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MASTER'S THESIS

**ALTERNATIVE WAYS OF GOING PUBLIC: CASE OF SPOTIFY**

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# TABLE OF CONTENTS

<b>INTRODUCTION</b> .....	<b>1</b>
<b>1 INITIAL PUBLIC OFFERING</b> .....	<b>3</b>
<b>1.1 A Brief History of The Initial Public Offering</b> .....	<b>4</b>
<b>1.2 Key participants and expected costs</b> .....	<b>5</b>
<b>1.3 Pricing</b> .....	<b>7</b>
<b>1.4 Traditional IPO Process</b> .....	<b>8</b>
<b>1.5 The Decrease in Traditional IPOs</b> .....	<b>10</b>
<b>1.6 Advantages and Limitations</b> .....	<b>12</b>
<b>2 DIRECT PUBLIC OFFERING</b> .....	<b>12</b>
<b>2.1 A Brief History of Direct Public Offering</b> .....	<b>13</b>
<b>2.2 SEC Regulations for Direct Listing</b> .....	<b>14</b>
<b>2.3 The NYSE and Nasdaq Rules Applicable to A Direct Listing</b> .....	<b>15</b>
2.3.1 Selling Shareholder Direct Listing .....	16
2.3.2 Primary Capital Raise via Direct Listing .....	18
<b>2.4 The Role of Investment Bank</b> .....	<b>20</b>
<b>2.5 Advantages and Limitations</b> .....	<b>21</b>
<b>3 CASE STUDY: ANALYSIS OF SPOTIFY DIRECT LISTING</b> .....	<b>22</b>
<b>3.1 About Spotify</b> .....	<b>22</b>
<b>3.2 Spotify’s Dual Stock Structure and Control Rights</b> .....	<b>24</b>
<b>3.3 Spotify’s Process of Going Public</b> .....	<b>26</b>
3.3.1 Mechanics .....	27
3.3.2 Role of Financial Advisors .....	28
3.3.3 Pricing and listing .....	29
3.3.4 Cost .....	29
<b>3.4 Reasons Behind Spotify’s Direct Listing</b> .....	<b>30</b>
3.4.1 Underpricing .....	31
3.4.1.1 <i>IPOs and Underpricing</i> .....	31
3.4.1.2 <i>Direct Listing and Underpricing</i> .....	33
3.4.2 Dilution .....	34
3.4.3 Liquidity .....	34

<b>3.5</b>	<b>Discounted Cash Flow Valuation of Spotify</b> .....	<b>36</b>
3.5.1	Discount rate .....	37
3.5.1.1	<i>Cost of Equity</i> .....	37
3.5.1.2	<i>Cost of Debt</i> .....	39
3.5.2	Current Earnings and Cash Flow .....	40
3.5.3	Future Earnings and Cash Flows.....	40
<b>3.6</b>	<b>Spotify after DPO</b> .....	<b>44</b>
	<b>CONCLUSION</b> .....	<b>46</b>
	<b>REFERENCE LIST</b> .....	<b>48</b>
	<b>APPENDICES</b> .....	<b>57</b>

## LIST OF FIGURES

Figure 1:	Average IPO costs in the U.S. in 2012, by company revenue.....	7
Figure 2:	Sample timeline and process overview of an IPO .....	8
Figure 3:	Number of U.S. offerings and average percentage first-day returns, 1980-2020.....	10
Figure 4:	Number of users per provider between 2016 and 2021 (in million).....	23
Figure 5:	Number of Spotify monthly active users (MAUs) worldwide from 1st quarter 2015 to 3rd quarter 2022 (in million).....	23
Figure 6:	Spotify quarterly revenues from 2016 to 2022 (in million EUR).....	24
Figure 7:	Stock Ownership of Spotify.....	25
Figure 8:	Spotify's process for its listing .....	26
Figure 9:	Spotify's stock price on its first trading day .....	45
Figure 10:	Price History and Performance .....	46

## LIST OF TABLES

Table 1:	Key participants in the IPO process and their basic roles.....	5
Table 2:	Expenses of the registration .....	30
Table 3:	Main characteristics of a traditional IPO, a pure direct listing, and Spotify's direct listing.....	30
Table 4:	Cost of Capital calculation .....	37
Table 5:	Cost of Equity calculation.....	38
Table 6:	Bottom-up Beta calculation .....	39
Table 7:	Cost of Debt calculation.....	40
Table 8:	Present Value of Future Cash Flow calculation (in million USD) .....	42

Table 9: DCF Analysis of Spotify (in million USD).....	43
Table 10: DCF Analysis of Spotify, growth of revenue 40 percent (in million USD).....	43
Table 11: DCF Analysis of Spotify, cost of revenue 50 percent (in million USD).....	44

## LIST OF APPENDICES

Appendix 1: POVZETEK.....	1
Appendix 2: Spotify's Present Value of Future Cash Flow calculation, growth of revenue 40 percent (in million USD).....	3
Appendix 3: Spotify's Present Value of Future Cash Flow calculation, cost of revenue 50 percent (in million USD).....	4

## LIST OF ABBREVIATIONS

sl. – Slovene

**CAPM** – (sl. model oblikovanja cen kapitalskih sredstev); capital asset pricing model

**CDL** – (sl. neposredna uvrstitev podjetja); company direct listing

**DCF** – (sl. diskontirani denarni tok); discounted cash flow

**DMM** – (sl. imenovani vzdrževalec trga); designated market maker

**DPO** – (sl. neposredna javna ponudba); direct public offering

**DTC** – (sl. depozitarno skrbniško podjetje); depository trust company

**EUR** – (sl. evro); euro

**IDO** – (sl. izdajatelj neposredne ponudbe); issuer direct offering

**IPO** – (sl. prva javna ponudba); initial public offering

**MAU** – (sl. mesečno aktivnih uporabnikov); monthly active users

**NYSE** – (sl. Newyorška borza); The New York Stock Exchange

**SEC** – (sl. Komisija za vrednostne papirje in borzo ZDA); U.S. Securities and Exchange Commission

**SPAC** – (sl. namensko osnovano prevzemno podjetje); Special Purpose Acquisition Company

**SRO** – (sl. samoreglativne organizacije); self-regulatory organizations

**US** – (sl. Združene države Amerike); the United States

**USD** – (sl. Ameriški dolar); United States dollar

**WACC** – (sl. tehtana povprečna cena kapitala); weighted average cost of capital



## INTRODUCTION

Many entrepreneurs believe that finding available financing is possible with the sound foundations of a business idea (the market opportunities, the management team, the operating systems, and controls) (Timmons & Sander, 1989). But the structure of funding sources changes with growth, internationalization, and changes in the respective industry. When debt financing might not be accessible anymore the company has to look for alternative capital-raising possibilities. To expand their business and invest in future operations, companies start to consider going public (EY, 2018). For other entrepreneurs, taking a company public may be the ultimate dream and mark of success, followed by a large payout (Hall, 2020).

The term “going public” can be used generally to describe any securities offering to the general public, i.e., common stock, debt, rights, or warrants (Sjostrom, 2001). Traditionally going public refers to a private company’s initial public offering (hereinafter: IPO) of common stock. An initial public offering is the process of the first sale of a company’s common shares to stock market investors on a publicly traded stock exchange. Thus, the company becomes a publicly traded and owned entity. For selling shares of the company’s common stock to the general public is responsible the underwriter. This is usually one or even more investment banks. But for listing, the company must meet some general requirements made by underwriters. Predictable and consistent revenue is one of them. Some underwriters request revenues of 10 million USD to 20 million USD per year with profits of around 1 million USD (Hall, 2020). Additionally, there should be presented the potential to achieve and sustain significant growth rates (i.e., 20 percent or more in revenues) for the next five to ten years (Sjostrom, 2001). Therefore, many companies are unable to go public due to unmet requirements.

One of the underwriter’s duties is to determine the price of the company’s stock and allocate shares among buyers. A great number of original IPO shares are distributed among regular customers that are mainly institutional investors. Consequently, most individual investors never get the chance to buy original IPO shares. According to Jay R. Ritter (2019), a finance professor at The Warrington College of Business at the University of Florida, “*Typically, 85 percent of a company’s shares during an IPO are sold to institutional investors, and the rest to individuals.*” So, on the first day of an IPO, shares are usually sold from institutional investors that bought original IPO shares from the underwriter to individual investors in the aftermarket (Hurt, 2005).

Underwriters determine the price of the original IPO stock in a way to attain the so-called “pop” – market terminology for when on opening day shares trade above their IPO price (Gonzalez, 2019). Investors buying original IPO shares at the offering price have practically ensured first-day profit. As Barry McCarthy, Spotify's chief financial officer explained for Inc. (2019), “*It's basically the fee that investors extract from investment bankers for their*

*continuous participation in the deal flow.*" Lately, we could observe some record "pops" for a large United States stock. In December 2020, Airbnb's shares finished up more than 112 percent the day after its IPO. Based on the price gain from its IPO this first-day swing made Airbnb the 10<sup>th</sup> best entrance in 2020 (Feiner, 2020). The question arises, are these lost profits for the company? Are IPOs creating underpriced new listings? And could we maximize shareholder value?

As an answer to described matters above more and more companies are looking for alternatives when raising capital and going public. Evidentially, there is a severe decline in the number of IPOs per year. Looking back, between 1980 and 2000, more than 300 companies went public each year (Nova, 2019), compared with an average of 180 a year between 2000 and 2020 (Statista, 2021a). Lately, an increasing number of companies are choosing non-traditional ways of going public. In 2020 we could observe a significant rise in the number of special purpose acquisition companies (hereinafter: SPACs) that went public (Statista, 2021a). Nonetheless, even more attention in recent years has received so-called direct public offerings (hereinafter: DPO). Although both alternatives to traditional underwritten initial public securities offerings have existed for decades, we can notice important updates in regulations. After Spotify's and Slack's successful direct listed offerings in 2018 and 2019, the U.S. Securities and Exchange Commission (hereinafter: SEC) has recently approved a proposed rule by the New York Stock Exchange (hereinafter: NYSE). Companies are now allowed to raise capital through a direct listing (Herren Lee & Crenshaw, 2020).

The purpose of the research is to explain why more and more companies today opt for non-traditional ways of going public, such as direct public offering (DPO). Why initial public offerings (IPO) are not a preferred option anymore? Furthermore, the purpose is to identify and provide an explanation regarding IPO's shortcomings, and DPO's advantages.

The goal of the master thesis is to explore the raising equity capital market and its regulation in the United States. Due to the wide list of nationally applicable rules research will focus only on the United States market and regulations there. The United States is the country with the largest stock markets worldwide. As of January 2020, their share of the total world equity market value was 54.5 percent (Statista, 2020). Namely, the two largest stock exchanges by market value worldwide are New York Stock Exchange and NASDAQ.

The primary research objective of this thesis is to explain the differences between initial public offering and direct listing based on an analysis of the capital market in the United States and the case study of an example. More specifically, the research will focus on a case study of the music streaming company Spotify. In 2017 Spotify started its process of direct listing. Spotify was the first large company in history that decided to use direct listing to go public. It was a novel approach and Spotify needed to work closely with the SEC to execute the listing. If Spotify is successful, this could change the way how companies will go public in the future. The following research questions will be used:



RQ1: Do IPOs create undervalued shares?

RO2: Why do larger companies choose DPO?

RO3: Does DPO creates better shareholder value than IPO?

RQ4: Why would a company choose a DPO over an IPO?

The research methodology used in this thesis is based on an in-depth theoretical and analytical review of existing literature. First, the history and concept of going public will be presented. Primarily, I will focus on secondary sources such as foreign scientific articles published by a broad range of professionals and institutions governing the United States capital market. Later, this theory will be tested through the analysis of an example. The following methodology will be applied:

- Exploring the theoretical background to understand the concept of raising equity capital and going public in the United States. The theoretical background includes the theory of Initial Public Offering and Direct Public Offering.
- Researching the already known practices of a direct listing, their advantages, and disadvantages.
- Analysis of practical example of a company going public through a direct listing.
- Defining own viewpoint and conclusion based on comprehensive literature examination.

The master thesis is structured in two parts. Part one is a deep theoretical overview of scientific literature on public offerings and consists of two chapters. The first chapter includes a brief overview of the structure and characteristics of traditional IPOs. This overview is followed by a concise treatment of the IPO's history, regulation, and process. At the end of the first chapter advantages and limitations of IPO are presented. The second chapter of part one describes an alternative approach to going public. First, it covers the history and evolvement of direct listing and later provides information on the development of direct listing regulations in the United States. Understanding public offering processes and regulations is a baseline for further analysis of the selected example. Part two covers the entire extent of a case study of the selected company that has executed a direct public offering. Empirical analysis and obtained results are explained and further questioned in this chapter. Based on discounted cash flow valuation method a company valuation is estimated. Following is an overview of a company's situation after the listing.

## **1 INITIAL PUBLIC OFFERING**

IPO stands for initial public offering and is a process when the shares of a private company are sold to investors for the first time (Statista, 2017). Those investors can be retail, banks, mutual funds, insurance companies, or similar. Initial public offerings have enormous

importance in the allocation of resources in market economies (Anderson, Beard, & Born, 1995). Therefore, it is important to understand how IPOs work.

The issuance allows businesses to raise capital from the general public (Skaff, 2020). However, large proportions of IPOs are split into tranches, each targeting a different kind of investor (Iannotta, 2010). They are typically divided into a retail tranche and an institutional tranche, where the latest takes 70-80 percent of total offerings, meaning only 20-30 percent of the total offering is available to retail investors (Iannotta, 2010). In some cases, particularly for larger IPOs, there could be a “friends and family” tranche or an “employee tranche”. Usually, all tranches have the same price, but there might be exceptions depending on the jurisdiction. For example, employee tranche shares are offered at a slight discount (Iannotta, 2010).

