

JAKE SIEWERT

This is Exchanges at Goldman Sachs where we discuss developments currently shaping markets, industries and the global economy. Today we're going to be talking about a timely topic as it relates to the public markets' direct listings and the changing nature of the IPO market. I'm joined in our New York studio here by David Ludwig, head of Americas Equity Capital Markets in Goldman Sachs' Investment Banking Division. David, welcome to the program.

DAVID LUDWIG

Thanks, Jake. It's good to be here.

JAKE SIEWERT

So last week we hosted a conference out in Las Vegas that brings together private companies with investors in the space. Explain a little bit about what that conference is and why we host it.

DAVID LUDWIG

Absolutely. So this was our ninth annual Private

Innovative Company Conference where we gathered the next generation of emerging technology companies together with over 500 attendees from the venture capital, corporate and private equity communities. This setting has actually become one of the key events that allows those companies who are driving disruption to connect and network with those with the foresight to fund long-term vision.

JAKE SIEWERT

So David, given the market backdrop you described, why is there interest right now in different ways of helping companies approach or enter the public markets?

DAVID LUDWIG

So Jake, when you think about the continuous evolution in the equity market and some of the step function that happened over the last decade, there has to be different alternatives to just a true IPO, and for decades the IPO has been the primary

avenue for companies that debut in the public markets and raise capital to the extent necessary, but the needs of a lot of companies have ultimately changed, and so what we've been focused on is, how do we help companies list in the way that's best suited for them? And so when you think even about the IPO, the IPO has evolved with greater customization, a focus on transparency and removal of the frictions that our clients are focused on.

But at the same time, we're very excited about some of the new pathways that have emerged over the last handful of years: most notably in the last couple of years the direct listing which we discussed in depth at PICC this year,... we're really proud that we served as the lead advisor in the first two direct listings, Spotify and Slack. Both of those were very successful in how those companies debuted in the public market, and each one of our clients' objectives were achieved over the course

of those processes, and we expect to be at the forefront of continued innovation in the months and years to come and believe that companies entering the public markets should be considering a direct listing and ultimately seeking the path that best achieves their objectives.

JAKE SIEWERT

Well, David, thanks for that introduction and thanks for joining us today.

DAVID LUDWIG

My pleasure being here.

JAKE SIEWERT

As David mentioned, last week at our conference in Las Vegas, I sat down with Barry McCarthy, CFO of Spotify, Greg Rodgers, a partner at Latham & Watkins, and Will Connolly in here at Goldman Sachs to talk all things direct listings. Please listen in to that conversation next.

(GOES TO LAS VEGAS PICC PANEL DISCUSSION)

JAKE SIEWERT

All right, thank you. I'm Jake Siewert and I work at Goldman Sachs,

I'm joined by we'll go from the far side to the near side. Greg Rodgers, who's a partner at Latham & Watkins and has been counsel on the two major public listings. Barry McCarthy, who's the CFO at Spotify, who is the real trailblazer in leading Spotify's direct listing, which was the first major company to use that approach. And Will Connolly, who runs Technology Equity Capital Markets at Goldman Sachs.

So thank you all for coming, and Will, I'll just turn it over to you to do a sort of broad overview of how we got here. Talk a little bit about the history of public markets in 30 seconds or less, and the evolution over the last couple of years.

WILL CONNOLLY

Yes. Great, I'll try to keep it short, and we won't start with the mutual fund in 1924 or anything like that. But the reality is companies have been listing in the public markets for hundreds of years. And Goldman Sachs has been helping companies list there, or succeed in the public markets, for over 100 years, but the reality over that period of time, a lot of things have changed.

So markets have changed, information availability's changed. Capital availability's changed, and businesses have changed as well. And so you have businesses with the benefit of technology that have built to scale much more quickly than they could have in the past, and you've also had several companies that have made the choice to raise a significantly greater amount of capital in the private markets than they would have ever done before. And against that backdrop, companies' needs and objectives are changing. And when those needs and objectives change, it makes sense that people

would seek out new ways to enter the public markets and seek out a more diverse set of approaches to enable them to be successful against their objectives.

And I think from our perspective, we had the unique opportunity to work with both Spotify and Slack as the lead advisor on their direct listings over the course of the last couple of years. And we're thrilled for their success, and Barry in particular, in really being the innovative force behind this new technology, if you will. And we're excited about the opportunity to continue to seek innovation on behalf of our clients.

