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***IPOs are back***  
What potential players need to know

# IPOs are back: What potential players need to know

While one of the most rewarding transactions a company may undertake, an IPO can also be among the most daunting. Ample preparation will improve the odds of making a successful entrance in a newly robust IPO market.

## IPO volume and proceeds

### IPO volume (completed IPOs)



### IPO proceeds (in billion \$)



Source: 2010 US IPO Watch: Analysis and Trends, PwC, March 2011

After a lackluster couple of years, the US IPO market made a strong comeback in 2010, with a 143% increase in volume over the prior year and a 55% leap in deal value. Fourth-quarter IPO activity proved especially vigorous, reaching levels the market hadn't seen since 2007.<sup>1</sup>

Continuing the momentum of 2010, IPO proceeds in the first quarter of 2011 reached \$12.4 billion, the highest first-quarter value since 2008 and a 194% increase in offering proceeds over first-quarter 2010. The strong first-quarter performance puts the US IPO market on pace to eclipse the proceeds for all of 2010, which totaled \$39 billion. The first quarter of 2011 also saw 52 new companies enter the IPO pipeline, signaling growing confidence in the US equity markets.<sup>2</sup>

Certainly this is welcome news to companies that have been contemplating an initial public offering. A positive market environment, however, is just one — albeit critical — factor in successfully executing an IPO. If a company isn't sufficiently prepared for public life and the many responsibilities it brings, the best market timing in the world will be of only so much help to that business.

Preparing to be a public company is more than just a one-day event. The process requires intense, long-term planning and execution to avoid the many potential pitfalls that come with transitioning to life as a public entity. The markets are still in recovery mode and short-term volatility will continue to challenge prospective issuers if they're not thoroughly prepared to move when the moment is right.

“In short, an IPO is not something to enter into lightly,” says Henri Leveque, a partner in PwC's Transaction Services group. “That said, with the right preparation and approach, going public can be an effective way to tap the capital market and a key component of an organization's growth strategy.”

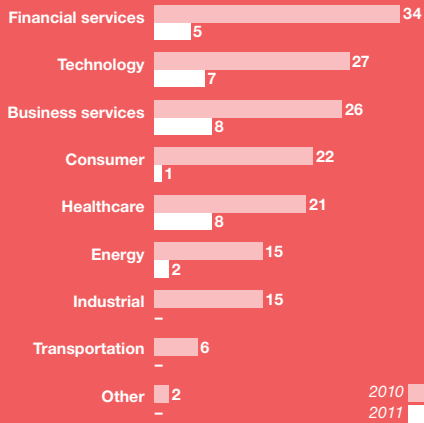
<sup>1</sup> 2010 US IPO Watch: Analysis and Trends, PwC, March 2011

<sup>2</sup> US IPO Watch Q1 2011, PwC, March 2011



**Market snapshot**

Where the deals are happening:  
Completed IPOs in 2010 and 2011



**Who's behind them**

**The main players**

*Financial sponsors:* In 2010, 128 IPOs were backed by financial sponsors, amounting to 76% of total IPO volume and 45% of total proceeds. With financial sponsors contributing 75% of the IPO volume in the first quarter of 2011, private equity looks to be a major player this year, too.

*Non-US issuers:* Issuers from outside the United States contributed 58 IPOs in 2010. Among the 13 countries represented, China was most active, with 42 IPOs. In the first quarter of 2011, foreign issuers accounted for 11 IPOs, six of them from China.

Source: 2010 US IPO Watch: Analysis and Trends, PwC, and US IPO Watch Q1 2011, PwC, March 2011

**Many tightly held private companies keep their cards close to their chest. Once a company goes public, it will have to show those cards.**

### **Sizing things up**

In considering an IPO, private companies should carefully assess their organizational and market readiness for going public. Most importantly, they should determine whether leaving the private sphere is indeed the right move for them.

### **Why go public?**

There are various reasons for going public. Common goals include

- Raising capital for expansion
- Raising capital for future acquisitions
- Attracting and retaining top talent
- Diversifying and reducing investor holdings

A company's owners may also have reasons other than these, including personal ones. Those objectives should be clearly communicated to the company's key stakeholders, with everyone agreeing on what the business hopes to achieve by going public.