When a company sells and issues new shares, we are talking about the primary offering (Iannotta, 2010). Another name for a primary offering is an IPO which enables the company to be publicly traded and raise capital (Skaff, 2020). A secondary offering is when an already listed firm is selling its issued shares, belonging to existing shareholders. The ownership of existing shares is transferred, and the shares of current shareholders are not diluted in this process (Skaff, 2020). The liquidity of the company’s shares increases, but the company does not profit directly from the sale of these shares (Skaff, 2020). Many IPOs are a blend of primary and secondary offerings (Iannotta, 2010). Some shares are newly issued, and others are current shares of the existing shareholders.

## **1.1 A Brief History of The Initial Public Offering**

The history of IPOs goes way back to the 17<sup>th</sup> century. Foundations of modern financial systems were developed by Dutch financial innovators (Goetzmann & Rouwenhorst, 2008). The Dutch economy depended heavily on a different group of competing trading firms operating separately and, in their interests, to buy and sell goods through Europe and Asia (Beall, 2020). The Dutch East India Company was established in March 1602 to defend the Dutch’s government geographic routes and maintain a merchant trade monopoly in the Indian Ocean (Beall, 2020). To do so, the Dutch East India Company would need funds that were not available to the government. To finance their business, they introduced at that time a novel approach. The Dutch East India Company was the world’s first company to sell its ownership of the company to the general public in the form of shares and bonds (Stringham, 2015). The outside investors received interest in the form of dividends yielding between 12 and 63 percent (Beall, 2020).

In the United States, the first modern IPO appeared around 1783 with the public offering of Bank of North America on the New York Stock Exchange (Museum of American Finance, n.d.). But the real evolution began at the end of the 19<sup>th</sup> century. Sears Roebuck and Co., at that time the largest mail order house in the world needed more capital to expand the railroad network (Goldman Sachs, n.d.). The company went public in 1906 with the help of Goldman

Sachs bank which educated investors about the opportunity and built crucial relationships for a successful offering. Altogether Sears Roebuck and Co. raised 40 million USD, which is 26.2 billion USD in 2018 dollars (Goldman Sachs, n.d.). Today this IPO is remembered for its innovativeness during a transformative time for American commerce and capital markets (Goldman Sachs, n.d.).

## 1.2 Key participants and expected costs

Before a company begins the process of IPO careful consideration of whether to go public or not should be made. However, let’s see why in the first-place companies consider going public.

There are a few reasons why companies decide on the initial public offering. The four most known motivations found in the literature are the following. The first, and probably the most important reason is liquidity. With an IPO the company can minimize the cost of capital and maximize the value of the company (Modigliani & Miller, 1963). When companies do not have available internal equity or debt financing, they will turn to external equity (Brau & Fawcett, 2006). Secondly, going public may serve as an exit strategy for major shareholders and allows other insiders to cash out (Zingales, 1995). Third, an IPO can help entrepreneurs facilitate the acquisition of the company at an attractive price (Zingales, 1995). By publicly listing shares the company can use them as a “currency” to either acquire other companies or to be acquired in a stock deal (Brau, Francis, & Koher, 2003). Fourth, IPOs could be seen as a strategic step. It can increase the visibility of the company on the financial markets with exposure and publicity through media (Deloitte, n.d.). This can boost the company’s reputation and brand. Additionally, performance-based compensation such as stock options and other management compensations are only possible if a company is listed and thus motivates the management for IPO (Iannotta, 2010).

No matter the reason for going public, the costs are significant due to the regulatory requirements of the process (Trainor, 2003). Additionally, there are many professionals needed to comprise a full registration team for the IPO process. Table 1 shows a full list of key participants and a description of their basic roles.

*Table 1: Key participants in the IPO process and their basic roles*

Participant	Basic Role
SEC	Reviews the registration statement and has the authority to allow or deny the issuance of shares.
Underwriter (Investment Bank)	Determine the value of the company according to industry and market analysis. Lead the marketing of an IPO and sell the securities.

is continuing

*Table 1: Key participants in the IPO process and their basic roles (cont.)*

Participant	Basic Role
Company Personnel	Essential in both the preparation and marketing of the offering. Provide company information necessary for drafting the registration form and assist throughout the registration process. After the filing, top management participates in a roadshow and meets with potential investors to present strategic, financial, and operational information and answer questions. Company personnel includes the CEO, CFO, controller, legal counsel, and other employees assisting with the IPO.
External Legal Counsel	Assists in the process of preparing the nonfinancial sections of the registration statement and responding to the SEC's comments. Drafts key documents for analysts and shareholders, anticipate structural changes, and handle compliance issues.
Underwriter's Legal Counsel	Drafts the underwriting agreement and ensures the completeness of the registration statement on behalf of the underwriter.
Independent Audit Firm	Completing the audit of financial statements and issuing an audit opinion, writing a comfort letter to document the performance of procedures requested by the underwriter, and reviewing all aspects of the registration statement.
Advisory Accounting Firm	Assist in preparation for an IPO. Offers independent counsel on IPO project management, complex financial reporting issues, strategic approaches, internal control matters, and post-deal concerns.
Financial Printer	Prepares the electronic filing for SEC in the requested guidelines and format.

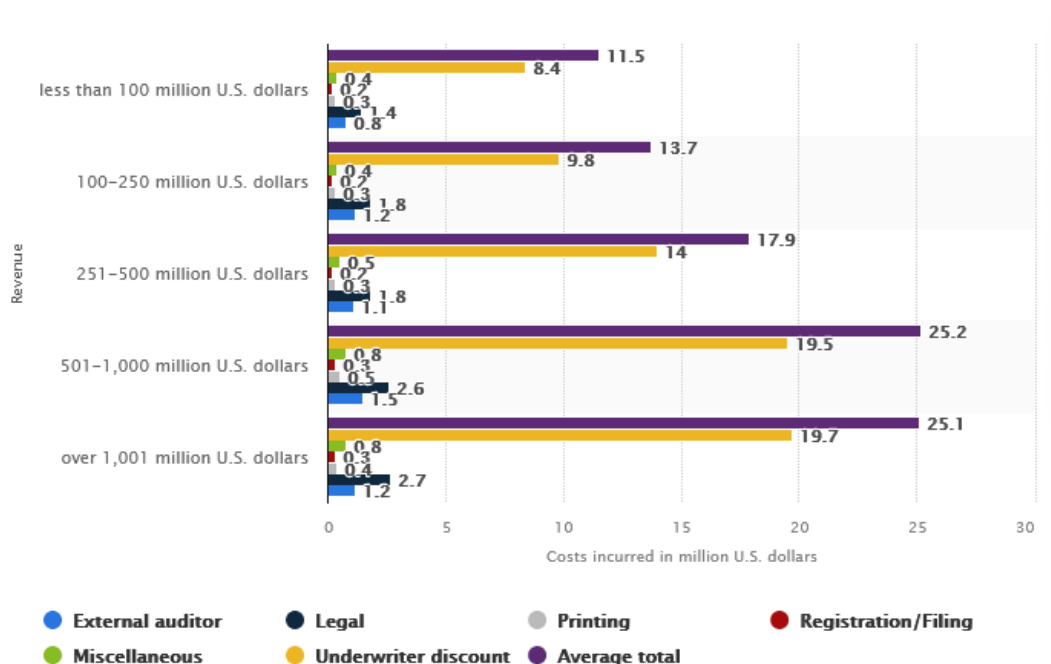
*Adapted from Deloitte (n.d.); Sheffield & Wilks (2017).*

The costs of an IPO can be divided into direct and indirect costs. Direct costs are all the necessary costs to complete the offering such as fees to lawyers, auditors, consultants, and most importantly, investment banks (Iannotta, 2010). The fee to the underwriter is the largest single expense (Trainor, 2003) and generally amounts to between 3 percent and 7 percent of the amount raised (i.e., the proceeds), depending on the deal size (Statista, 2017). On the other hand, the propensity for new issues to be underpriced is one of the greatest indirect costs. There is a common practice of artificially setting the offering price for securities below the aftermarket's expected equilibrium price (Trainor, 2003). It is one of the underwriters' selling techniques to sell the maximum number of securities but results in the "money left on the table" (Trainor, 2003). This loss for the issuer is the difference between the price of sold shares and the price after the first day on the aftermarket (Iannotta, 2010).

As is visible from figure 1, no matter the size of the issuer, the underwriter's discount presents the highest percentage of the total average costs. The larger the company though,

the higher this cost is. For the IPOs where the issuer’s revenue exceeds 250 million USD underwriter’s discount increases up to 78 percent of total costs. Compared with this, other costs seem minimal. Following in second place are legal fees with 7 percent and in third place are audit fees with 5 percent of the total costs for large IPOs (Statista, 2012b). Registration-related costs account for only 2 percent.

Figure 1: Average IPO costs in the U.S. in 2012, by company revenue



Source: Statista (2012a).

### 1.3 Pricing

An issuer and its investment bank have a few different mechanisms to price an equity offering. It is important to discuss the mechanisms and chose one before the IPO process starts as there are some differences in steps taken depending on the price-setting mechanism (Iannotta, 2010). More specifically, we know three primary ways to price and distribute securities which are open price (book-building), fixed price, and auctions.

With the *fixed-price* method, a company determines a price with the help of an investment bank before bids are proposed. The share price is known to investors before the company goes public. When making the application, investors pay the full share price (Iannotta, 2010).

When a *book-building* method is chosen, the data analysis of potential investors’ demand is used to determine the price (Akhilesh, 2020). Through the so-called “roadshow” the issue is presented, and a price range is suggested to institutional investors (Iannotta, 2010). After the roadshow investors bid on shares, specifying the number of shares and the price willing to pay (Rathburn, 2019). Based on the information provided the investment bank settles the

offer price and allocates shares among investors (Iannotta, 2010). When there is sufficient demand at the offer price the book is closed (Iannotta, 2010). This open-price mechanism is widely used in the US (Busaba & Chang, 2010).

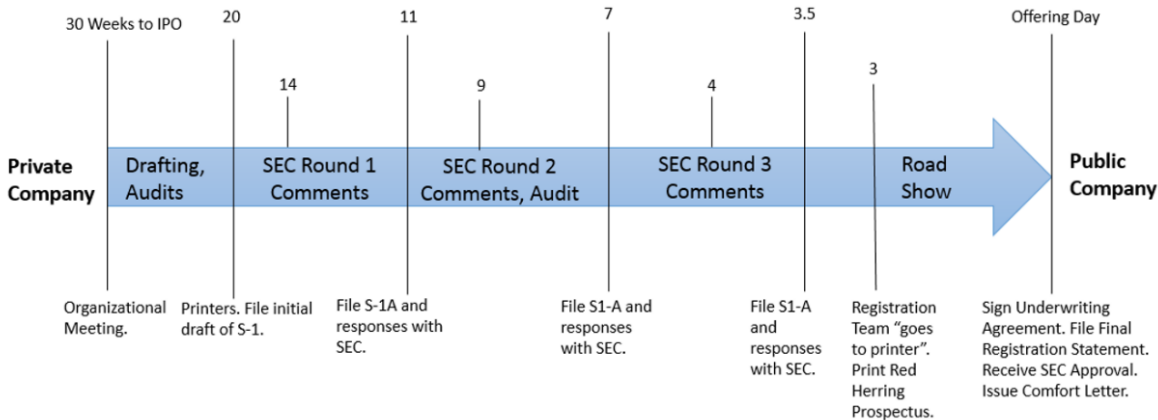
Book-building or open price mechanism is preferred in practice, but a company may use any of the two described styles above alone or in combination (Jagannathan & Sherman, 2006).

Through a Dutch *auction*, the price is determined after taking in all bids from potential investors. Bids are listed from highest to lowest, and the highest bids that enable all shares to be sold are accepted (Telis, 2012). In the end, the price for all winning bidders is the same (Chen, 2020). Auction is the least common method of price setting but there are some well-known examples such as Google’s IPO in 2004 (Iannotta, 2010). Companies turn to this untraditional process to avoid underpricing of shares which is a common problem in the mechanisms described before since underwriters attract investors by selling shares at a discount (Chen, 2020).

**1.4 Traditional IPO Process**

The typical IPO process can be divided into four main steps: selecting the underwriter, registering the offering with the Securities and Exchange Commission, marketing the offering, and closing and selling. As is visible in figure 2, it is a long-term process and takes on average four to six months (Iannotta, 2010). Sometimes, it may even take a year or more (Deloitte, n.d.). Before the process begins it is as well important for a company to prepare and do some pre-public planning to enable a smoother IPO process (Deloitte, n.d.). This may include the preparation of financial statements, auditing, legal review of documents, and nonetheless, making a positive image on the market (Deloitte, n.d.).

*Figure 2: Sample timeline and process overview of an IPO*



Source: Sheffield & Wilks (2017).

The first and one of the most important steps is selecting the underwriter (Skaff, 2020). To do so, a company usually invites several investment banks to discuss the expected public offering price range, underwriting commissions and expenses, and distribution capacity (Sjostrom, 2001). A company and a selected underwriter usually enter into a non-binding letter of intent and determine the size of the offering, the type of securities to be offered, the underwriters' compensation and expense allowance, and the type of underwriting (Sjostrom, 2001).