I think the interesting thing, it's a fascinating topic and a lot of people have perspectives and it's getting a lot of discussion right now, which is great. It's put a new rigor on the process or thinking around going public across a wide range of

matters. And so I think that's fantastic, and in particular, we couldn't have two better people to talk about it with this group here today.

Barry is the visionary and the vanguard, and really had the foresight and confidence to believe you could do something a different way, and do that successfully. And Greg, who served as both counsel to Barry and the Spotify team, but counsel to Goldman Sachs around Slack, has really played a leading role in creating the legal framework, and evolving the legal frameworks; we'll talk about evolution, to make this a successful option for companies to consider.

JAKE SIEWERT

So Barry, you're the trailblazer, the pioneer. What gave you the confidence to know; it was obviously risky to do it, but what gave you the confidence to know that it was the right thing to do for Spotify, and you've been CFO at another public

company, maybe that perspective informed your decision. And what were the objectives you were to achieve?

BARRY MCCARTHY

Before I answer that, let me just suck up to my host and say no Goldman Sachs, no Spotify, because every step of the way they were there to lead the financings, and into the public marketplace. And how much of an innovator was I? I just took an old, tired idea that had already existed in the public markets and recrafted it, and applied it to a tech IPO. And I was smart enough to turn to Greg and say: Do this for me. No Latham, no direct listing. So when I took Netflix public, in the 12 months prior to going public, I think we had 600,000 subs, 71 million of revenue, \$13 million of cash on the balance sheet. And then that was in 2002; in 2010 when I left, for that calendar year, there were 21 million subs, two billion revenue, 150 million of cash, net of debt. When we were thinking about

taking Spotify public, we had 4.2 billion of revenue, we had 1.7 billion of net cash on the balance sheet, and we had 71 million subs.

And so I realized that it was one of those Dorothy, we're not in Kansas anymore moments. And for a long time, I have watched the public market and thought that it was chronically broken. And I thought surely there must be a better way. So there were a couple of things I was trying to solve for,. One is it's just an IPO without the 'O.' And we had a billion seven of cash, and which we couldn't even begin to deploy at the time, so if we had gone public, we would have sold 12 to 15 percent of the market cap in order to have the liquid secondary market, so it would have been a one-and-a-half, two-and-a-half billion dollar size transaction. For what?

Two, we wanted liquidity. In a traditional process,

everybody gets locked up for 180 days; maybe that lockup gets staggered. It violated a core principle for us. I think we had 2,100 shareholders; we had employees who had owned the stock for a long period of time. We wanted them to have the opportunity to get liquid at the same time other shareholders were able to get liquid.

Three, we had this core value around radical transparency. We'd been absolutely transparent with our private shareholders; we wanted to take the same approach with public shareholders. And there's this quiet period that's imposed by the 33 Act, when you're going public, and the staff graciously agreed to work with us to allow us to both give guidance and to host an investor day. If you want to understand what the best practice is for dealing with investors, look to the public market.

Well, public market companies don't have

roadshows; they have investor days. And they present the entire strategy over three or four hours, the investors get to see the entire management team. We got to put it up on the web and make it simultaneously available to everybody in the world at the same time; I think we had something like 27,000 streams in that first day when we put it up there. We had educational videos about how the business model worked, and so we used the power of the web to help people engage in the process.

And then lastly, we wanted market-based price discovery. And every stock, including direct listing stocks, open exactly the same way. Every day.

When we looked at the universe of companies that have gone public, particularly transactions over a billion dollars, it looked to us like you had a one-in-ten chance of having a successful offering and a successful offering defined by the bank, would vary

a little bit by bank, would be something like 27 to 30 percent price increase on the first day of trading; on the close on the first day of trading, as compared with the issue price.

There's all this friction that gets introduced into the process; lockups is one of them. You've got hedge funds shorting into the lockup expiration, and there's market stabilization and then they're artificially limiting the demand in order to stoke the price, and it's just all bullshit. And I had this core belief that wisdom of crowds trumps experts, and if we just would eliminate the friction and get out of the way, the marketplace would find equilibrium like that. And that is, in fact, what happened, which is why we get to sit up here today.

JAKE SIEWERT

So you talk about having the market decide the price, and deciding who gets the shares. Most of the people in this room have had the ability so far

to choose their shareholders and choose their prices. What's that transition like?