There should also be consensus on whether going public is in fact the best way to achieve the agreed-upon objectives. Companies seeking capital, for instance, may find that accessing funds via other avenues (e.g., debt, private equity sources, or mezzanine funds) is a better or more-efficient option than an IPO.<sup>3</sup> A business should explore all reasonable alternatives before making a decision.

Then, too, there's the matter of knowing what exactly an IPO entails—both the preparation for the transaction itself (no small undertaking), as well as the ongoing demands and responsibilities of being a public company. Companies that venture down the IPO path with a well-studied roadmap in hand should be well equipped to face the challenges ahead.

### **A public-company mindset: Does your business have one?**

While IPO preparedness involves many logistical considerations (accounting, regulatory, legal, tax), there's also the matter of whether a company is mentally prepared for the public arena. Before proceeding with an IPO, a company should gauge whether it is both culturally and psychologically ready for the changes that public status will bring.

### **Withstanding public scrutiny**

"Many tightly held private companies keep their cards close to their chest," notes Dan Frey, a partner in PwC's Private Company Services practice. "Once a company goes public, it will have to show those cards." This forfeiture of privacy starts with the initial registration statement that's filed with the Securities and Exchange Commission (SEC) and continues with the various ongoing financial-statement disclosures that a public company must make about numerous aspects of its business, operations, finances, and executive compensation.

"Because private companies often keep these details to themselves, suddenly having this information come under the scrutiny of regulators, analysts, shareholders, and the financial press can be quite jarring," says Frey. "Companies that prepare themselves for this new reality should have an easier time adapting to it."

### **Meeting performance expectations**

A company must be ready to meet shareholder and market expectations from Day One. For their part, shareholders will expect the company to meet short-term performance goals and want to see steady growth in areas such as sales, profits, market share, and product innovation. Analysts' short-term earnings expectations must be met as well. A company's failure to hit these marks can dramatically hurt the long-term valuation of its business. Chief among a newly public company's challenges, then, is learning how to balance short-term growth objectives with the long-term health of its business.

<sup>3</sup> For more on the range of capital sources available to private companies, please see *Growing Your Business*, Issue 62, "Financing the Future: Strategies for Accessing Capital," PwC, 2011.

## Spotlight on compensation

### The Dodd-Frank Act

Companies contemplating an IPO will want to be alert to the executive-compensation provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The provisions apply to all public companies. Here's a glance at some of them:

*Expanded compensation disclosures:* Companies will now need to disclose (1) the relationship between executive compensation and the company's financial performance, including stock performance and dividend policy; (2) the median compensation of all employees (excluding the CEO), the CEO's total compensation, and the ratio of the two; and (3) the company's policy regarding whether employees or directors are allowed to hedge the risk in equity securities that are received as part of their compensation.

*Say on pay:* These are nonbinding, advisory shareholder votes regarding executive compensation. Boards may be under pressure to react to say-on-pay voting results. If they ignore the results, board members could become the target of a withhold-vote campaign in subsequent board elections.

*Clawback provisions:* These are more stringent than the clawback provisions under Sarbanes-Oxley. A company will now have to claw back all excess financial compensation that was paid based on erroneous financial statements (even if the reporting errors were unintentional). Clawbacks will reach back three years before the year of the financial restatement and extend to the compensation of all executive officers (not just the CEO and CFO), including those who have left the company.

*Compensation committee independence:* The Act introduces independence requirements similar to those required of audit committees, primarily by mandating that the SEC direct national securities exchanges to prohibit listing any company lacking an independent compensation committee.

## Spotlight on sustainability

Public companies have a fiduciary responsibility to provide investors with transparent information about the risks and opportunities that can influence stock prices. Such risks and opportunities include those pertaining to sustainability and climate change.

Regulators — including the SEC and EPA — expect corporations to adequately disclose and appropriately manage the potential impact of climate change. Consumers, prospective investors, and other stakeholders have expectations as well.

Take shareholders, for instance. In the 2010 proxy season, they filed a record 100-plus climate change resolutions — an almost 50% increase over the previous year.\* The targets of those resolutions were not limited to companies in the energy sector. They also included big-box retailers, financial institutions, and construction companies.