In a *best-effort* underwriting agreement, the underwriter is not obligated to purchase the securities but agrees on using "best efforts" to sell them on a company's behalf (Kagan, 2020). Underwriters are simply operating as agents. Compensation for the underwriter is paid in a flat commission (Nickerson, 2019). Under a *firm commitment* agreement, the underwriters agree to purchase all the securities offered by the issuer at a fixed price (Kagan, 2020). Then the underwriter sets the public offering price and resells the securities at that price to the interested buyers. As the underwriter takes the risk of setting the right public offering price, the underwriter receives compensation in the form of a spread (Nickerson, 2019). This spread is a difference between the paid price for the security and the public offering price, which is usually between 7 – 10 percent (Nickerson, 2019). This form of underwriting agreement ensures a certain sum of money that a company will receive by a certain date and is most commonly used (Deloitte, n.d.).

The second step in the IPO process is filing a registration statement with the SEC, which is frequently the most time-consuming phase (Nickerson, 2019). The registration statement is a lengthy, informative document including information about the offering, a description of the company, audited financials, managerial information, and a list of key risk factors (Nickerson, 2019). Along with the registration statement company must attach the prospectus, which is a brief overview document given to any investor who purchases or is involved in buying the newly issued securities (Skaff, 2020). By the Securities Act of 1933, it is not allowed to offer securities for sale until the registration statement is filed (Sjostrom, 2001).

After the company files the registration statement with the SEC the "waiting period" or "quiet period" begins (Nickerson, 2019). During this period, the issuer is prohibited from disclosing corporate details that could influence the stock price set by underwriters (Ludovico, 2020). The main goal of this provision is to prevent unfairly manipulated stock prices and to avoid the chance of favoring any investor over others (Ludovico, 2020). While SEC is reviewing the filing, the underwriter creates a red hearing document for the company, which is a copy of the original prospectus (Skaff, 2020). If the book-building method is chosen, the management team of the company works with the underwriter for several months to conduct a roadshow and create interest in the offering (Nickerson, 2019). They promote the offering throughout the country and are "building a book" of interested investors (Nickerson, 2019).

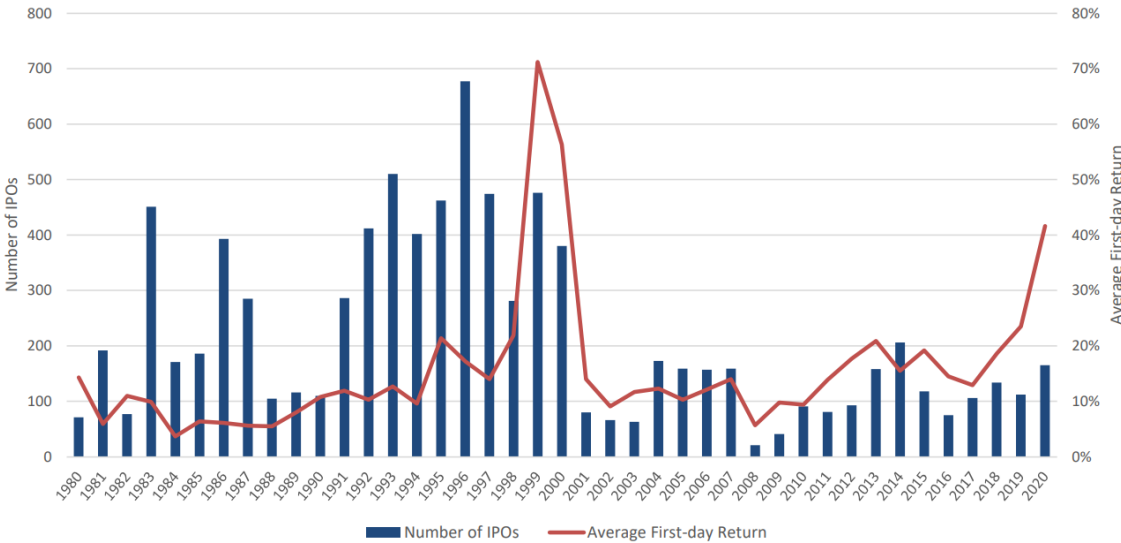
Securities can be sold once SEC declares a registration statement effective (Deloitte, n.d.). Effective day determines when securities will be issued to the public. The price and a specific number of shares to be sold are settled one day before the effective date by the underwriter and the company based on collected information (Skaff, 2020).

Following the issuance of the shares to the public, underwriters often have an overallotment or “greenshoe” option, to buy back shares and stabilize the share price (Nickerson, 2019). Additionally, in most IPOs pre-IPO investors, such as employees of the company and initial investors, are not allowed to sell their securities for generally 180 days after the IPO (Nickerson, 2019). This is called a lock-up period and ensures that the remaining company’s shares will not be sold and consequently lower the price (Brav & Gompers, 2003).

**1.5 The Decrease in Traditional IPOs**

For the past two decades, the declining trend of companies going public is observed. The main shift happened in 2001 when Bubble crashed (Coffee, 2018b). Under regulations at that time caused investors’ distrust in capital markets (Coffee, 2018b). In 2012, SEC has introduced Sarbanes-Oxley Act to increase investor confidence. New regulations included tighter accounting controls and additional disclosures (Christensen, 2018). Nevertheless, as we can see in figure 3, the number of IPOs has never returned to the pre-2000 level. Traditionally, young companies decided to go public to raise new capital and expand their business. But lately, companies tend to remain in the private market longer than before and go public later in their lifecycle, if at all (Herren Lee & Crenshaw, 2020). Twenty years ago, the average listed firm had a lifespan of twelve years, while today's average listed firm has a lifespan of eighteen years and is worth four times more (The Economist, 2017).

*Figure 3: Number of U.S. offerings and average percentage first-day returns, 1980-2020*



Source: Ritter (2020).



Historically, the public market has been one of the most efficient places to raise capital but through the years this has changed (Christensen, 2018). To understand this change we need to investigate different theories and events that might have influenced it. The rise of private funding might be the most obvious. With low-interest rates, money became way more accessible to companies (Christensen, 2018). The Jumpstart Our Business Startups Acts in 2012 and 2015 made it easier for private companies to obtain funding, and to encourage investing act permits much greater investment flexibility for non-accredited investors (Christensen, 2018). Private investors used to be more alert and prepared to invest in any one company only in small amounts (Partnoy, 2018). Due to low stock market returns investors turned to equity investing, providing low-cost funds for startups and early-stage companies (Christensen, 2018).

Another reason for fewer number of IPOs is a dramatic decline in first-day returns that attract investors and underwriters (Coffee, 2018b). This pattern is especially noticeable for small IPOs (less than 60 million USD in annual sales) (Coffee, 2018b). Data is showing that most small offerings have had negative earnings per share for years after the offering and poor first-day returns (Coffee, 2018b). Under the theory of Professor Jay Ritter smaller independent companies do not gain as much value with the IPO as larger companies (Christensen, 2018). Consequently, there is an increasing number of strategic acquisitions of small growth firms by large companies (Christensen, 2018). Premiums in the mergers and acquisitions market are higher than in the IPO market and thus way more attractive to smaller firms (Coffee, 2018b). Consequently, this impacts the number of IPOs as smaller companies are not motivated to go public and rather look for other options.

Some may argue that new regulations including Sarbanes-Oxley harmed new IPOs and associate this drop with higher regulatory costs and complicated SEC rules (The Economist, 2017). Under this theory small- or medium-sized companies have been the most impacted, due to the increased amount of time and money needed to go public (Christensen, 2018). On the other hand, Professor Coffee (2018b) argues that the IPO volume has declined at a similar level in Europe and Japan. In Canada, where regulations are less strict the decline in IPO volumes was even higher (Coffee, 2018b). Let us also remember that the highest cost related to an IPO is the underwriter's discount, while regulatory and legal costs present only a smaller portion.

To conclude, there is no single answer to the decline of IPOs, but it is rather a combination of all the above. The SEC is actively working towards attracting more listings in the public market by changing and accepting new regulations (Herren Lee & Crenshaw, 2020). We can observe that 2021 was a record year in the United States with 951 initial public offerings which is more than twice as many as in the year 2020 (Statista, 2022a). However, only 42 percent of these were traditional IPOs (Statista, 2022b). The number of IPOs typically follows the economy as a whole - an increase of IPOs in times of economic growth and a decline during periods of economic downturn. This explains a dramatic slowdown of IPOs in 2022 due to heightened volatility caused by geopolitical tensions and high inflation.

## **1.6 Advantages and Limitations**

One of the most important advantages of an IPO is capital raising. The IPO results in an immediate cash infusion and as well help with additional future capital raising (Sjostrom, 2001). In 2020 the median IPO raised was 190 million USD, compared to about 100 million USD in the prior year (Cameron & Morrison, 2021). As a result of the ability to trade the company's shares, the overall liquidity of the company's assets increased dramatically (Skaff, 2020). An IPO creates liquidity for founders, early-stage investors, management, and employees after the lockup period (Deloitte, n.d.). Instead of increasing cash compensation, a public company can offer personnel stock options and other incentive compensation plans (Deloitte, n.d.). While an IPO creates a lot of media attention and puts the company in the spotlight, it can bring along positive exposure and a good reputation (Skaff, 2020). Consequently, a company could get new customers and vendors as financial and other data have been reviewed by regulators (Sjostrom, 2001). Prospective vendors and consumers may be more comfortable doing business with a public company (Deloitte, n.d.).

The most evident disadvantage of initial public offerings is, that IPOs are expensive. The largest cost associated with an IPO is underwriter fees, which can amount to as high as 13 percent of the gross offering proceeds (Sjostrom, 2001). Some other additional expenses are legal, auditor, registration, and printing fees (Timmons & Sander, 1989). Overall, the process is time-consuming and requires the company's focus (Skaff, 2020). A public company is also obligated to report operating results every quarter to SEC (Deloitte, n.d.). There is a loss of confidentiality and increased transparency after an IPO. Information such as certain events, directors, compensation, and certain shareholders are now available to competitors, customers, employees, and others (Deloitte, n.d.). Finally, the sale of shares dilutes ownership and consequently reduces the level of control of the company (Deloitte, n.d.). Management and shareholder interests are usually different so there is decreased flexibility in decisions (Sjostrom, 2001).

## **2 DIRECT PUBLIC OFFERING**

A direct public offering is an alternative way to become a public company. The company offers its securities directly to the public (Kenton, 2020). It differs from an IPO in two ways. First, there is no traditional underwriting done by investment banks. As there is no underwriting, underwriters are not required. Cutting out the intermediaries from a public offering substantially lowers the cost of capital of a DPO. Therefore, a DPO is attractive to small companies and companies with an established and loyal client base.

Second, it can be done without issuing securities to public investors to raise capital (Fenwick, 2019). According to Karen Snow (n.d.), "A direct listing provides access to liquidity, no lock-up period, and enables companies to access the public markets without raising capital." If the one of main reasons to go public by IPO is to raise capital, the main motivation behind

DPO is liquidity (Horton, 2019). This means that stock can be easily sold for cash (Horton, 2019). The owners, employees, or early-stage investors have the option but not the obligation to sell their shares on the stock market (Jaffe, Rodgers, & Gutierrez, 2018).

## **2.1 A Brief History of Direct Public Offering**

In 1983 the Securities and Exchange Commission of the United States created a new type of stock offering known as direct public offerings (Watson, n.d.). The main idea was to enable small businesses to raise small amounts of capital without going through the entire process of an IPO (Watson, n.d.). At that time DPOs were very popular among small companies since they cost less and the process was not so long compared to an IPO (Watson, n.d.). With the development of the internet, direct public offerings became an even more established practice. Smaller companies could reach investors, to whom information was easily accessible through the internet (Giddings, 1998). Historically, direct public offerings have been an established practice on over-the-counter markets but are rarely used on a national exchange (Anthony L.G., 2018). This practice has been used by smaller biotech companies with smaller market caps or companies concerned about insufficient liquidity in the IPO process (Jo, Throne, & Fieber, 2019).

Altogether 11 companies went public through direct listing in the past 20 years, with a median market cap of 530 million USD (Pozen, Rajgopal, & Stoumbos, 2017). In recent years, direct listings are becoming more popular as a way for a private company to go public (Gibson Dunn, 2021). High-profile technology companies have started to use DPO to go public. With Spotify in 2018, and Slack in 2019, the NYSE managed to pioneer the first-ever direct listing (NYSE, n.d.).

The reason why DPOs are today more attractive to larger companies might be the abundance of investor capital. Historically, institutional investors avoided investing in private technology companies, but today pre-IPO fundraising rounds are common (Fenwick, 2019).

Secondly, in a direct listing, securities are sold on an exchange directly into trading markets without intermediary selling processes, participants, and the substantial expenses, that are associated with an IPO process (Beck, Rapp, & Livingstone, 2020). There is no book-building process that can be found in a typical IPO and neither an initial price at which underwriters sell shares to the public (Cohen, Jaffe, Lu, Rodgers, & Williams, 2019). Instead, the reference price in a direct listing is a directional guide to the market for where the stock would trade on the first day of trading (Fenwick, 2020). Following such a process there are no underwriter's discount costs. Finally, with a direct listing company can then enjoy many of the benefits of a traditional IPO (Gibson Dunn, 2021).

## 2.2 SEC Regulations for Direct Listing

The Securities and Exchange Commission is an independent agency of the United States federal government, that was established by the Exchange Act in 1934 as part of President Roosevelt's effort to regulate the country's securities markets. Based on the 1934 Act, 15 U.S. Code § 78d, the primary purposes of the Commission with regulatory powers are to enforce the Securities Act and other statutes, regulate the nation's stock and options exchange, and propose securities rules. Under the 15 U.S. Code § 78s(a) the SEC also delegates authority to Self-Regulatory Organizations (hereinafter: SROs), among which are national stock exchanges. One of the authorities they are given is to propose amendments to their constitutions that must be submitted to the Commission for examination and possible approval.