BARRY MCCARTHY

Well, as a public company you don't have any control over who your shareholders are, and if you think you're going to, you need to lie down 'til the thought passes, then get back up. The best you can hope to do is go spend time with people you think are really smart, and convince them that they ought to own the stock, too. So you can encourage some people to buy it based on the way you allocate your time, but you can't prevent others from owning the stock once it becomes public.

Now, I would say a related insight is that the long-term shareholders that the banks are going to encourage you to spend your time with; Fidelity and T. Rowe and others, who are going to buy the stock and put it away on the shelf, have no influence whatsoever on your stock price. None.

Because they don't participate in the price-setting mechanism. They're sitting out the dance.

As I watched over time, and the average sized trade in Netflix, from 2002 to 2010, just dove for the floor, even as the total volume increased dramatically. And it's because the high frequency traders are now part of the game. And it's the momentum guys and the high frequency guys who set the price. So go spend time with the big guys because, one, they can buy a lot of stock, so you get a good return on your investment of time. Two, they're super-smart, they have great insights, so you'll learn a lot. Those will be more enjoyable meetings. But don't do it because you think it will help your stock price; it won't.

JAKE SIEWERT

So, Greg, you were counsel with Spotify, you were counsel with Goldman on the Slack direct listing. Barry mentioned how the SEC allowed certain

things. How is the SEC approaching this phenomenon, and particularly as it starts to maybe take off next year, and what should companies be thinking about in terms of their risk, direct listing versus IPO?

GREG RODGERS

Spotify came around at exactly the right time in the sort of regulatory regime. I mean we got very lucky with Barry being an innovator; Barry's boss is a disruptor in his business. But over on the SEC side, we got sort of lucky. The chairman of the SEC, Jay Clayton, is an ex-deal guy himself. The head of corporate finance is a guy named Bill Hinman, he's a deal guy from the Valley. So from a very top-down perspective we got a lot of support for trying to do something new. That's sort of the good news.

The bad news, right, is the SEC's mandate is to protect the small investor. So once we got buy-in

at the high level, there was a ton of work to work out the details. And Spotify, it took about a year, roughly, from start to finish. A normal way IPO is more like six months. That incremental time was all spent working out details with the staff, among several work streams. What the disclosure would look like. We did REG-M, that's market manipulation rulemaking. The NYSE required its own rulemaking.

Now, the good news for the people in this room is we were involved in a meeting literally today in Washington, D.C., where one of the top regulators referred to the way that Spotify and Slack did their listings as the old way, and it's totally fine. So two is now a playbook we can follow, and as long as you know the secret sauce, you should be fine if you go that route.

JAKE SIEWERT

So the documentation's similar, but what are the

tradeoffs from a legal perspective? Do you see any gradations in the risk for the issuer?

GREG RODGERS

Yes, so that's still wide open. We haven't had any jurisprudence that would test the relative liability regimes, but I personally think that on an apples to apples basis, and you got to make some assumptions, right? Because a normal IPO would be a 15 to 20 percent quote probably; Slack traded like 30 percent on the first day. So it's more a shares trading. More shares, theoretically more liability.

But the direct listing has a few good things going for it. One, a lot of those trades were actually not under the registration statement. I won't get into it with you guys, but there's two ways shares sell in a direct listing. One is under the registration statement; one is pursuant to rule 144, which has a much lower liability regime associated with it. And

the mix is very important. Actually, in Spotify there were very few we believe; they're hard to trace, which is the second advantage I'll get to; very few actual registered sales.

Then, to the tracing point, a plaintiff should, in theory, have to make a registration related claim, trace its purchase back to the registration statement. And in a normal way, I feel that's pretty easy because all of the shares for the first six months were registered shares; everything else was locked up. In a direct listing, the whole pre-listing float becomes available. Many of those sales were happening under rule 144. Our litigators like the tracing argument there.

And then third, there's just a different damages analysis. All these suits we're talking about are mainly stock drop suits, and you usually get tagged for the difference between what the company sold

at, and what it dropped to. In a direct listing, with market-based pricing, what's the argument? We'll see that play out, but I think on an apples to apples basis, we like the chances.

JAKE SIEWERT

So, Will, talk a little bit about the bank's role. And assess the two direct listings, the two big ones. How do institutional investors feel about that several years in?