Board members and management at IPO-bound companies should therefore develop a plan for addressing public expectations and concerns about sustainability. The time to initiate this effort is in the IPO-planning stage. Doing so will help the business respond appropriately to due diligence inquiries from prospective investors, underwriters, and credit rating agencies.

During this process, the company should assess the financial and reputational risks that sustainability and climate change pose to the business, as well as see how competitors are positioning themselves in the marketplace vis-à-vis these concerns.

\* Investor Network on Climate Risk, a project of Ceres



## ***The market moment*** Determining whether yours has arrived

The demand for and timeliness of an initial public offering can vary dramatically, depending on a number of market forces. Financial-reporting considerations may influence an IPO's timing, too. Staying alert to these factors is critical, since missing an IPO window by as little as a few weeks can result in a postponed or withdrawn IPO or a lower market valuation.

A good way to gauge whether now is the right time to make your public debut is to look at your business through the eyes of the market. Determine, for instance, whether your company has a sufficiently appealing track record. Generally, a company that outpaces the industry average in growth will have a better chance of attracting prospective investors.

Also determine how well your business can demonstrate, through historical sales data and accurate forecasting, that it has a reasonably good prospect of maintaining strong sales and earnings growth. Prospective investors will want to see such indications. In the case of early-stage companies, they may need to rely on emphasizing the uniqueness of their products or services in lieu of presenting an established track record.

### Relinquishing control

Once a company issues publicly traded shares, the company's owners must forfeit a portion of the returns associated with the business's growth. They'll also have less ability to control the company's ownership.

These and other considerations (including IPO expenses—legal, accounting, actuarial) should be taken into account when a company weighs the pros and cons of going public.

### **The evolution of your company**

There are three general phases of an IPO:

- IPO readiness
- The IPO process
- Life after the IPO

While each phase has its own set of activities and concerns, the second and third phases overlap a good deal. That's because the completion of an IPO isn't so much the end of a process as it is the beginning of the company's new life.

Indeed, life at the company changes as soon as the decision to go public is made. The required preparation in the months leading up to an IPO is considerable and often distracting to the business, which will need to devote significant time, effort, and money to the undertaking. It is important, therefore, that a company be sure it has adequate in-house resources before venturing down the IPO path, or else enlists outside expertise. A business must be ready to meet shareholder, regulatory, and market expectations at the outset.

"Not only that," says Fentress Seagroves, a principal in PwC's Transaction Services group. "A company needs to realize that the hard work isn't over once the initial public offering is completed. The business must match the effort it put into going public with the effort of actually being public." This includes meeting a range of ongoing obligations to regulators, shareholders, and other market participants.

### IPO readiness: Learning to think and act like a public company

While the planning process for an IPO can start as little as three months before a public offering, PwC recommends that a well-considered plan be executed over a period of one to two years: "This window gives a private business the chance to properly assess the challenges of being public," says Leveque, "as well as time to practice thinking and acting like a public company." During this period, a company should take the following steps:

#### *Build an effective management team:*

The investment community wants to be sure a company isn't being run single-handedly. The management team needs to be cohesive and share a long-term vision for the company, to obtain maximum financial return and valuation.

#### *Appoint independent members to the board of directors and create an audit committee:*

All of the major stock exchanges and markets require that a registered company have a majority of independent directors on its board. "Taking the time to build out the board of directors well before an IPO event is critical to the overall success of going public," says Frey. A public company's board must also have an audit committee, which plays a key role in ensuring the integrity and transparency of a company's financial reporting. Investors now expect such reporting to undergo objective, board-level review.

#### *Evaluate corporate governance principles and practices:*

Both the NYSE and NASDAQ require that corporate governance standards be met. NYSE companies must, in addition, have an internal audit function. Institutional and other investors will also be looking to see whether sound corporate governance is in place.

#### *Take stock of processes and infrastructure:*

Any weakness in systems or failure to comply with regulatory requirements could bring the company public embarrassment, reputational damage, and fines.