There is an established process of going public through traditional IPO and regulations are well-known (Schwartz, 2012). But the same does not imply direct listings. The process for DPO and regulations are not well-defined (Horton, 2019). Before we explain the direct listing process, we will investigate the Security Laws of registration statements. The issuers of securities are obliged to file a registration statement with the SEC (Ludovico, 2020). As stated in 17 CFR § 230.404(a):

*A registration statement shall consist of the facing sheet of the applicable form; a prospectus containing the information called for by Part I of such form; the information, list of exhibits, undertakings and signatures required to be set forth in Part II of such form; financial statements and schedules; exhibits; any other information or documents filed as part of the registration statement; and all documents or information incorporated by reference in the foregoing (whether or not required to be filed).*

It is mandated by the above-mentioned rule that all registration statements provide the public with the same detailed content and are standardized. But the company can register using multiple SEC registration forms, that are designed to address the needs of an individual company to better align them with the investor's right to be fully informed (Ludovico, 2020). Below I will present how a company can use a Securities Act registration statement and an Exchange Act registration statement.

In the traditional IPO, the Securities Act Form S-1 registration statement (or Form F-1 for foreigners) is used. The same form may also be used when a person that has shares in a private placement wants to resell them. Form S-1 under the Securities Act of 1933 registration statement may be used 1) when a private company is selling their securities on a public exchange for the first time (i.e. conducting an IPO), or 2) if a company is already listed on the market and shareholders want to resell shares known as "resale registration statement" or "selling shareholder registration statement" (Horton, 2019). Additionally, for a resale registration statement Form S-3 or F-3 can be used. As explained by Jaffe, Rodgers, & Gutierrez, (2018): "Form S-3 allows a company to forward-incorporate reports filed under

the Exchange Act and keep the registration statement up to date with all material information regarding the company without filing a post-effective amendment or prospectus supplement”. Among other requirements, a company to be eligible to use a Form S-3 or F-3 registration statement must have been subject to the reporting requirements of Section 13 or 15(d) of the Exchange Act for at least 12 months (Jaffe, Rodgers, & Gutierrez, 2018).

Under the Exchange Act registration statement Form 10, a company can register its shares without necessarily filing under the Securities Act of 1933, if the issuer is not making any sale (Coffee, 2018a). Consequently, no underwriter is needed to register under Form 10, and it might be the right filing for companies going public through direct listing (Ludovico, 2020). By Professor Horton (2019), direct listings through the Exchange Act Form 10 registration statement are also referred to as “pure”. Note that for unregistered securities to be publicly sold under Rule 144, the issuer must be subject to the reporting requirements of the Exchange Act for at least 90 days before the sale. Additionally, as stated in 17 CFR § 230.144: “The rule includes holding periods for restricted securities to establish that the holder did not purchase with a view to an unregistered public distribution” where “the term “restricted securities” is defined and includes securities acquired from the issuer or an affiliate in a transaction or chain of transactions not involving a public offering”. Upon the Exchange Act registration statement effectiveness shares begin trading immediately (Horton, 2019).

In case a company has already filed a Securities Act Form S-1 registration statement, then a shorter Exchange Act Form 8-A registration can be used (Horton, 2019). When using an Exchange Act registration statement, is almost as time-consuming as a Securities Act registration, and will take at least four months (Horton, 2019). The costs paid to lawyers and accountants are similar under both filings (Horton, 2019). But under Exchange Act, no underwriter is needed, hence there is no additional cost associated with underwriting. The other distinction is that using an Exchange Act registration statement can allow a company to bypass the Securities Act’s restriction on communication (Horton, 2019). While all companies that file an S-1 form (or F-1 for foreigners) must go through a quiet period that ends on the day the registration is declared effective (Ludovico, 2020).

### **2.3 The NYSE and Nasdaq Rules Applicable to A Direct Listing**

Under the direct listing process, existing shareholders’ shares are registered for resale and have the option but not the obligation to sell their shares, which gives them flexibility and liquidity for the company’s stock (Gibson Dunn, 2021). As historically defined by stock exchange rules, direct listing requires the registration of a secondary offering of a company’s shares. This can be done through a registration statement on Form S-1 or other relevant registration forms (Gibson Dunn, 2021). It must be publicly filed with and declared effective by, the Securities and Exchange Commission at least 15 days before release (Gibson Dunn, 2021).

Before the establishment of the direct listing rules, companies that did not already register common stock under the Exchange Act needed to demonstrate an aggregate market value of more than 100 million USD (110 million USD for Nasdaq) of “publicly held” stock (Gibson Dunn, 2021). The valuation had to be done by an independent third party and proven by recent trading prices in a Private Placement Market (Gibson Dunn, 2021). Many companies interested in direct listings were not able to meet the second valuation requirements. Here we have in mind especially privately held companies with no need for additional funding (e.g., ‘unicorns’). A company might not have its shares traded in a trading market for unrestricted securities or such trading is not sufficient for the evaluation of the company’s trading price (Gibson Dunn, 2021). These rules have changed in 2018 when the Commission found the NYSE proposed rule change consistent with the Exchange Act.

### 2.3.1 Selling Shareholder Direct Listing

In June 2017, the NYSE filed a rule change process with the SEC (Securities and Exchange Commission, 2018). NYSE proposed three rule changes that would permit direct listing on the exchange in cases where there is not sufficient Private Placement Market trading to establish a reliable price (Securities and Exchange Commission, 2018). In February 2018, the SEC approved two out of three rule changes proposed by the NYSE, which permits issuers to list on NYSE only upon the effectiveness of a selling shareholder registration statement under the Securities Act, without a related underwritten IPO and without previously trading on a public market (Securities and Exchange Commission, 2018, p. 14).

The listing company is required to meet one of the following applicable financial standards. First, the “NYSE Earnings Test” where each of the aggregate adjusted pre-tax income for the last three fiscal years is more than 10 million USD, with at least 2 million USD in each of the two most recent fiscal years and positive income in each of the last three fiscal years, or second, the “Global Market Capitalization Test” where global market capitalization is more than 200 million USD. At the time of listing the company must have 400 round lot shareholders (shareholders that hold more than 100 shares) and 1.1 million publicly held shares.

Under Amendment No. 3, an issuer with no sustained history of trading on a private placement market for such security must present a recent valuation from an independent third party, indicating at least 250 million USD in the aggregate market value of publicly held shares (Securities and Exchange Commission, 2018). This third party agent, to be independent, should not own more than 5 percent of the class of securities to be listed, provide any investment banking service to the listing applicant within the 12 months before listing, or provide any investment banking services or other related transactions in connection with the proposed listing (Securities and Exchange Commission, 2018). The Commission concluded that a valuation increase of at least two-and-a-half times the primary 100 million USD requirement, and additional independence valuation agent requirements

present a significant degree of protection for investors and the public interests (Securities and Exchange Commission, 2018).

In cases where there is no recent sustained history of trading in a private placement market, the reference price will be determined by the Exchange in consultation with a financial advisor to the issuer (Securities and Exchange Commission, 2018). Nevertheless, Designated Market Maker (hereinafter: DMM) would remain responsible for facilitating the opening of trading. There is no specific formula to determine the reference price, but it is rather based on a variety of factors, such as buy and sell orders submitted by brokers to the exchange (Cohen, Jaffe, Lu, Rodgers, & Williams, 2019), comparable public companies and reports from a company's independent valuation provider (Fenwick, 2019). This reference price determination is solely done by the financial advisor, and it is not allowed for a company to participate (Fenwick, 2020). The day before the issue day a reference price is released. The reference price is just a starting point for the price-discovery process and no shares are traded at the reference price (Fenwick, 2020). The minimum initial reference price is 4.00 USD (Securities and Exchange Commission, 2022b). The supply and demand for the security are established via auction, on the first day of trading (Skaff, 2020). When the selected market maker believes the conditions are adequate, they release the stock to the public (Skaff, 2020). Additionally, before opening the Exchange has the authority to declare a regulatory halt for a security that is the subject of a non-IPO listing to allow the DMM to complete the initial pricing and open the security before other markets can trade (Securities and Exchange Commission, 2018).

In a standard IPO, after the company files the S-1 registration statement with the SEC, the underwriters organize a roadshow, where company representatives meet with potential institutional investors. In a direct listing, after filing the S-1 statement company can go effective without a waiting period (NYSE, n.d.). Roadshows are not organized by the underwriters, but the company must use alternative forms of investor education activities that are permitted by the direct listing process (Cohen, Jaffe, Lu, Rodgers, & Williams, 2019). Investor education activities may vary between companies due to different company profiles, the business model, and already existing interest from either institutional or retail investors (Cohen, Jaffe, Lu, Rodgers, & Williams, 2019). For market-based pricing in a direct listing, the buy side must understand the company's business (Cohen, Jaffe, Lu, Rodgers, & Williams, 2019).

The NYSE is offering direct listing on a secondary market (Gibson Dunn, 2021). On the other hand, in 2019 Nasdaq adopted requirements for a direct listing on its second-tier Nasdaq Global Select and Nasdaq Global Markets while also for its third-tier Nasdaq Capital Market (Securities and Exchange Commission, 2019). NYSE and Nasdaq rules are fundamentally the same but are formed as an exception to each exchange's requirement for the respectable market value of the company to be listed (Gibson Dunn, 2021).

### 2.3.2 Primary Capital Raise via Direct Listing

In the past, companies were not allowed to raise new capital as part of the direct listing process (Gibson Dunn, 2021). Nevertheless, the game has changed on December 22, 2020, when the SEC issued its final approval of a new listing rule proposed by the NYSE (Herren Lee & Crenshaw, 2020). The new listing standard allows companies a primary offering along with, or instead of, a direct secondary listing under NYSE's approach. It is referred to as a Primary Direct Floor Listing (Gibson Dunn, 2021).

With a Primary Direct Floor Listing a company is issuing new shares and must file an S-1 registration statement, just as in a traditional IPO process. Thus, it is required to reveal a price range of the anticipated initial sale of the shares on the cover page of the preliminary prospectus (Fenwick, 2020). The lowest price of the price range is a reference price (Fenwick, 2020).

A company to be eligible for a Primary Direct Floor Listing under NYSE's rule has to fulfill one of the two requirements (Gibson Dunn, 2021). First, a company should sell at least 100 million USD in the opening auction on the first day of listing (Fenwick, 2020). Second, a company should have an aggregated market value of shares sold in the opening auction and a market value of publicly held shares before the listing equal to at least 250 million USD (Fenwick, 2020). The market value is computed using a price per share equal to the lowest price of the price range established by the company in its S-1 registration statement (Fenwick, 2020). Additionally, at the time of listing a company conducting a Primary Direct Floor Listing must have 400 round lot shareholders (shareholders that hold more than 100 shares) and 1.1 million publicly held shares outstanding (Fenwick, 2020). Furthermore, companies performing a Primary Direct Floor Listing must complete all other initial listing criteria at the time of initial listing (Gibson Dunn, 2021).

As previously stated, a Primary Direct Floor Listing allows the company to sell shares in the opening auction on the first day of trading on the exchange (Fenwick, 2020). To accomplish this, the NYSE created a new order type Issuer Direct Offering Order (hereinafter: IDO Order) (Gibson Dunn, 2021). Although the final rules contain many details about the IDO Order, the most prominent is that a Primary Direct Floor Listing settles only if 1) the auction price would be within the price range specified by the company on its S-1 registration statement, with 20 percent threshold (Securities and Exchange Commission, 2022b) and 2) all shares to be offered can be sold within that price range (Gibson Dunn, 2021). The shares will not start trading in case there is insufficient buying interest, and the designated market maker is unable to price the auction to fulfill the IDO Order (Fenwick, 2020).

In September 2020 Nasdaq has as well submitted to the SEC a rule filing to allow capital raise within the direct listing. This proposal was revised several times and finally approved by the SEC in May 2021 (Securities and Exchange Commission, 2021). Nasdaq's new rule permits a Direct Listing with a Capital Raise onto the Nasdaq Global Select Market, under



which a company itself can sell new shares in the opening auction on the first day of trading on the Exchange (Securities and Exchange Commission, 2021).

In addition to the initial requirements of Selling Shareholder Direct Listing a company listing on the Nasdaq Global Select Market has to fulfill the following conditions to satisfy the Market Value of Unrestricted Publicly Held Shares under a Direct Listing with a Capital Raise. The total amount combining the market value of shares sold on the first-day auction and Unrestricted Publicly Held Shares needs to be at least 110 million USD or 100 million USD in case the company has stockholders' equity of at least 110 million USD (Securities and Exchange Commission, 2021). As an exception SEC agreed that all shares including officers, directors, or owners of more than 10 percent of the company's common stock will be used in the calculation of Publicly Held Shares (Securities and Exchange Commission, 2021). To protect the investors, Market Value calculation and as well the security's bid price must be calculated using the lowest price per share of the price range stated in the effective registration statement (Securities and Exchange Commission, 2021).

Concerning a Direct Listing with a Capital Raise a new order type "Company Direct Listing Order" or "CDL Order" is established. CDL Order is a market order and needs to be submitted and executed in the opening auction for the full quantity of offered shares. Under the second requirement, Nasdaq Halt Cross needs to be executed for the opening auction to proceed. As stated in the SEC approval (2021), Nasdaq Halt Cross is "the process for determining the price at which Eligible Interest shall be executed at the open of trading for a halted security and for executing that Eligible Interest" where "Eligible Interest means any quotation or any order that has been entered into the system and designated with a time-in-force that would allow the order to be in force at the time of the Halt Cross". Under the initial SEC approval (2021) securities would be released for trading on the first day of listing only if sufficient buy interest to satisfy the CDL Order and the actual price calculated by the Cross is within the price range - at or above the lowest price and at or below the highest price established - in the effective registration statement.