WILL CONNOLLY

Yes, well look, I think the two direct listings were hands-down successful. Barry walked through his objectives, and those objectives were achieved. And Slack had slightly different objectives, and we made a few tweaks, and their objectives were achieved. So the first two direct listings were definitely successful, and that's why you'll see more of them.

I think one of the interesting things about first to the

second is we did see, in some respects, a shift in investor participation. Investors who talked to us after Spotify's direct listing and said: That was a difficult process for us; we don't know how to get our arms around it, we didn't feel comfortable participating in it. Some of those investors actually were some of the most active participants in Slack's direct listing. And so that shows the market's learning, and the market's capable of learning. So I think that's great from a success perspective.

There's still things where the direct listing can get better and continue to evolve, and I think we're going to see that. So there should be more flexibility for more companies to do more different things within the context of direct listings. For example, potentially raising capital. Those are things we're working on.

On the other hand, the market should get better at trading direct listings, too. And right now they have an N of two, and that N is going to grow, and the market's going to learn. And so I think the market will have a better ability to handicap. And Greg made the reference, an IPO you have a set float; 10, 15, 20 percent. You know what the supply is for a six-month period. In a direct listing you don't, and I think the market's going to figure that out over time and change or modify their behavior in a similar way, just to drive hopefully greater efficiency at the end.

I think as it relates to the bank's role, is actually not that different. We're doing all of the things that we would; do in an IPO; we're giving company advice on positioning, we're helping talk through metrics and guidance strategy, we're talking about what investors they should be visiting and educating, we're giving advice on the analyst day. We're

anticipating what questions people are going to ask, we're making sure the plumbing's going to work so that it goes off without a hitch.

We can't execute a roadshow with the company because that would be an underwriting activity. So the company goes on its roadshow by itself, and then we go on our roadshow and go see all the potential sellers and all the potential buyers, and have multiple meetings to help inform both sides of the market how that market's going to develop. And an informed market will hopefully lead to efficient outcomes. And so you actually have multiple roadshows going on in the case of a direct listing between the time the company goes effective and the time the stock actually starts trading. So I think it's actually really similar; there's just legally some slight differences about how we go about it.

JAKE SIEWERT

So, Barry, what advice would you give to people in this room who are thinking about entering the public markets? And not all of them may have the built-in advantages that you had at Spotify, with the healthy cash, healthy business, really without the need for new capital. How should they think about the risks? And is there anything that you now would have done a little bit differently, having gone through it?

BARRY MCCARTHY

Well, there are many elements of the direct listing process that you could make part of a traditional IPO. Like you could give guidance, you could in addition to roadshow, host an investor day. I think those would be smart things to do. You'd still be subject to a lockup and you wouldn't get the benefit of price discovery, and depending on the skillset of you and your CFO, and the depth of your accounting team, you may not be trying to optimize for your cost of capital, and you don't really care

about the 30 percent discount you're going to leave on the table. And a traditional offering will work fine.

Looking back on your IPO ten years from now, you'll realize that notwithstanding all of the hoopla; it's just a financing event, that's all it is. It's a pretty expensive financing event, but from time to time there are inefficiencies in the capital markets, so it affords you the opportunity to raise capital in really inexpensive ways. So if your business needs cash, just think opportunistically about where your lowest cost of capital is, go get it when the window opens, and then if you have the luxury of being well-capitalized, you can think more creatively about your going public event than you would if you were cash-strapped and absolutely had to have it now. You could raise it before or you could raise it after. Like if you did a secondary transaction, you're

going to pay a two percent discount to the days close, maybe four; that's it. That's your total transaction cost. So do a direct listing, be public for six months and then do follow-up.

JAKE SIEWERT

So, Greg, Barry mentioned a secondary. What are the chances that the SEC comes around and allows a direct listing with a simultaneous or near-simultaneous raising of capital?

GREG RODGERS

The SEC's mandate is to have as many public companies as possible. And I think they do recognize that the inability to raise primary capital is a limiter. So I think in the long term, I like our chances there. There are a number similar to the first process, that got us to the secondary; there are a number of hurdles to sort of overcome, so I think it'll take a while. In the meantime, as I said, they're very happy with the Spotify Slack playbook, and to Barry's point, you can raise capital before or

you can do a 144-A convert right after, and then a year after, you're a seasoned issuer and can do any sort of short form registration you like. But I do like the chances long-term for primary capital.