*Check whether your financial reporting and internal controls are up to speed:*

Life as a public company means getting comfortable with the rhythm of quarterly and annual reporting and ensuring that there are sufficient internal controls for that reporting.

— *Assess readiness to meet stringent compliance demands:* A public company's finance department must have sufficient accounting and reporting expertise to file quarterly and annual financial statements with the SEC. The company's CEO and CFO will also have to personally evaluate and explicitly report to the public the effectiveness of the company's internal controls for financial reporting (per the Sarbanes-Oxley Act of 2002). The company's external auditor, too, will need to annually attest to the effectiveness of those internal controls.

— *Have your financial statements audited and resolve potential issues:* Part of this entails being able to describe, in both the initial registration statement and all future financial statements, the effect that underlying factors have had on the company's performance. Failure to do this will shake investor confidence and might even result in delisting.

— *Lax reporting isn't an option:* Without adequate financial reporting, a company not only makes itself vulnerable to enforcement action by the SEC, but also impairs its ability to (1) accurately forecast results and (2) analyze current-period results for purposes of budgeting and subsequent financial reporting—a vicious cycle any company would wish to avoid.

“However, financial reporting, done well, is more than just a compliance exercise,” points out Frey. “It's also an effective way to communicate to investors. Presenting an accurate and transparent narrative in its financial statements is critical to a company's ongoing success in the marketplace.”

*Have a tax checkup:*

This exercise helps a company understand the tax advantages and tax costs of going public. There are often significant tax-saving opportunities that can reduce the taxes of the company or individual owners if properly planned before the IPO.

— *Assess tax-allocation consequences:*

Most companies are generally in the form of a C corporation. Therefore, either prior to going public or as a result of an IPO transaction, an S corporation will generally terminate its S corporation status and become a C corporation. The next day, the company will begin a new tax year as a C corporation and have to decide how to allocate its taxable income, deductions, and credits between the two tax years (the S corporation tax year and the C corporation tax year). This allocation choice will have significant tax consequences that should be planned for well in advance of the IPO.

*The IPO process / Life after the IPO*

Preparing for life as a public company should happen in parallel with the IPO process. Although there are activities that occur only in the run-up to an IPO, such as choosing a stock market and an underwriter, many of the IPO-preparation activities will carry over into the company's post-IPO life.

Perhaps the biggest difference between these two phases is that during the IPO process, the unavoidable flurry of preparatory activity poses a considerable distraction to the business. During that time, much attention is given to the initial filing of documents, due diligence, and marketing effort, which compete with the day-to-day business for management's attention. Once the transaction is completed, however, certain other IPO activities will simply become par for the course in the company's new life as a public entity:

*Develop budgets, forecasts, and performance measures:*

Proper budgeting, forecasting, and performance measurement, along with a public company's ability to meet its (and analysts') earnings estimates, can significantly impact the company's stock performance. The market allows very little margin for error in this area.

*Maintain investor enthusiasm:*

Public perception of a company has a direct effect on the value of its stock. "If investor enthusiasm wanes, so will trading," cautions Seagroves. "If a company's shares trade thinly, there's a good chance the intended benefits of the IPO won't be achieved." It's important, therefore, that a public company have a solid investor-relations team that communicates regularly with investors, analysts, and the media to maintain a positive image and to ensure that the company's story is being told accurately.

*Comply with Sarbanes-Oxley requirements:*

Upon filing its financial statements with the SEC, a company must comply with certain provisions of the Sarbanes-Oxley Act. The most significant of these provisions is the requirement that an independent auditor report on the effectiveness of a company's internal controls. "That requirement generally kicks in with the company's second annual report after the IPO, depending on the company's overall market capitalization," says Frey. "Compliance can be both time-consuming and resource-intensive, so companies should make sure they schedule accordingly and line up sufficient expertise."

**Conclusion**

Thinking through these realities well before deciding to go public is as important as market timing, if an IPO is to achieve the desired benefits. In some cases, those benefits can materialize as early as the first year after going public. In other cases, it might not be until several years after an IPO that a company knows for sure whether the benefits outweigh the costs. By planning early and striking the right balance of resources, a company can give itself the best possible chance for success when its IPO window opens.

**More information**

Want to learn more about IPOs?  
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