In April 2022 SEC approved the proposed modification to the Price Range Limitation by Nasdaq. Under the previous rule, the offerings where the opening auction price is below the lowest price or above the highest price of the price range determined in the company's effective registration statement could not be released for trading by Nasdaq (Securities and Exchange Commission, 2022a). Nasdaq believes there could be cases with opening auction prices higher than the price range in the company's effective registration statement as this range is determined by the company and its advisors (Securities and Exchange Commission, 2022a). In such examples security offering needs to be postponed or canceled by Exchange and additional market risk for the company is created (e.g., investor attention). In contrast, there is no such Price Range Limitation in a traditional IPO although the pricing mechanism is similar, which could lead to fewer companies using a Direct Listing with a Capital Raise when going public (Securities and Exchange Commission, 2022a).

Therefore, the newly proposed and approved rule states that security could be released for trading by Nasdaq if “the actual price at which the Cross would occur is as much as 20 percent below the lowest price” or “is above the highest price in the price range established by the issuer in its effective registration statement” (Securities and Exchange Commission, 2022a, p. 6). Consequently, the Market Value of Unrestricted Publicly Held Shares is calculated using “the price per share equal to the price that is 20 percent below the lowest price of the price range disclosed by the issuer in its effective registration statement” (Securities and Exchange Commission, 2022a). As this is the minimum price at which the company could sell its shares, this price is used to determine if the applicable bid price and market capitalization requirements are met by the company (Securities and Exchange Commission, 2022a).

In cases when the actual price calculated by the Cross is within 20 percent below the lowest price of the price range established in the effective statement, Nasdaq will institute the so-called Post-Pricing Period (Securities and Exchange Commission, 2022a). Within this period the issuer can provide any additional disclosures that would arise from the calculation of the actual price (Securities and Exchange Commission, 2022a). During Post-Pricing Period it is not permitted to modify any existing or enter additional orders (Securities and Exchange Commission, 2022a). Nasdaq ends the Post-Pricing Period when the issuer confirms that no additional disclosures are required as per the federal securities laws (Securities and Exchange Commission, 2022a).

## **2.4 The Role of Investment Bank**

Investment banks play a different role in direct listings than in traditional IPOs. They are still required by the SEC rules in the direct listing process, however not as an underwriter but as financial advisors (Horton, 2019). In a direct listing, the financial advisors do not partake in any book-building activity, marketing, selling, or stabilizing (Cohen, Jaffe, Lu, Rodgers, & Williams, 2019). Instead, they assist with valuation, assist the designated market maker (DMM) in setting an opening price, provide advice and assistance in preparing files, and assist with drafting investor presentations (Horton, 2019).

Although financial advisors oversee many responsibilities, two of them are of the most importance. First, according to the Listed Company Manual (2022b) at § 102.01B, the financial advisor assists in the valuation of the company. A company to be eligible to undergo direct listing must first submit a valuation of more than 250 million USD. The Listed Company Manual also mandates that the valuation must be performed by a party with “experience” and “demonstratable expertise” in valuations – referring to an investment bank.

Second, the financial advisor must help and guide the designated market maker in setting a fair opening price (Horton, 2019). If there is no recent recorded trading history before listing, a designated market maker is required to work with financial advisors without the cooperation of the firm (Cohen, Jaffe, Lu, Rodgers, & Williams, 2019). As part of this role,

the selected financial advisers are required to provide their view of the company's ownership, pre-listing selling, and buying interest based on potential investors and stockholders (Cohen, Jaffe, Lu, Rodgers, & Williams, 2019).

## **2.5 Advantages and Limitations**

As mentioned before, the primary motivation behind an IPO is raising capital, while for direct listing is liquidity. It enables shareholders to be able to sell stocks for cash fast and at low transaction costs (Fontenay, 2017). Although private securities markets exist, they do not work entirely (Horton, 2019). NASDAQ Private Market is for example mostly limited to institutional investors who want to purchase large blocks of shares. So, there is no real substitute for the public markets when it comes to liquidity and the company needs to be publicly listed on a national exchange (Fontenay, 2017).

When going public with a direct listing company bypasses the mandatory lock-up period as compared to an IPO. Meaning, all existing shareholders (even management and shareholders holding more than 10 percent of shares) have the opportunity to participate on the first day of trading at the market price. There is equal access to all sellers and buyers. Alongside institutional buyers, direct listings offer access to a wider group of investors (Gibson Dunn, 2021). Private investors are as well able to participate in the offering through their broker-dealer.

For an opening price calculation, a different method than in IPOs is used. Buy and sell orders are collected so the opening price is based on a market supply and demand, offering maximum transparency and market-driven price discovery. As historically observed, the IPO price at which shares are sold to the underwriters is usually lower than the IPO closing price on the first day of trading, creating a lost opportunity for the issuing company (Securities and Exchange Commission, 2021, p. 5). On the other hand, with a direct listing, this spread between the IPO price and the later market price is reduced as there is no underwriter between the issuer and investors. Consequently, with DPO a company avoids costs related to the underwriter fees and discounts. Instead of the underwriter, the issuer needs to hire a financial advisor, whose fees are still substantially lower compared to underwriting discounts and commissions.

On the other hand, a few downsides should be considered when choosing a direct listing. To be eligible for a direct offering with a capital raise, a company has to file a preliminary prospectus to SEC including an estimated price range. For securities to be released for trading, an opening price that depends on supply and demand needs to be within this estimated price range stated in the effective registration statement. The range in which stock will be traded is hard to predict as it depends on market demand, creating higher volatility. But there is no such price range in a shareholder resale direct listing. With a DPO the issuer has higher flexibility in marketing the offering, but more comprehensive investor education

is needed to attract potential investors as there are no roadshows organized by an underwriter. Additionally, there is no sharing of research analyst information.

Second, as mentioned before, there is no underwriter and book-building process, where the opening price is determined and can be used as a benchmark for the first day of trading. This creates initial trading even more volatile. Third, in case no new shares are offered only existing shares can be sold. In case current shareholders are not willing to sell their shares on the first day of listing, no transactions will occur.

### **3 CASE STUDY: ANALYSIS OF SPOTIFY DIRECT LISTING**

Although the number of IPOs is decreasing year over year, it is still the most common way to go public and raise capital (Jo, Throne, & Fieber, 2019). Spotify, on the other hand, decided not to go public in the usual way through an initial public offering. Instead of that, they choose to go public through a direct public offering. Until that time no other large private company went public in this way. It was a novel and innovative approach for a big company to go public. Spotify began its process of becoming a public company in early 2017. If Spotify is successful in going public via DPO this could change the way how companies access the public markets, especially so-called “unicorns”. As explained by De Fontenay “Unicorns are companies that achieve valuations of one billion dollars or more while remaining private companies” (Fontenay, 2017, p. 459).

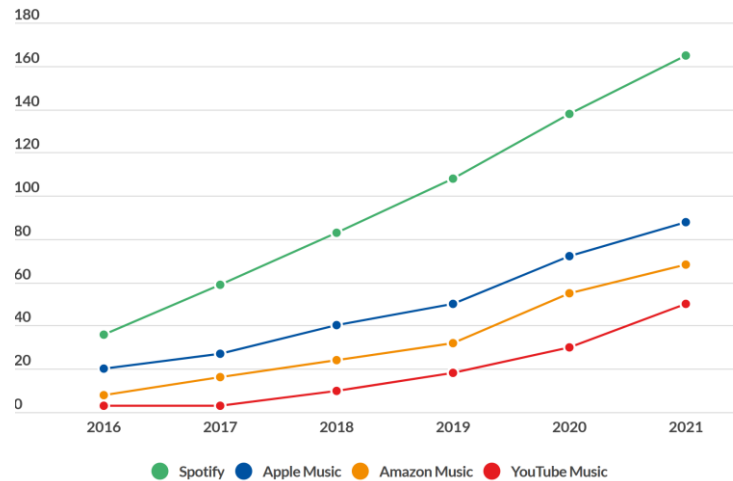
In this chapter, I will use Spotify’s example of direct listing for a case study. By choosing a direct listing, Spotify wanted to accomplish a few goals. I will research what could those goals be. First, the industry and company itself will be presented. Following, I will describe Spotify's process of going public and do a deep analysis of possible main reasons for Spotify to choose the riskier approach when going public. Additionally, I will present my valuation of Spotify in 2018 before the listing, using discounted cash flow method. In the end, I will cover post-listing performance and the current situation of the company.

#### **3.1 About Spotify**

Spotify AB is Luxembourg limited liability company that was established in 2006 by Daniel Ek and Martin Lorentzon in Stockholm, Sweden (Sweney, 2016). In 2008 they have launched a music streaming app with the same name Spotify. The company has its headquarters in Stockholm and London (Statista, 2021g). Their business model is unique and offers its streaming services to their users in two versions – free and premium. The free version includes advertisements with limited skips while Spotify Premium is a subscription version and includes increased sound quality, on-demand, offline, and ad-free listening (Spotify, 2020). Apart from streaming and online radio Spotify's platform is known for its strong social components, for instance, users can create and share music playlists on other social networks or recommend tracks to connected users (Statista, 2021g). Spotify is today

the world's most popular audio streaming services provider in the industry (Statista, 2021b). Some of Spotify's main competitors are Apple Music, Pandora, and Amazon Music. Figure 4 shows the number of users per provider.

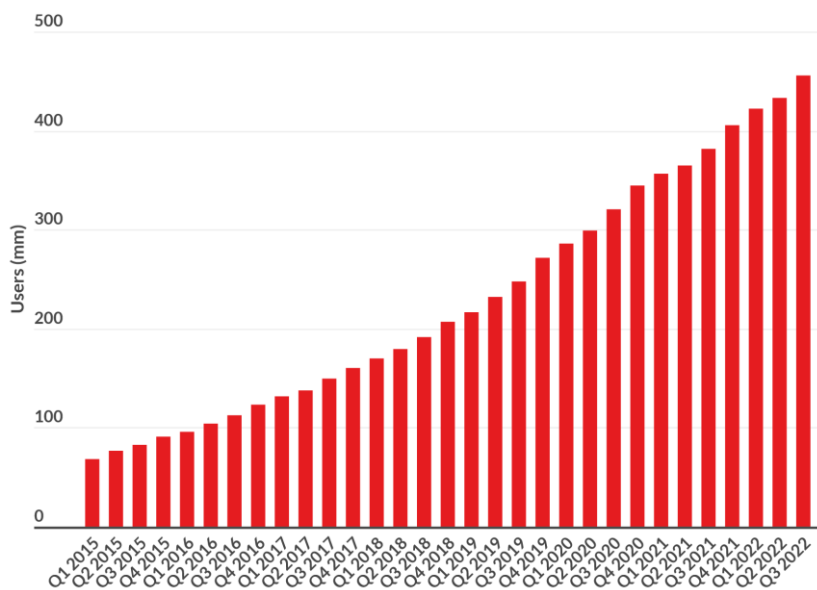
Figure 4: Number of users per provider between 2016 and 2021 (in million)



Source: Mansoor (2022).

Spotify offers over 70 million tracks and has over 345 million monthly active users (hereinafter: MAU) out of which 165 million present Premium Subscribers (Spotify, 2020). Through the last five years, we can observe steady growth of active users. See figure 5. Spotify is available on smartphones, computers, and tablets as an app or browser version across 92 markets (Spotify, 2020).

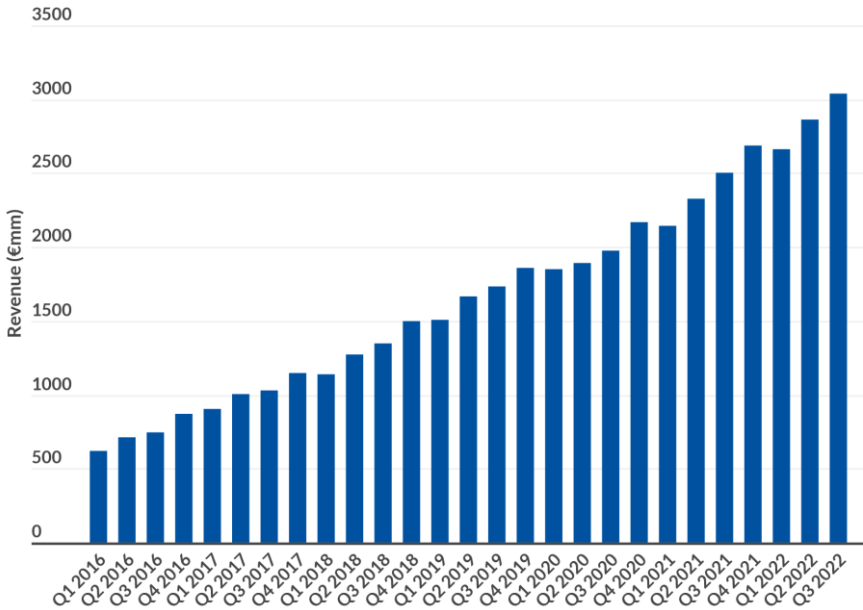
Figure 5: Number of Spotify monthly active users (MAUs) worldwide from 1st quarter 2015 to 3rd quarter 2022 (in million)



Source: Mansoor (2022).

In 2020 Spotify generated revenues of about 7.9 billion EUR (see figure 6), which is almost twice as revenues in 2017 (Statista, 2021f). Most of Spotify's revenues come from subscriptions on the premium version and through advertisements on its free version. In 2020 both figures were the highest reported to date, with premium revenues presenting 7.1 billion EUR and ad-supported revenue of 145 million EUR (Statista, 2021f).

