Professional Perspective

Current Considerations for Preparing to Go Public

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Going public now is not the same as in the last decade, and certainly not the same as the beginning of the pandemic. Market uncertainties, the U.S. Securities and Exchange Commission's rulemaking, stock exchange regulations, and shifting investor focus have once again changed the face of initial public offerings (IPOs). Timelines, focus areas, and going-public alternatives have been impacted.

This article looks at the critical role of environmental, social, and governance issues in IPOs and explores the benefits and risks of the different avenues for taking a company public.

Environmental, Social & Governance Reporting Is Essential

Who would have thought that environmental, social, and governance (ESG) issues would expand to play such a significant role at the IPO stage? Companies are now incorporating ESG planning into their IPO preparations for a variety of reasons, including increasing focus from institutional investors. There are a number of steps that companies should take and ways they can mitigate risks as ESG is incorporated into their practices and processes.

Factors Driving ESG in IPO Process

A variety of considerations drive these trends. Many institutional investors now incorporate ESG factors into their investment processes, including firms, such as BlackRock, Vanguard, and State Street, that have adopted ESG-related voting policies, including board diversity and climate change. These institutional investors expect portfolio companies to make certain ESG disclosures, including under climate-related frameworks, beyond what is currently necessary under U.S. regulatory requirements.

Some funds now exclusively invest in companies meeting certain ESG criteria, both from a socially responsible investing standpoint—where certain types of companies are excluded from investments—and from an ESG standpoint—where companies with "good" ESG practices are included. ESG issues that are important to investors vary based on the type of the investor, with institutional investors generally focusing on the ESG issues that are expected to have a positive financial impact on the company and increase shareholder value in the long-term. These issues include creating better workplaces and sustainability issues relating to the company's ability to thrive in the long-term. Assessing any governance risks—whether anti-corruption, related party transactions, or culture—can also be a consideration.

The U.S. federal government's general focus on climate change, including the SEC's proposed ESG rulemaking, as well as the EU's sustainable finance strategy, the creation of the International Sustainability Standards Board (ISSB), and other international ESG developments, provide an additional impetus to address ESG issues early on. Accordingly, for companies preparing to go public, ESG is impacting every fiber of the organization—from a company's greenhouse gas emission measurements and energy, water, and waste management, to board, management, and workforce composition, to cybersecurity, corporate ethics, and insider trading policies.

Not only is ESG being considered and planned for following a company's IPO, ESG is now part of the IPO preparation process. While the SEC has not yet adopted comprehensive climate change disclosure rules, and only limited ESG disclosure requirements or guidance in other areas, such as board diversity and cybersecurity, investors increasingly expect companies to adopt ESG practices and programs. These expectations are buoyed, in part, by increasing ESG requirements adopted by global regulators.

Companies with strong ESG programs, processes, and disclosures as part of their IPO may attract increased investor interest, both institutional and retail, and may be viewed as a more stable investment, as ESG performance can contribute to higher valuations, better stock performance, and a lower cost of capital. Underwriters and investment banks are also increasingly invested in ESG. For instance, Goldman Sachs will only take a company public if it has at least two diverse board members, including one woman.

Securities exchange requirements play a role as well. Companies seeking to list on Nasdaq generally seek to enhance their board diversity. Nasdaq requires public disclosure of board-level diversity statistics using a standardized template and an explanation of why a company does or does not have a certain number of diverse directors within specified timelines.

Finally, outside stakeholders, such as customers and employees, are also increasingly interested in companies with robust ESG practices. Management and directors are aware of many of these factors and seek to adopt practices that will attract ongoing interest in their company. Further, companies that do not adopt ESG practices in connection with their IPO may struggle to compete with established public companies with such practices. Also, putting into place the necessary processes in connection with the IPO can lower the burden going forward.

Incorporating ESG in IPO Planning

Driven by the factors outlined above, companies increasingly undertake priority assessments of ESG issues, and begin developing their ESG programs, at the IPO stage. They also implement ESG governance structures at the board and management level, and at least begin developing processes and documentation allocating these responsibilities and incorporating ESG matters into the companies' controls and procedures and enterprise risk management programs.

As part of IPO preparation, companies and underwriting teams evaluate board composition and director qualifications to assess board diversity and the board's ESG expertise—from climate and sustainability to cybersecurity and data privacy, to talent management, to human rights and supply chain management.

In addition, pre-IPO companies are increasingly preparing for ESG reporting under standards and frameworks such as the Sustainability Accounting Standards Board (SASB) and Task Force on Climate-Related Financial Disclosures (TCFD), as well as eventual reporting in periodic SEC filings, particularly if a company intends to market its IPO to institutional investors. In those cases, care is also being taken to develop ESG disclosures for IPO registration statements, going beyond risk disclosures to include areas the SEC has indicated interest in, including management and board oversight and qualifications, climate change, and talent management.

Mitigating Greenwashing Risks

Balancing between additional ESG disclosures and the accompanying increased risks can be difficult. More disclosures may lead to additional risk of "greenwashing" allegations, potentially resulting in enforcement actions and litigation. But choosing not to disclose ESG information may also result in investor actions, such as declined investment, shareholder proposals, or litigation—for instance, for alleged failure to implement proper structures governing oversight of ESG, employee discrimination lawsuits, and the like.

Companies can mitigate such risks by building out their internal structures and reporting, ensuring that necessary data is properly collected and accessible in multiple locations, and that data is validated. Any information that will be publicly disclosed should be run through similar controls as the financial and other information currently required to be disclosed.

