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Direct Listing as Alternative to an IPO

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Pioneer Spotify | Price setting on the first day of trading | No stabilization purchases | Free float requirements can be challenging

The booking and rental platform Airbnb could become, in the coming year, the third company which chooses not the classic way of going public in the United States via an Initial Public Offering (IPO), but instead chooses a so-called direct listing. Airbnb would thus follow the example of the music streaming service Spotify and the instant messaging provider Slack. Both companies completed their high-profile listings on the NYSE without simultaneously offering shares to investors in an IPO. Instead, the entire share capital was listed for trading on the stock exchange by means of a direct listing. The existing company shareholders were only then able to sell their shares on the stock exchange. The relevant sales prices achieved were based on supply and demand.

Role of the banks

Such a direct listing eliminates essential tasks that investment banks undertake in the context of IPOs. Typically, the banks determine initial investor demand prior to the IPO. They then carry out a bookbuilding process prior to the listing in order to determine the price for the offered shares, and finally the banks distribute such shares to selected investors at the offer price in agreement with the company.

The fact that Spotify chose a direct listing for its stock exchange debut was considered revolutionary in the U.S. market and had very specific reasons. Due to successful financing rounds, Spotify was no longer dependent on raising new money through an IPO. Rather, the company wanted to give its already very large shareholder base direct access to the capital markets without having to impose on its shareholders the lock-up restrictions required by the banks in IPOs (typically 180 days after the start of trading). At the same time, Spotify was interested in a transparent and market-based price determination. A bookbuilding by investment banks, as in an IPO, in which only selected investors can place subscription orders within a previously determined price range, was not carried out.

Of course, even in the case of a direct listing the involvement of investment banks is not entirely dispensable. The banks primarily take on the role of financial advisors who support the company in the preparation of the listing. But in the case of a direct listing, they do not participate in the price determination. This brings with it a change in the pre-marketing activities in the run-up to the IPO. Usually, the banks organize initial meetings between selected investors and the company's management several months before the planned listing date to present the company to investors. This investor dialogue intensifies up to the management roadshow immediately before the start of trading.

Opening auction

In a direct listing, these pre-marketing steps organized by the banks are omitted. They are taken over by the company itself. It is therefore no coincidence that a high-profile company such as Spotify was the first candidate to go public in the United States via a direct listing. For pre-marketing purposes, both Spotify and Slack held an Investor Day lasting several hours, during which they presented their business and strategy, including their financial targets, to investors.

In the context of a direct listing, the price determination itself occurs on the first trading day in an opening auction, in which supply and demand are brought together for the first time. How many shares are actually available for sale and how great the demand is, is not known before the start of trading. Not only can all shareholders sell directly. Any investor who has placed a buy order may also acquire shares. Investors in the listings of Spotify and Slack could look at the share purchase prices achieved in previous financing rounds for reference. However, the actual opening trading prices of both companies were set independently of these reference prices and were significantly higher. Additional share price uncertainties may arise after the start of trading. In contrast to the IPO, there are no banks that can support, at least to a certain extent, a price falling below the first trading price by means of stabilization purchases.

Model for Germany?

A transaction structure mirroring a direct listing would probably be perceived as less revolutionary in Germany than was the case with Spotify in the United States. The prospectus law applicable in Germany recognizes both offer prospectus and listing prospectuses. A stock exchange listing without a simultaneous public offering of shares is by no means new in the German context. In the past, there have been several such listings in the German market, mostly in combination with a private placement of shares to selected investors in advance. Evonik Industries, Schaeffler and Jost Werke, for example, chose this structure.

Also the price determination by way of an opening auction chosen for direct listings is known in German practice. It is used in a similar form for pure stock exchange listings, for example in the context of spin-offs. In these cases as well, there is no predetermined placement price on which the first trading price of the shares could be based. Rather, an initial price is determined in an opening auction, which typically takes longer than in an IPO and brings together supply and demand.

One challenge for issuers in the case of pure stock exchange admissions are the applicable regulations on the required minimum free float. Before admission to trading, it must be confirmed to the stock exchange that the shares to be admitted are sufficiently spread. This is assumed if, in relation to the European Economic Area, at least 25% of the shares to be admitted are in free float (holdings below 5%) and at least 100 shareholders hold the shares to be admitted. Achieving this minimum free float only in connection with the subsequent start of trading is not sufficient.

Since no new shares will be issued to investors in the course of the listing, the free float requirements must be fulfilled already before the start of trading. The stock exchange does permit exceptions from the 25% threshold to a certain extent, if sufficient trading can nevertheless be expected based on the number of shares to be admitted. The 100-shareholder principle, on the other hand, is strictly applied in practice. In the United States, free-float requirements also represent a challenge for issuers in direct listings. However, from the point of view of NYSE, for example, it is sufficient if the minimum free float is achieved in connection with the commencement of trading. In addition, start-ups in the United States, which already have a large number of shareholders due to financing rounds and employee participation models, are generally more common than in Germany.

US companies have it easier

Whether the German market will also develop an interest in direct listings based on the U.S. model is likely to depend on whether — as was the case in the United States at the time — suitable stock exchange candidates can be found for which this transaction structure can be considered due to the setup of the company and the lack of IPO proceeds. For U.S. companies, especially in the tech sector, an active and well-established venture capital market offers the opportunity to raise money through private financing rounds even before going public. German companies, with some exceptions, are likely to find it harder to do so due to the local market conditions.