Figure 6: Spotify quarterly revenues from 2016 to 2022 (in million EUR)



Source: Mansoor (2022).

Although Spotify's revenues are constantly growing the company has been operating at a loss since its inception (Statista, 2021g). In 2017 this loss amounted to 1.2 billion EUR due to a one-time equity swap with Tencent that represented a 1 billion total loss (Spotify Technology, 2018). The highest cost of revenue presents the royalty fees that Spotify pays to music record labels and other rights holders, for the right to stream music to users (Spotify Technology, 2018), with payments amounting to over 5 billion EUR in the year 2020 (Spotify, 2020).

**3.2 Spotify’s Dual Stock Structure and Control Rights**

When a company has a dual-class structure it means they offer at least two types or classes of stocks (CPI, n.d.). This could be for example Class A and Class B, which would have a different dividend payout or different voting rights. In most cases, companies offer one class of stock to the general public (CPI, n.d.). When owners of the company do not want to give up control but still want to go public, they could create a class of stock that provide greater control and voting rights (Hayes, 2021).

Usually, Class B shares are offered to the general public and have limited voting rights, while Class A shares are superior (Hayes, 2021). In most cases, these so-called super-voting shares are not publicly traded and are owned by the company founders (Hayes, 2021). If we assume that Class A shares have 10:1 voting rights which means that holders of those shares get ten votes for each share of stock they have in the company. On the other hand, in case Class B shares have 1:1 voting rights, meaning their holders get one vote per share of stock. However, the opposite could hold as well and there is no rule.

The dual stock structure came into existence in the late 19<sup>th</sup> century, but recently it became especially popular among technology startups that wish to retain control over their company (Hayes, 2021). One of the most famous examples is Alphabet Inc. (Google) which issued second Class B shares before its IPO. Class B shares were issued to founders and key executives, having 10 times as many votes compared to ordinary Class A shares sold to the public (Alphabet, 2004). Additionally, Class C shares were offered to regular Google employees which provide no voting rights (CPI, n.d.).

When looking into Spotify's shareholders' structure we can notice that founders Daniel Ek and Martin Lorentzon have decided to keep the majority control over the company using a dual-class stock structure. As stated in their F-1 filing the beneficiary certificates provide the holders additional voting rights, where each beneficiary certificate entitles its holder to one vote (Spotify Technology, 2018). It is visible from figure 6 that Spotify's founders Daniel Ek and Martin Lorentzon together own nearly 40 percent of total shares while having 80.3 percent of the total voting power. This gives their shares the voting rights of approximately 2:1.

*Figure 7: Stock Ownership of Spotify*

Name	Ordinary Shares		Beneficiary Certificates <sup>(7)</sup>		Percent of Total Voting Power
	Number	Percent	Number	Percent	
Daniel Ek <sup>(1)(5)(6)</sup>	46,792,520	25.7%	162,274,000	42.8%	37.3%
Martin Lorentzon <sup>(2)</sup>	23,612,720	13.2%	216,927,200	57.2%	43.1%
Sony Music Entertainment International Ltd <sup>(3)</sup>	10,164,560	5.7%	—	—	1.8%
Entities affiliated with TCV <sup>(4)</sup>	9,616,720	5.4%	—	—	1.7%
Tiger Global <sup>(5)</sup>	12,183,440	6.9%	—	—	2.2%
Tencent <sup>(6)</sup>	13,352,440	7.5%	—	—	2.4%

*Source: Spotify Technology (2018a).*

Super voting rights give voting power to their holders, who are usually founders of the company, which enables them to continue with the long-term vision they have for the company (Leung & Tung, 2018). Contrarily, equity investors are more focused on short-term returns. In case company management starts to make bad decisions and mismanage the company, unaffiliated shareholders are powerless to do anything about it. Furthermore, it is common for those founders to have low equity shareholding, meaning they are less affected in case of bad decisions (Leung & Tung, 2018). This gap between high voting power and low equity shareholding is also known as the 'wedge' (Leung & Tung, 2018). The bigger

the wedge is, other things equal, it results in a decrease in firm value (Leung & Tung, 2018). It creates volatility in the market and can affect the share market price. In Spotify’s example, this price volatility is especially problematic due to choosing a direct listing offering, where the price floor is not set by the underwriter. Keeping this in mind, they would want to keep a stable and preferably high stock price. But in a dual-class stock structure, there is a risk of decreased value of shares that do not have voting rights. Specifically, Spotify their common (‘Class B’) stocks have less value for investors due to lower voting rights, meaning investors have no control over the company in which they invest. This brings the risk of a lower price of Spotify’s shares. But Ek and Lorentzon are prepared to take this risk in exchange for keeping control over the company and navigating the long-term perspective of Spotify.

### 3.3 Spotify’s Process of Going Public

Based on a theory, direct listing seemed like a perfect way for Spotify to go public. Music streaming company already had registered privately traded 178.1 million shares outstanding and the company was valued to be worth more than 20 billion USD (Farrell, 2018). Spotify’s main reason to go public was not to raise new capital but rather to provide liquidity to early investors and potentially participate in future acquisitions (Coffee, 2018a). But being the first large company to go public via direct listing, Spotify had to work closely with the SEC, the NYSE, and their financial advisers to fulfill regulatory compliance. The process itself differed from a traditional IPO and included some specific steps. The timeline and major actions on the way to Spotify’s listing are presented in figure 8.

Figure 8: Spotify’s process for its listing



Source: Jaffe, Rodgers, & Gutierrez (2018).

Before Spotify filed its first public registration statement on February 28, 2018, the company went through negotiations with the SEC for a couple of months and submitted its first confidential filing to the SEC in December 2017 (Nickerson, 2019). At the time of Spotify’s listing, NYSE had experiences with listing companies in connection to an IPO with firm underwriting commitment, upon transfer from another market, or according to a spin-off (Securities and Exchange Commission, 2018, p. 13). For each of those, issuers needed to



demonstrate and meet specific requirements. NYSE was eligible to list a private company that was not registered with the SEC beforehand – like Spotify – on a case-by-case basis, if that company had first, a valuation of 100 million USD by an independent third-party or second, several months of sustained trading history in a trading system for unregistered securities operated by a national securities exchange or a registered broker-dealer, or a so-called private placement market (Securities and Exchange Commission, 2018, p. 4). Spotify did have a history of private resales of their shares, but their trading activity was not enough to fulfill the NYSE requirements (Spotify Technology, 2018a, p. 185).

Therefore, to be able to list a company with no sufficient Private Placement Market trading, the NYSE filed a rule change process with the SEC in June 2017. Although Spotify's name was never mentioned, it was widely understood that Spotify's case was considered when proposing the rule changes (Osipovich & Farrell, 2017). Commission has approved rule changes proposed by NYSE in February 2018 (Securities and Exchange Commission, 2018).

### 3.3.1 Mechanics

Spotify did not go public via pure direct listing but was rather subject to more complicated rules and needed to first file a Security Act registration statement and later an Exchange Act registration statement. For a foreign private issuer like Spotify, their first step in the process was the Securities Act registration of shares with the SEC through Form F-1 registration statement (Spotify Technology, 2018). Spotify did not issue any new shares for sale but instead registered just one part of their ordinary shares for resale (Spotify Technology, 2018). Now, in a traditional IPO registration statement all non-registered shares are locked up from sale for a period of 180 days. Spotify wanted to bypass this obstacle and enable their existing shareholders to sell on the NYSE on the first day of trading. To do so, Spotify would need to either register all shareholders' shares or ensure that an exemption from registration would allow shareholders to sell without registration (Jaffe, Rodgers, & Gutierrez, 2018). Accordingly, out of 178,112,840 ordinary shares outstanding (Spotify Technology, 2018, p. 150), Spotify has registered 55,731,480 shares (Spotify Technology, 2018, p. 1). To understand why only 31 percent of Spotify's shares were registered, it makes sense to separate its shareholders into three groups.

In the first group, we have only Chinese social media company Tencent shareholders, which presents about 9 percent of Spotify's total shares (Spotify Technology, 2018, p. 150). An early lock-up agreement prevented Tencent to participate in the listing (Spotify Technology, 2018). The second group of shareholders consisted of non-affiliates that held shares for at least one year period. Under Rule 144, these shareholders were eligible to resell their shares to the public at any time without registration. Spotify expected that number to be approximately 106,228,920 ordinary shares which is about 60 percent (Spotify Technology, 2018, p. 173). The third group consisted of affiliates and non-affiliates that did not meet the requirements for selling under Rule 144 and did not hold their shares for at least one year

period. This group presents the remaining 31 percent of shares or 55,731,480 ordinary shares (Spotify Technology, 2018, p. 173).

Accordingly, Spotify registered only shares held by affiliates and non-affiliates who had acquired their shares within the prior 12 months or otherwise did not meet the requirements for selling under Rule 144 (Spotify Technology, 2018). Those shareholders, from group three, were the primary intended beneficiaries of the direct listing as they were not eligible for public resale. Under Rule 144, an affiliate or non-affiliate from the second group, that held shares for at least six months was able to sell those shares once an issuer – Spotify has been subject to the reporting requirements of Section 13 or Section 15(d) the Exchange Act for a period of at least 90 days (Spotify Technology, 2018). Hence, Spotify announced an intention to keep the Registration Statement effective for a period of 90 days after the effectiveness of the Registration Statement (Spotify Technology, 2018). With this approach, Spotify enabled registered shareholders to resell immediately upon listing, as long as the registration statement remained effective (Spotify Technology, 2018). While the registration statement was effective, Spotify encountered a quiet period as they registered under Form F-1.

### 3.3.2 Role of Financial Advisors

Spotify hired three investment banks, namely Goldman Sachs, Morgan Stanley, and Allen & Company that acted as their financial advisors. As Spotify undergo direct listing their financial advisors did not act as underwriters, who are in traditional IPO participating in the distribution of securities. The main role of Spotify's financial advisors was to define objectives related to the Registration and Listing, draft Form F-1 registration statement, and draft public communications and investor presentations in connection to the listing. Spotify hired Morgan Stanley, one of its financial advisors, to act as its independent valuation agent and to act as a consultant with the NYSE's designated market maker which is required by NYSE's direct rules (Jaffe, Rodgers, & Gutierrez, 2018). Morgan Stanley's main role was to provide DMM ownership of Spotify's outstanding shares and assist with pre-listing buy and sell interest.

Additionally, financial advisors have assisted in the preparation of investor materials for a one-time "Investor Day" online presentation to the public. The event happened in March 2017 and was streamed online. Around ten thousand viewers have watched the presentation on the internet (Jaffe, Rodgers, & Gutierrez, 2018). The main purpose of Investor Day was to educate investors on company and investment opportunities. The whole executive team has been participating in the presentation, which lasted over two hours. This is twice as long as usual roadshow meetings, where usually only the chief executive officer and chief financial officer are present.

### 3.3.3 Pricing and listing

As per traditional IPO rules, a preliminary prospectus includes a price range of the anticipated sale price of the shares on its cover page. This price range is usually estimated by the issuer, any selling shareholders, and the underwriters based on the expected clearing price for an IPO. In Spotify's case, the company did not anticipate offering any new shares and was not allowed to cooperate with any pricing. To provide an appropriate preliminary prospectus and conduct investor education Spotify referred to Item 501(b)(3) of Regulation S-K to explain how the price would be determined (Jaffe, Rodgers, & Gutierrez, 2018). On its preliminary prospectus cover page, Spotify provided the low and high sales price per ordinary share on the private placement market and disclosed that their listing is a novel method without an underwriter, so trading volume and price of ordinary shares may be more volatile as in underwriter initial public offering. Furthermore, it was stated that "the opening price of ordinary shares on the NYSE will be determined by buy and sell orders collected by the NYSE from broker-dealers" (Spotify Technology, 2018).

It took SEC approximately three months to review Spotify's registration statement which is of the same timing as for an IPO, and it was declared effective on March 23, 2018 (Jaffe, Rodgers, & Gutierrez, 2018). In a traditional IPO the day after the registration statement is marked effective, the offering would be priced and begin trading. Spotify did not follow the same path but rather waited for more than a week before listing its offer. Reasons for that are that Spotify was subject to reporting requirements of the Exchange Act and needed to release a standard financial outlook for the first quarter and full year of 2018 and allow enough time for investors before the listing. Secondly, as this was a resale shareholder offering, they wanted to ensure enough time before the first day of trading for existing shareholders to deposit their shares through the Depository Trust Company (hereinafter: DCT) into a brokerage account (Jaffe, Rodgers, & Gutierrez, 2018).

### 3.3.4 Cost

Now let's see if Spotify has saved any money by going public through a direct listing. As we saw in chapter one, the highest cost in an IPO presents the underwriter's fee. To be able to compare Spotify's actual cost, I will estimate the amount Spotify would have to pay if going public through an IPO. A large company offering over 300 million USD pays on average 37 million in underwriter's fees (Horton, 2019). But Spotify is an exceptionally large company, comparable to mega-cap Tech IPOs, where companies on average offer 15-20 percent of their shares (J.P.Morgan, 2018). If Spotify would sell such a percentage this would mean 25-35 million shares. With the opening price of 165,90 USD estimated offering of IPO would be between 4-6 billion USD. Let's assume that the underwriter's fee would be 2 percent for a such large deal, and we get to 80-120 million USD. We can also compare the actual case of Snap's IPO in 2017. The company had a similar valuation as Spotify and paid roughly 100 million USD to their investment banks (Farrell, 2018).

Spotify did not have to pay for underwriting, but its highest cost was financial advisors. As stated in their registration statement, the estimated expense of the advisers’ fee was 35 million USD. This is significantly below our estimated IPO costs for such a company. In table 2, the total costs in connection to Spotify’s direct listing are presented.

