true market price at which the stock will open at. Conversely a direct listing uses a secondary exchange to set the opening price through the demand and bidding prices for the stock.

SEC Regulations

With the emergence of the Direct Listing to markets came new rules and regulations established by the market through the SEC. On February 14, 2019 Nasdaq Stock Market LLC filed a notice to the SEC for a rule change of Listing Rule IM-5315-1. The rule seeks to provide a better understanding of the conditions by which a private company must comply with to list on Nasdaq by means of a direct list, opposed to using a traditional IPO to raise capital. The Nasdaq rule mirrors that of the NYSE, which can be found in Section 102.01B of the NYSE Listed Company Manual (Clarkin, et al.). Both rules observe the means by which a private company can seek to list its securities on the secondary market, as securities that have been registered for the resale of securities that have been sold at a prior point in time by means of private placement. Companies that seek to use a direct listing must be able to prove and show sufficient valuation. Companies that cannot provide a trading price from prior private placement trading must present an independent valuation of at least $250 million (Sullivan & Cromwell LLP). This seeks to combat some of the risks associate with the direct listing and ensure that the company has adequate amount of capital available to suffice the list.

The rules created by the NYSE and Nasdaq entail a strict order of events companies must go through to be about to publicly trade its securities. The company must first file a registration statement pursuant that permits existing shareholders to sell their shares. They then must provide a third-party valuation from an institute that has extensive understanding and capabilities to do so. This third-party cannot be entailed to receive more than five percent of the company's shares to be listed. Additionally, this third-party could not have provided investment banking to the company in the twelve months prior to the issuance. If the company has engaged in past private market trading, Nasdaq or the NYSE will place the company's trading price "equal to the lesser of (i) the value calculable based on a Valuation, as defined in Listing Rule IM-5315-1, that meets the requirements of IM-5315-1(e) and (f) and (ii) the value calculable based on the most recent trading price in a Private Placement Market" (SEC). These rules also state that the third-party company is not subject to the requirements for a direct listing.

Most recently, in December of 2019 the SEC rejected the NYSE's plan to create a new type of direct listing that would allowing company to not only issue public securities through a direct listing but also raise capital. This has been one of the deterrents of using a direct listing opposed to a traditional IPO method. The NYSE is continuing to look for alternatives and expansion opportunities for the direct listing and giving corporations additional means to issue securities opposed to a traditional underwritten IPO. Additionally, the proposal offered that the "round lot" rule, investors with at least 100 shares, be relaxed from the previous rule of a minimum of 400 shares. Nasdaq has also begun exploring an improved direct listing.

The SEC has been focused on finding ways to combat the wide range of valuations companies have received prior to their IPOs. This has led to unpredictability in the market and several failed and underpriced IPOs. Additionally, companies failing IPOs have sparked the interest in the direct listing process. Most recently, WeWork's cancellation of their IPO and subpar releases of Peloton and Smile Direct Club have led to some concern by the SEC.

Direct Listings have sparked the interested of companies and have led to potential gains and changes to be in place in the near future. Airbnb is now considering using a direct listing model to go public this year. This would be the largest Direct List to date, with Spotify being valued at $26.5 billion and Slack being valued at $15.7 billion. Morgan Stanley and other bank have begun holding conferences on the direct list process. Companies are in need of information to become informed and knowledge before making their decision to use a direct listing opposed to the vastly known and proven traditional underwritten IPO. "No marketing efforts are permissible without a compliant preliminary prospectus on file with the SEC, and such prospectus must include an estimated price range. In a traditional IPO, the cover page of the preliminary prospectus contains a price range of the anticipated initial sale price of the shares. In a direct listing, the current market practice is to describe how the initial reference price is derived (e.g., by buy and sell orders collected by the applicable exchange from various broker-dealers)" (Gibson Dunn).

Google Process

Since a direct listing is such a new process, there are no true precedents for its history and past results. Although there are no true precedents, there are selected cases where a company opted to not use a traditional IPO, one being Google, Inc. Google in fear of underpricing chose to use an untraditional, Dutch Auction Process to release their primary offering. Today, this thinking has returned and advanced with the emergence and innovation of the direct listing.

In the late 1990s, dot-com bubble took off as technology companies were rapidly releasing IPO's as the use and adoption of the internet into life became more widespread. This rise of technology led the composite stock market index to rise to an all-time high, which resulted in extremely high valuations and cash generations for IPO's released during this time period. Unfortunately, Google, Inc. was not matured enough as a company to release the IPO during this boom, and ultimately, the dot-com bubble resulted in the stock market crashing in the early 2000s.