These controls should include disclosure committee and audit committee reviews and, increasingly, external review and attestation. On the other hand, companies should be aware of potentially competing laws, where ESG practices could violate existing laws. For instance, Texas, in an effort to protect the oil and gas industry, has adopted laws that essentially prevent the state from doing business with financial institutions that divest from fossil fuels.

Ways of Going Public

The initial step is to determine whether it is the right time to go public—and if so, how? For some companies, particularly those able to raise sufficient capital using private equity, staying private may make more sense. Private companies are subject to far fewer regulatory requirements and burdens, with founders generally retaining more control over their companies. If going public, public visibility may also bring a higher level of scrutiny and potentially higher exposure to liability.

Still, companies may find it more difficult to raise capital as a private company, particularly from investors that invest in both private and public companies at times when public equity is viewed as being cheap. In addition, companies may want greater market visibility, and their shareholders may desire additional liquidity for their holdings. Based on these factors, and combined with positive market conditions, the IPO/SPAC market boomed in 2020 and 2021.

Traditional IPOs & Alternatives

In addition to traditional IPOs, by which companies raise capital by selling new shares underwritten by investment banks, companies generally evaluate other alternatives for going public. A variety of factors go into determining the method a company chooses to use to go public. Companies seeking to raise capital directly and desiring guidance with the process are more likely to use a traditional IPO. Traditional IPOs typically incur additional expenses compared to other alternatives and take longer to complete, but will result in net proceeds going directly to the company and underwriter assistance with ensuring the shares are sold.

Direct Listings. Direct listings, by which companies sell shares without the investment bank underwriting, are a newer option available for some companies due to the loosening of stock exchange regulations. Direct listings have led to some notable and successful company debuts.

In a direct listing, companies generally incur fewer costs—in particular, no underwriting fees are incurred, although investment bankers usually act as financial advisors. This approach provides additional liquidity to existing shareholders, as the shares held by existing shareholders are typically not subject to lock up restrictions. While in a typical direct listing, the company does not receive any direct proceeds (as only existing shareholders sell their shares in the listing), both NYSE and Nasdaq now permit companies to sell their shares in a direct listing, providing capital directly to the company. Downsides to direct listings include lack of support for the company in selling its shares and increased share price volatility. Accordingly, direct listing is generally a realistic alternative only for larger, well-known companies.

Reverse Mergers & SPACs. Reverse mergers and other alternatives may be appropriate based on the size, business, and reputation of a company. A reverse merger can be faster and less expensive than an IPO, as well as less dependent on market conditions, but does not provide any funds to the company and often comes with former shell company issues, including limitations on the ability to remove restrictive stock legends and resell without resale registration pursuant to Rule 144 promulgated under the Securities Act. In many cases, a potential combination with a special purpose acquisition company (SPAC)—often referred to as a "de-SPAC merger" or a "de-SPAC transaction"—has also been on the table.

SPAC transactions can have various benefits, potentially resulting in faster transactions, with higher valuations, decreased dilution, and lower fees. However, the SPAC market, which has boomed in the last couple of years, has undoubtedly cooled off to date in 2022. Market conditions remain difficult, including market volatility, inflationary pressures, rising interest rates, Russia's invasion of Ukraine and related sanctions and uncertainties, and the threat of a potential recession.

Further, the SEC is signaling its disfavor of SPACs. The SEC's recent interpretative guidance regarding warrant accounting issues for SPACs and proposed rulemaking relating to conflicts of interest, projections, and liability issues, particularly for underwriters participating in both the SPAC and de-SPAC transaction, among others, are at the minimum intended to equalize going public through a combination with a SPAC and a traditional IPO. The SEC has also urged Nasdaq and NYSE to impose more stringent listing standards for SPACs.

Given the current regulatory climate and uncertainties, some investment banks have suspended their involvement with SPACs for the time being, and companies are generally reviewing potential SPAC combinations with more caution. As a result, SPACs may no longer be a speedy alternative to public markets.

Despite potential risks, going-public alternatives continue to be evaluated, usually in parallel to a traditional IPO. After the last couple of years, there are many SPACs with significant capital, as well as a number of SPACs that are approaching the end of the period to identify, and complete mergers with, operating target companies.

As such, in some cases, economics may still weigh in favor of a de-SPAC transaction. The SPAC is motivated to quickly complete a merger before being forced to liquidate for not completing its initial business combination within the required time period and may also be willing to pay a premium to ensure timely completion. Companies that go public in a de-SPAC transaction may also incur fewer fees on their end, including avoiding an underwriter discount on, and potential underpricing of, their shares. In other instances, a traditional IPO is a significantly more straightforward path, without the overhang of SPAC-specific accounting, shell company, and liability issues.

Short- & Long-Term Planning

Market conditions in the first quarter of 2022 brought a sharp decline in IPOs—although April 2022 saw a small uptick—and many companies put their going-public plans on hold. Filings to withdraw IPO registrations, particularly for SPACs, have increased dramatically in 2022, with 64 such filings as of April 11—compared with 57 for all of 2021. As the market uncertainties continue, companies and their deal teams are preparing both for the long term and also getting their companies "public-ready" as quickly as possible, so as not to miss an opportunity when a market window opens.

There are still some IPOs in the pipeline. Due diligence, IPO documentation, and public company readiness workstreams proceed, often full speed ahead. Given a potentially longer trajectory, however, many companies may need to obtain capital infusions prior to their previously planned, and possibly delayed IPOs and manage expectations regarding timelines and, potentially, valuations. The performance of the next few large scheduled IPOs should be instructive and is expected to influence other companies' IPO plans.