*Table 2: Expenses of the registration*

Type of Expense	Cost in USD
SEC registration fee	55,357
Listing fee	320,000
Printing costs	875,000
Auditors’ fee	1,848,900
Legal fees and expenses	5,544,965
The transfer agent and registrar fees	73,806
Other advisers’ fees	35,000,000
Miscellaneous fees and expenses	2,000,972
<b>Total</b>	<b>45,719,000</b>

*Source: Spotify Technology, p.185 (2018).*

We can conclude that Spotify did spend much less money with direct listing than it would be going public with a traditional IPO.

**3.4 Reasons Behind Spotify’s Direct Listing**

Before analyzing in deep why Spotify choose direct listing I will present the main differences between traditional initial public offering, pure direct listing, and Spotify’s direct listing. In table 3 main characteristics are summarized, as explained in chapters before.

*Table 3: Main characteristics of a traditional IPO, a pure direct listing, and Spotify’s direct listing*

	IPO	Pure DPO	Spotify DPO
<b>Purpose</b>	Raise capital, liquidity, and consideration for later acquisitions	Liquidity, consideration for later acquisitions	Liquidity, consideration for later acquisitions
<b>Restrictions on communications</b>	Quiet period applies	No restrictions	Quiet period applies

is continuing

*Table 3: Main characteristics of a traditional IPO, a pure direct listing, and Spotify's direct listing (cont.)*

	<b>IPO</b>	<b>Pure DPO</b>	<b>Spotify DPO</b>
<b>Required SEC filings</b>	Securities Act registration statement (S-1) followed by Exchange Act registration statement (8-A)	Exchange Act registration statement (Form 10)	Securities Act registration statement (F-1) followed by Exchange Act registration statement (8-A)
<b>Required NYSE filings</b>	Listing application	Listing application	Listing application
<b>Role of investment banks</b>	Underwriter	Financial Advisor	Financial Advisor
<b>Amount exceptionally large company pays to investment bank</b>	80-120 million USD (large companies pay on average 37 million USD)	N/A	35 million USD

*Adapted from Horton (2019); J.P. Morgan (2018).*

### 3.4.1 Underpricing

#### 3.4.1.1 IPOs and Underpricing

The main goal of an IPO is to raise new capital from investors for the future growth of the company and its business. To do so, issuing company is willing to sell its shares at the highest possible price to investors that are willing to buy. When going public through IPO investment banks will play a role of a middleman and purchase the securities from the issuer and resell them at a slightly higher price to the market. This spread between the prices that the underwriter earns is the direct cost of the IPO. On the first day of trading the share price might “pop” and generate a return for the investors who purchased stocks from the underwriter (Nickerson, 2019). This creates indirect costs which in some cases even excide direct costs.

Underpricing is a practice when the underwriter sells IPO shares at a price below their real value in the stock market, causing guaranteed first-day returns for the investors, as the share price end of the first trading day closes at a significantly higher price (Kindness, 2020). Underpricing problem is of the biggest indirect costs and presents the potential lost earnings for the issuer. The average first-day return on U.S. IPOs in the last 10 years, between July 2009 and June 2019, has been 16 percent (Ritter, 2019). This represents over 43 billion USD

that was “left on the table”. The average amount per IPO of 37 million USD is more than twice as paid fees to underwriters (Ritter, 2019). In 2020 we could observe software unicorn Snowflake going public and becoming the second-most underpriced IPO in history, as measured by dollars left on the table (Tully, 2020). Snowflake saw its stock rise by 112 percent on the first day of the IPO, leading to 4.88 billion USD left on the table (Tully, 2020).

One of the theories says that underpricing is a way to attract investors to participate in the IPO market in the first place. This changing risk composition hypothesis assumes that the riskier the IPO, the more underpriced shares will be to cover against the risk, which can be technological or valuation uncertainty (Loughran & Ritter, 2004). According to Capital Asset Pricing Model (CAPM), investors will expect higher returns in case of exposing to more risk and buying risky (higher beta) stocks. Consequently, underwriters tend to underprice the shares based on how risky the IPO might be and increase the expected return for the investors.

A somehow related theory developed by Kevin Rock (1986) explains IPO underpricing with information asymmetry. His theory divides investors into informed and uninformed. Uninformed investors bid on all IPOs, good and weak, which might not deliver returns, and eventually, when returns will not be sufficient, they will leave the IPO market so only informed investors will stay (Rock, 1986). On the other hand, informed investors will bid only on IPOs that are expected to bring high returns. Uninformed investors have left the IPO market due to bidding and losing money and there is an insufficient number of informed investors to bid on weak IPOs which means that demand for the IPO is lower than supply. To solve this problem and still sell the entire IPO issue underwriters need to bring uninformed investors back to the market and insure they will bid on the stock. They achieve this by underpricing the share and providing investors with an opportunity to earn a return.

Another theory argues that investment banks communicate with institutional investors before the offer price is set through book-building and, in this way, get an idea of what price they are willing to pay (Sherman, 2005). With underpricing the stock underwriters show appreciation to investors for disclosing the price and quantity in which they are interested.

Finally, investment banks would rather underprice the IPO than overprice it due to their liability for any type of misinformation. American securities laws impose strict liability on the issuer and underwriter for material misstatement (Solomon, 2011). Underwriters could face huge financial losses in case it is proven in court that overpriced shares were sold to the investors (Prachi, n.d). The hypothesis that underpricing works as a form of insurance against legal liabilities and associated damage to the reputation of the investment banker was developed and tested by Tinic (1988).

To conclude, the reasons behind IPOs underpricing varied through the years (Loughran & Ritter, 2004). No matter the final cause, the underpricing is a real risk for the company when going public. The question is whether companies can eliminate that risk of underpricing.

### *3.4.1.2 Direct Listing and Underpricing*

Contrary to an IPO, when a company goes public through a direct listing no shares are sold to the underwriter and they do not participate in pricing the shares. Instead, the stock price is determined by market demand. A company that engages in DPO already holds privately owned shares which become publicly traded on the day of the offering. The possibility of underpricing is diminished by eliminating the underwriter from the process of pricing. We can assume that since in the DPO process shares are priced by the market, an issuer has no risk of indirect cost connected with underpricing.

The previously mentioned risk composition theory of IPOs seems to be resolved if a direct listing is used to go public. The hypothesis argues that for the underwriter to sell all shares of the risky IPO to the investors, the opening price needs to be lower than the market value. First, with a direct offering, no new shares are sold. Instead, shares that are already owned by private investors are offered on a public market. Because there are no new shares issued there is no need to underprice the shares and sell them. Second, the ‘opening’ price is set based on supply and demand in the market, and not by the underwriter.

The same reasons apply to the information asymmetry theory, which suggests that underwriters need to create a higher return for uninformed investors to sell them weak IPOs. As in direct listing, no underwriters are involved, and no new shares are issued this theory is resolved as well.

In case when a company before a direct listing does not have its shares on a private market, the reference price is defined by the company’s financial advisors. The stock price is not set truly by pure market forces, but it is rather based on a variety of factors, such as buy and sell orders submitted by brokers to the exchange, comparable public companies, and reports from a company’s independent valuation provider. In these cases, investment bank takes the role of financial advisor but not the role of the underwriter, so they do not profit from selling shares to the market, which is why the underpricing hypothesis does not apply in this case as well.

In 2020 the SEC has approved an additional type of direct listing in which a company can list new shares in an opening auction on the first day of trading. Designated Market Maker (DMM) is responsible for determining the auction price (Mayer Brown, 2020). The pricing mechanism is different than in IPO where the book-building process is used, and it is based on buy and sell orders which could mean the underpricing is eliminated. But looking back to prior examples of auction-based IPOs there is evidence of underpricing problems and mispricing as well. The main issue with IPO auctions is the entry number of bidders and what would be an optimal participation level (Jagannathan & Sherman, 2006). A higher number of potential bidders in an auction brings more possibility of a winner’s curse or free rider problem, as it is hard to ensure the participation of only serious investors (Jagannathan & Sherman, 2006). This can consequently lead to an underpriced IPO.

Specifically, looking into Spotify's example the company had privately owned shares before DPO. Nevertheless, they have hired Morgan Stanley as their financial advisor to consult with the designated market makers of the NYSE and help set the opening price of the shares (Spotify Technology, 2018). To set the price Morgan Stanley collected the buy and sell orders on the exchange, so the price was not set by pure market forces. But Morgan Stanley did not work as an underwriter which means that Spotify has theoretically avoided the underpricing hypothesis.

### 3.4.2 Dilution

When going public through an IPO company usually offers already existing shares as well as newly issued shares. Because of this process existing shareholders have to purchase new shares to keep the same share of the company, or their equity position is diluted (Jo, Throne, & Fieber, 2019). Normally this dilution is overlooked by the existing shareholders due to a significant increase in share value and the overall positive result of going public. On the other hand, this dilution effect could be eliminated by going public through the DPO process. When a company offers to the market only pre-existing shares and no new shares are issued, earnings per share remain steady and there is no dilution of shares (Nickerson, 2019).

Because Spotify had a sufficient volume of shares that have previously traded on the private market, they could use the direct listing and offer those existing shares to the public market without issuing any new shares. Consequently, existing shareholders retain their equity position and control of the company, without the dilution effect. Nevertheless, there is a dilution risk for existing shareholders if in the future company raises secondary funding through the issuance of equity or convertible debt securities (Spotify Technology, 2018). From Spotify's F-1 filing, we can notice the added risks of dilution if the existing shareholders – Spotify's officers and executives exercise the stock options, restricted stock units, and warrants (Spotify Technology, 2018). In case not all would be exercising their options or only a few individuals would exercise them first, they would receive the greatest payout, and the ownership of others would be diluted.

### 3.4.3 Liquidity

When a company goes public through an IPO it enables its initial investors to sell their shares in the company and cash out. IPO improves liquidity, meaning investment is easier to be sold, especially for a fair value. Better liquidity brings as well higher valuation for the company (Fernando, 2021). This way investors that bought shares in the early stage of the company's life can realize a very profitable return once a company becomes publicly traded. Consequently, liquidity is one of the main reasons for a company to go public.

On the other hand, DPO increases liquidity for existing shareholders too. When a company goes public through a direct listing, existing shareholders can sell their shares, considering



there is a demand for the shares. In traditional IPO, investment banks take the role of intermediary between the issuer and buyers. They underwrite the stocks and assure there is a liquid market where shares can be bought and sold. This way there is enough demand for issuing company to sell all the shares. But with DPO there are no investment banks included in the process of buying and selling which creates initial volatility. If there is no demand on the market or it is too low, not all investors can sell their shares. Additionally, the price of shares is solely determined by market demand and supply, resulting in shares trading at a discount due to illiquidity. Low demand and the inability of investors to cash out are key risks a company takes when going public through a direct listing.

In Spotify's example, the company was well known in private markets and invested in the advertisement before the offering. Furthermore, the future valuation of the company was very optimistic meaning Spotify did not have to worry about the demand side. Even before the offering, many private-equity investors were interested in buying Spotify's shares once they are publicly traded. While the demand side is important, we should not overlook the supply side. In DPO, the availability of stocks depends on the willingness of current investors and employees to sell the shares. If on the day of the offering, there is no initial investor that is willing to sell shares, no transactions will occur. When some investment banks offered initial Spotify's investors to purchase the company's shares, they rejected the offer (Farrell, 2018). In Spotify's case, the risk of not enough sellers was higher than the too-low demand for their shares on the market. The reason behind this might be that initial shareholders believed the market will value Spotify's shares even higher and private valuations were inaccurate. In the past, the valuation of Spotify was increasing significantly year over year. The company was valued at 6 billion USD in 2016, increasing to 12 billion USD a year later and by the end of 2017 Spotify's valuation rose to 15 billion USD (Farrell, 2018). By keeping their shares initial investors wanted to guarantee the highest return. Choosing a direct listing and having a lower supply could as well prevent possible IPO underpricing of shares, while still providing liquidity to the investors that would like to sell their shares. When the company started to trade on April 3, 2018, few shareholders were willing to sell their shares at the opening price. But over the six months price of the share has increased from 135 USD to 178 USD which created an orderly market with a healthy daily volume of between 1 and 10 million shares (Horton, 2019). For comparison, low volume is an average daily volume of fewer than 200,000 shares per day (Horton, 2019). Volume can be a good representative of liquidity (Horton, 2019).

Apart from initial capital firm investors, Spotify's direct listing presents liquidity to its employees. One of Spotify's benefits for their employees was stock options as equity compensation. Spotify issued 1,723,080 shares via employee stock options by the end of 2017, which is 1.03 percent of the total 167,258,400 shares outstanding at that time (Spotify Technology, 2018).

### 3.5 Discounted Cash Flow Valuation of Spotify

Before Spotify went public there were few company valuations available online. Those estimations were anywhere between 9 to 25 billion USD. From Spotify's registration statement, we can see that the Fair market value of outstanding private stock in 2017 was between 37.5 USD and 120.5 USD (Spotify Technology, 2018, p. 1). With a total of 167,258,400 Ordinary Shares Outstanding (Spotify Technology, 2018, p. 175) this gives us a company valuation between 8 to 20 billion USD. That is a wide range of stock prices and therefore could not be solely used for a fair valuation. Therefore, to estimate the offering price I have done the calculation myself.