The dot-com bubble was extremely beneficial for newly public companies, as IPO's obtained its highest returns IPO's in 1999 and 2000, grossing over $65 billion each year. By the time Google was mature enough to release their stock to the public, the gross profit of IPO's was at a 10-year low of $10 billion in 2003 (Ritter). Google's rejection of the normal process became immediately evident early on, as they stated Google "is not a conventional company" (Google, Inc. S-1 Form) and they would utilize methods that were not generally accepted by Wall Street and those who opposed could choose to not invest in their IPO. Google wanted investors that would not oppose their current operations and would allow them to continue to operate with unorthodox methods that had brought them to their current success.

Ultimately, Google elected to use a Dutch Auction, a process that was unseen in the United States stock exchange. The Dutch Auction gives every investor from investment banks to individuals the opportunity to bid on Google, Inc. shares based on the price each investor was willing to purchase a share at. Google view this process as a way to ensure their company was priced at a fair market value, during a time period when IPO underpricing was at high. They were looking to have a balanced blend of both large institutional and small individual investors. The Dutch Auction was completely open, meaning anyone could buy Google's shares. The only restriction was an investor was required to purchase a minimum of five shares. The uncertainty and skepticism of the process resulted in several investors withdrawing from underwriting the IPO due to several concerns. Most notably was Merrill Lynch who dropped out very late in the process with no clear reasoning behind the decision (Robicheaux, Herrington).

Another controversial decision Google made was releasing their IPO on Nasdaq opposed to the NYSE. Two classes of stock were created by Google, Class A and Class B. Class A stock was a standard variety that would be sold directly to common investors daily and would carry one vote. Class B stock was reserved for the founders and company insiders and would carry ten votes per share.

On July 26, 2004, Google announced that it projected a valuation between $108 and $135 per share. This would result in $2.7 billion raised and a market value of $36 billion, a valuation that was vastly higher and more optimistic than any IPO during this time. To boost the attraction of their IPO, Google executives went on a road show to potential investors. They still faced several hurdles as their IPO neared. On the day before the stock began trading, Google lowered their project price range of the stock to between $85 and $95. Additionally, they were required to reduce the number of shares to 19.6 half of the original amount, due to copyright allegations from rival Yahoo. These last minute alterations effectively change the company's potential market value from $36 billion by over 30% to $25.8 billion. Additionally, the projected capital gains from the sale were cut substantially, from about $2.7 billion to $1.9 billion (Robicheaux, Herrington).

Google, Inc. (GOOG) began trading on August 19, 2004 at a price of $85. Despite initially high valuations, Google only brought in $1.67 billion. $1.2 billion was new capital and $472 million was distributed among executives and investors based on the number of shares they provided. Although Google had used a Dutch Auction to combat against underpricing, their stock price surged to over $100 by the end of trading day one. Thus, the Dutch Auction appears to have underpriced the issue. After six weeks Google shares were selling for over $135 and over $232 by May of 2005. Within nine months of the IPO, Google stock was trading at 2.7 times more than the initial offer price.

Current Examples / Results of Direct Listings

An IPO can be costly and unpredictable and a big step in a company's life. An IPO process has been around for several years, but even so, there are still several questions that can be observed from the company's perspective. Looking recently to 2017 and the Snap, Inc. IPO, which opted for a traditional underwritten IPO, there is a clear example of how costly and potentially disappointing an IPO can be. After the work of their twenty-six underwriters, Snap came to the valuation at $17 per share. The stock opened at $24.00 on the stock exchange (Appendix IV). The price then soared forty-four percent from the original price, ultimately closing at $24.48 (the price reached a high of $26.05 during the first day). Through their IPO, Snap, Inc. raised $2.45 billion. As a result of Snap's extreme underpricing they lost out on $1.1 billion, if the stock would have been value at $24.48. This would have resulted in Snap raising $3.56 billion from their IPO. Cumulatively, 145 million shares were sold by the company and fifty-five million were sold by insiders.

Although Snap, Inc. still received solid returns, they paid nearly $85 million (2.5%) in fees to underwriters. A majority of the fees were paid to Morgan Stanley and Goldman Sachs. Morgan Stanley received sixty million shares (30.2% of the shares allocated to the underwriters), which equated to 25.71 million in fees. Goldman Sachs received 50 million shares, which equates to 24.8% of the underwriters shares and $21.08 million. This reflects a large net gain to the underwriters known as “IPO Candy.” This allows the banks to sell shares of their premium IPO to their best buy-side customers. Another speculation is that banks purposely price IPO below the recommended price because they to ensure a large “pop” in the IPO price, which will in turn draw more demand and positive momentum around the stock.