JAKE SIEWERT

And so, Will, as the market evolves and companies explore different options, how are the banks thinking about what they're going to be offering, and will there be a bewildering array of choices, or will it be relatively IPO, direct listing, or direct listing-plus?

WILL CONNOLLY

I think there's going to be a lot of options,. And I think we're evolving to an era where you're going to have companies in a lot of different positions with a different set of objectives. And there's no cookie-cutter approach that should be employed for every company. Doing something because someone else did it is the best way to get to a bad solution for you. And I think that's the way

that people are going to start looking at it. People are going to start saying: What am I trying to design? And it'll be more efficient than when Spotify did it, because they broke a lot of new ground. But it'll be more efficient, and people will feel greater license to modify things around their set of objectives.

And so I think the direct listing, what does that mean? That means the direct listing is here to stay and we're going to see more of them. And I think we're going to see changes. So as Greg mentioned, I think at some point we'll see primary capital in the direct listing. It also means that I think the IPO's going to change, and so an ancillary benefit of all this discussion is people have been looking at it and saying: Well, should a lockup exist; should it not exist? Should we be pricing more aggressively than what was historically a definition of success? And I think

those are all really smart questions for companies to be asking, and the result is we're talking about with every company that's thinking about entering the public market, we're talking about direct listing and we're talking about how we can design something that's successful relative to their objectives. And I think that's a really great outcome.

GREG RODGERS

If I could comment on that, Barry made the reference of borrowing tools from the direct listing to the IPO. The truth is the same is in reverse; like Barry chose not to do a traditional roadshow, chose not to do like sort of analyst activity, but you could incorporate that, particularly in a business that was harder to understand than Spotify.

WILL CONNOLLY

Yes, Slack did a bunch of the roadshows.

BARRY MCCARTHY

You're relying on your underwriters, equity

research analysts, to basically teach the street your story. It's important to realize that that educational process doesn't exist in a direct listing. Because there are no analysts that come over the wall, which I happen to think is a good thing. And among the reasons we gave the investor day was to teach the entire analyst community how the business model worked and what our expectations were for future performance, and right after the investor day, all of them began to publish research about Spotify. And suddenly you had this enormous echo chamber that was educating the world of institutional investors about how the business model worked; that doesn't exist in the traditional process. There is no echo chamber.

But more importantly, if you're not doing the talking, nobody else is. And so you can hear the sound of crickets. So if you're not prepared to give guidance, if you're not prepared to educate

investors, you're going to end up in a really bad place. Imagine it's Friday night, your partner/significant other is expecting you for dinner at seven p.m. And you get stuck at work and you don't show up 'til 10, and you didn't call. How do you suppose that ends? Not well, right? And if you had called, or emailed, and you managed expectations, it would have been a much better outcome.

It's the same relationship with institutional investors. However little you know about your business, you know a lot more than they do. And so if you're waiting for them to fill in the blanks, it's going to end badly for you. So I couldn't encourage you strongly enough to give guidance and give real guidance. Because if you're just going to sandbag your guidance, saying you're going to outperform your guidance, all you're doing is teaching them to ignore you, and you might as well not have participated in the conversation in the

first place, because they are going to ignore you and they're going to start setting their own expectations for the performance of your business.

So don't go do a direct listing if you're not prepared to give guidance.

JAKE SIEWERT

So before we get a question or two, I'm going to ask you to make a prediction for next year; not who's going to win the presidential election, although that'll be fun, but how many direct listings do you think we'll see next year? I'll start with you, Greg.

GREG RODGERS

We talk about this a lot. I have some inside information on this topic, but I'd say at least five.

JAKE SIEWERT

Barry? You have no inside information, what do you think?

BARRY MCCARTHY

No, I have no idea. I mean I solved their problem, I have no idea what the rest of the world is about.

JAKE SIEWERT

You must have some insight?

WILL CONNOLLY

We're working on it with a number of companies right now, and I would anticipate that there'll be more next year than there have been in totality to date.

JAKE SIEWERT

Okay, so three-plus.

BARRY MCCARTHY

There's continued momentum until somebody falls on their face, and then there'll be a reset.

JAKE SIEWERT

That's true of the IPO as well.

JAKE SIEWERT

All right, thank you very much, thanks for joining us.

That concludes this episode of Exchanges at

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