This result, although an extreme one, continues with the trend of IPO underpricing. According to Ritter, between 2001-2008 the average first day return of IPOs has been approximately 14.3%. This results in $65.08 billion left on the table for the issuing companies.

Companies in the past have tried to combat the underpricing that has become so common with the traditional IPO underwriting. As seen on August 19, 2004, Google’s use of the Dutch Auction instead of a traditional IPO still resulted in extreme underpricing and lost capital for the company.

In recent years, the emergence of the direct list has given companies the option to avoid the underpricing effects and receive the highest returns from their IPO. This option has mostly been explored by tech-based companies but can be used for any IPO. Looking more closely at Spotify’s IPO on April 3, 2018, the New York Stock Exchange provided a reference of $132. Their IPO opened at a fair value price of $165.90, which was amount original shareholders received for each of their shares. Spotify’s share price rose to $169.00 on the first day but closed at $149.01 (Appendix II). One of the current negatives to the direct listing process is the inability to raise cash. This can be avoided by pre-IPO funding. Spotify was able to raise ample amounts of capital that allowed them to go public without needing the cash benefits of it.

Following the success of Spotify's direct list, Slack chose to use the direct listing process for their IPO and filed for an IPO on April 26, 2019 (Appendix V). On June 19, 2019 Slack's stock was released to the public with a reference price of $26. Still Slack's share price surged 48.5% in its first day of trading on the NYSE. It opened at a share price of $38.50 ($12.50 above the reference price). The pop surged Slack's market cap to $19.5 billion. As of April 2019, on the secondary market Slack was valued at nearly $17 billion. Slack was able to raise $427 million in its final round of financing, which pushed its valuation to $7.1 billion (Appendix III).

Although there are still some questions surrounding the direct listing process, it is still viewed as an attractive alternative to the traditional IPO. Most recently, Airbnb announced it plans to utilize a direct list for its IPO in 2020 after receiving a private valuation of $31 billion (Appendix VI). This would be the largest company to date to use a direct list. This decision comes largely as a result of seeing the recent results of other technology giants: Uber, Slack, Lyft, and Spotify. It also comes following the complete failure and collapse of WeWork's (The We Company) attempted IPO.

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Appendix I

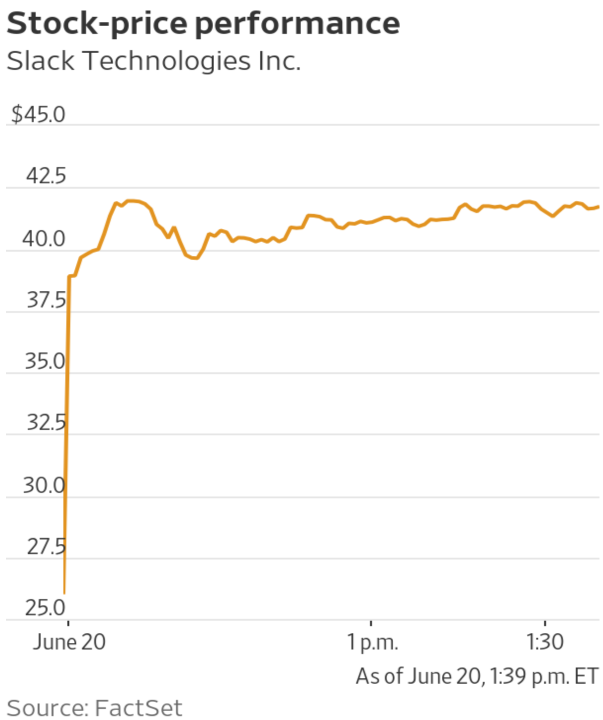
Traditional Underwritten IPO	Direct Listing
Advantages	**Advantages**
Fundraising	Reduced Costs
Exit Opportunity	Liquidity for Shareholders
Publicity and Credibiility	Stock Price is Determined by Market Demand
Reduced Overall Cost of Capital	No Dilution Due to Creation of New Shares
Stock as a Mean of Payment	No Lockup Period
Liquidity	
Disadvantages	**Disadvantages**
Additional Regulatory Requirements and Disclosures	Unable to Raise New Capital
Market Pressures	Higher Volatility of Stock Price
Transaction Costs	No Large Investors to Back the Sale
Amount of Time Needed	No Overallotment Option

Appendix II

Spotify Day 1 Stock Price

Appendix III

Slack Day 1 Stock Price



Appendix IV

Snap Day 1 Stock Price

Appendix V

Source: CNBC

Appendix VI

Potential 2020 Direct Listings
Airbnb
GitLab
Asana
DoorDash