To estimate the fair value of Spotify before the offering, when the company was still private, I decided to use discounted cash flow (hereinafter: DCF) valuation method. Under discounted cash flow method, the value of an asset is the present value of expected future cash flows on that asset. The intrinsic value of any asset can be estimated by predicting cash flows, growth, and risk. To be able to estimate the value of an asset as per discounted cash flow equation (1), we need the life of the asset to estimate, the cash flows during the life of the asset to estimate, and the discount rate to apply to these cash flows to get present value.

$$Value = \sum_{t=1}^n \frac{CF_t}{(1+r)^t} \quad (1)$$

where:

- $CF_t$  is cash flow in time  $t$
- $r$  is the appropriate discount rate given the riskiness of the cash flow

There are two possible approaches within discounted cash flow method, equity, and firm valuations. Free cash flow to equity values just the equity stake in the business, whereas expected cash flows to equity are discounted with the cost of equity. The second approach is the discount cash flow to a firm method, which values the entire business, including equity and other claim holders in the firm. In this model, expected cash flows are discounted by the weighted average cost of capital (hereinafter: WACC). The latest is the approach I choose for my valuation.

Although private companies usually do not have available detailed financial statements and use different accounting standards, I have extracted most of the financial data from Spotify's registration statement, where five years of the most important items are presented. For market data that is needed for a valuation, I have used data available on Damodaran Online. Below are listed steps that I followed:

- Estimate the discount rates to use in the valuation.
- Estimate current earnings and cash flow on the asset to all claim holders.
- Estimate the future earnings and cash flows of the firm by estimating the expected growth rate in earnings.

### 3.5.1 Discount rate

The first step was calculating the discount rate. For my valuation I have decided to use discounted cash flow to firm valuation method, therefore the appropriate discount rate is a cost of capital or WACC. The currency used for discount rate calculation is USD, which was as well used for estimating cash flows. The weighted average cost of capital is calculated by the following equation (2).

$$WACC = \left( Re \times \frac{E}{D+E} \right) + \left( Rd \times (1 - t) \times \left( \frac{D}{D+E} \right) \right) \quad (2)$$

where:

- Re is the cost of equity
- Rd is the cost of debt
- E is the market value of total equity
- D is the market value of total debt
- t is a tax rate

To compute Spotify's Cost of Capital as shown in table 4, I have extracted the average market debt-to-equity ratio for publicly traded firms from Aswath Damodaran (2022c). Based on the list of companies within the industries, the most appropriate for Spotify's business is the Entertainment industry, for which the debt-to-equity ratio is 0.34 (2022c). Consequently, the weights used for the WACC calculation are 0.25 for debt and 0.75 for equity. Although Spotify is subject to income taxes in Luxemburg, Sweden, the United States, and numerous foreign jurisdictions (Spotify Technology, 2018), the assumption to take the lowest tax rate of 22 percent for Sweden was made. In the following two chapters, I will describe how the cost of equity and the cost of debt was computed.

*Table 4: Cost of Capital calculation*

Market Debt to Equity ratio (entertainment)	0.34
Tax rate	22.00%
Cost of Equity	11.07%
Cost of Debt	17.48%
<b>Cost of Capital (WACC)</b>	<b>11.71%</b>

*Source: own work.*

#### 3.5.1.1 Cost of Equity

For the cost of equity calculation, the capital asset pricing model as per equation (3) was used.

$$CAPM = r_f + \beta_i [E[r_M] - r_f] \quad (3)$$

where:

- $r_f$  is a risk-free rate
- $E[r_M]$  is the expected return on the Market Index (Diversified Portfolio)
- $\beta$  is the beta of the company

In table 5 cost of equity for Spotify is calculated. From Aswath Damodaran, I have extracted data for the US T-Bond interest rate of 2.41% (2022a) which was used as a risk-free rate, and equity risk premium of 5.08% (2022b) that was used as the expected return. The company's beta measures volatility or systematic risk of security compared to the market as a whole. Because Spotify is a private company with insufficient market prices or returns to use, I have calculated a Bottom-Up Beta.

*Table 5: Cost of Equity calculation*

Risk-free rate	2.41%
ERP	5.08%
Bottom-Up Beta	1.70
<b>Cost of Equity</b>	<b>11.07%</b>

*Source: own work.*

As per equation (4), levered bottom-up beta is computed by multiplying unlevered beta with the market debt-to-equity ratio for a firm.

$$\beta_L = \beta_U \times \left[ 1 + (1 - t) \times \frac{D}{E} \right] \quad (4)$$

where:

- $\beta_U$  is unlevered beta
- $t$  is a tax rate
- $E$  is the market value of total equity
- $D$  is the market value of total debt

First, to get unlevered beta, I have used the Average Unlevered beta corrected for cash for the Entertainment industry, which is 0.96, extracted from Aswath Damodaran (2022c). I have adjusted this number and used a slightly higher unlevered beta. I assume that Spotify is still in its growth phase and is a young company, so its beta should be higher than for more mature firms. At the same time, Spotify is offering discretionary services which is supporting my argument that their beta should be higher than the average. I have adjusted this market beta for the market risk to get to the Total Unlevered Beta. This was done by dividing

Unlevered beta with the square root of the standard deviation for the Entertainment industry that was as well extracted from Aswath Damodaran (2022c).

To get to the Levered beta, as shown in table 6, I used the same average market debt-to-equity ratio for the Entertainment industry, and tax rate as for the WACC calculation.

*Table 6: Bottom-up Beta calculation*

Unlevered beta corrected for cash (Entertainment)	0.96
Unlevered Beta for Spotify	1.00
Correlation Coefficient (Entertainment)	0.74
Total Unlevered Beta	1.35
Market D/E (Entertainment)	0.34
Tax Rate (Sweden)	22%
<b>Levered Bottom-Up Beta</b>	<b>1.70</b>

*Source: own work.*

### 3.5.1.2 Cost of Debt

The cost of debt is the rate at which a company can borrow at the time. The cost of debt reflects the company's default risk and the level of interest rates in the market. For public companies with outstanding loans or bonds, there are readily available interest rates that can be used as a spread. On the other hand, bond ratings can be used to estimate a default spread. But Spotify was still a private company and did not have a rating, nor any recent bank loans to use as a reference. Therefore, I have estimated a synthetic rating using the interest coverage ratio as per equation (5).

$$\text{Interest Coverage Ratio} = \frac{EBIT}{\text{Interest Expense}} \quad (5)$$

From Spotify's SEC Registration Statement, I have extracted operating income and lease expense, latest I treated as interest expense. I have matched the interest coverage ratio to the credit rating published by Damodaran Online (Damodaran, 2023), and determined Spotify's default spread of 20 percent. To get to the pre-tax cost of debt I have summed the default spread and risk-free rate of 2.41 percent, which was previously used in calculations. But for the WACC calculation, the after-tax cost of debt is needed, therefore I have adjusted the pre-tax cost of debt for the tax rate as per equation (6).

$$\text{After Tax Cost of Debt} = (\text{Spread} + r_f) \times (1 - t) \quad (6)$$

where:

- Spread is the difference in returns due to different credit qualities

- $r_f$  is a risk-free rate
- $t$  is a tax rate

In table 7 the calculation of the cost of debt is presented.

*Table 7: Cost of Debt calculation*

EBIT	(427)mUSD
Interest	769mUSD
Interest Coverage Ratio	(0.56)
Rating	D2/D
Spread	20.00%
Risk-free rate	2.41%
Tax Rate (Sweden)	22.00%
<b>Cost of Debt</b>	<b>17.48%</b>

*Source: own work.*

### 3.5.2 Current Earnings and Cash Flow

Secondly, after the discount rate calculation, I have estimated the current earnings and free cash flows. A starting point was estimating the current earnings of the firm after taxes. From Spotify's Form F-1, I have obtained an operating loss of 427 million USD for 2017. I have adjusted this number for financial and capital expenditure which was mixed in with the operating expense. Although leases are treated as operational expenses, in reality, these are financial expenses and need to be reclassified as such. Research and development expenses should as well be reclassified as capital expenditures and not operating expenses. Adjusted current earnings after tax for Spotify in 2017 are (234) million USD.

Going further, a company needs to reinvest in future growth each year. To get the reinvestment value I used the Sales to the Invested Capital ratio for the entertainment industry from Damodaran Online (2023) and multiplied it by the yearly revenue growth.

$$Reinvestment = \frac{Change\ in\ Revenues}{Sales\ to\ Capital\ Ratio} \quad (7)$$

The final Cash Flow to the Firm after reinvestment for Spotify in 2017 is (1.381) million USD.

### 3.5.3 Future Earnings and Cash Flows

To compute the value of Spotify I decided to project 11 years of future cash flows, as the company was still in its early growth phase in 2017. In that year Spotify's revenue growth was 41 percent but my assumption is that next five years company would grow by only 20

percent. By 2028 their growth would fall to 10 percent due to new and already existing competitors at that time Apple, Google, and Amazon. Spotify's cost of revenue in 2017 was about 80 percent and I assume that this number would fall as well, as going forward their main cost would be licensing. In my first calculation, I assumed that the cost of revenue in 2028 will be 70 percent. When it comes to profitability it is not a secret that Spotify was losing a lot of money, but I found very optimistic financial analysis online. Based on that, I assumed that in the next 11 years, their operating margin would increase to 82 percent.

To estimate the present value of future cash flows I used my computed Cost of Capital of 11.71 percent as a starting discount rate. As the Market Cost of Capital for the entertainment industry retrieved from Damodaran Online is slightly lower, it was used as the ending discount rate to adjust for a public offering, where investors have diversified portfolios. The discount rate percentage is decreasing steadily year over year. In table 8 total breakdown of Spotify's present value of future cash flows calculation is presented.

Table 8: Present Value of Future Cash Flow calculation (in million USD)

		0	1	2	3	4	5	6	7	8	9	10	11
in million USD	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
<b>Revenue</b>	3,268	4,622	5,546	6,655	7,986	9,584	11,500	12,650	13,915	15,307	16,838	18,521	20,373
<b>Revenue Growth</b>		41%	20%	20%	20%	20%	20%	10%	10%	10%	10%	10%	10%
<b>Cost of Revenue</b>	2,824	3,662	4,348	5,162	6,127	7,272	8,630	9,387	10,208	11,101	12,069	13,121	14,261
<b>% Cost of Revenue</b>	86%	79%	78%	78%	77%	76%	75%	74%	73%	73%	72%	71%	70%
<b>Gross profit</b>	444	959	1,198	1,493	1,859	2,311	2,870	3,264	3,707	4,206	4,768	5,401	6,112
<b>Adjusted Operating Margin</b>	-87%	-31%	-21%	-11%	0%	10%	20%	31%	41%	51%	61%	72%	82%
<b>Adjusted Operating profit</b>	(386)	(300)	(251)	(159)	(7)	229	580	996	1,513	2,150	2,928	3,873	5,012
<b>EBIT (1-t)</b>	(301)	(234)	(196)	(124)	(5)	179	453	777	1,180	1,677	2,284	3,021	3,909
<b>Sales / Invested Capital</b>	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18
<b>Reinvestment</b>		1,147	783	940	1,128	1,354	1,624	975	1,072	1,179	1,297	1,427	1,570
<b>Free Cash Flow to Firm</b>		(1,381)	(979)	(1,064)	(1,133)	(1,175)	(1,172)	(198)	108	498	987	1,594	2,340
<b>Discount Rate</b>			11,7%	11,7%	11,6%	11,6%	11,5%	11,5%	11,4%	11,4%	11,3%	11,3%	11,2%
<b>PV</b>		(1,381)	(877)	(854)	(815)	(758)	(679)	(103)	51	210	376	547	726

Source: own work.



For estimating terminal value, I used a stable growth rate for the Entertainment industry of 4.11 percent retrieved from Damodaran Online (2022c). For the probability of failure, I assumed only 10 percent, as Spotify is a market leader in its business. From the adjusted Value of Operating Assets, I have deducted debt, added cash, and added value of investments, which I retrieved from Spotify's SEC Registration Statement.

*Table 9: DCF Analysis of Spotify (in million USD)*

Terminal Value	32,860
PV of Terminal Value	10,191
PV of Year 1-11	(3,558)
<b>Value of Operating Assets</b>	<b>6,633</b>
Probability of Failure	10%
Adjusted value of Operating Assets	5,970
- Debt	1,067
+ Cash	1,705
Investments	0,336
<b>Value of All Assets</b>	<b>6,944</b>

*Source: own work.*

Under the above assumptions, Spotify's valuation is almost 7 billion USD. This number is low compared to projections and the share price range. Therefore, I wanted to see what valuation I would get if assumptions would change.

If I assume the company would continue growing with a 40 percent growth rate for the next 5 years and then the growth would fall to 15 percent Spotify's valuation increases to 16.8 billion USD.

*Table 10: DCF Analysis of Spotify, growth of revenue 40 percent (in million USD)*

Terminal Value	111,926
PV of Terminal Value	34,713
PV of Year 1-11	(17,125)
<b>Value of Operating Assets</b>	<b>17,588</b>
Probability of Failure	10%
Adjusted value of Operating Assets	15,829
- Debt	1,067
+ Cash	1,705
Investments	336
<b>Value of All Assets</b>	<b>16,803</b>

*Source: own work.*

On the other hand, as Spotify’s main cost is licensing, I believe their cost in the future could be even lower. This time I assumed their cost of revenue would fall to 50 percent until 2028. This assumption results in Spotify’s valuation of 19.8 billion USD.

*Table 11: DCF Analysis of Spotify, cost of revenue 50 percent (in million USD)*

Terminal Value	69,464
PV of Terminal Value	21,544
PV of Year 1-11	(667)
<b>Value of Operating Assets</b>	<b>20,877</b>
Probability of Failure	10%
Adjusted value of Operating Assets	18,789
- Debt	1,067
+ Cash	1,705
Investments	336
<b>Value of All Assets</b>	<b>19,763</b>

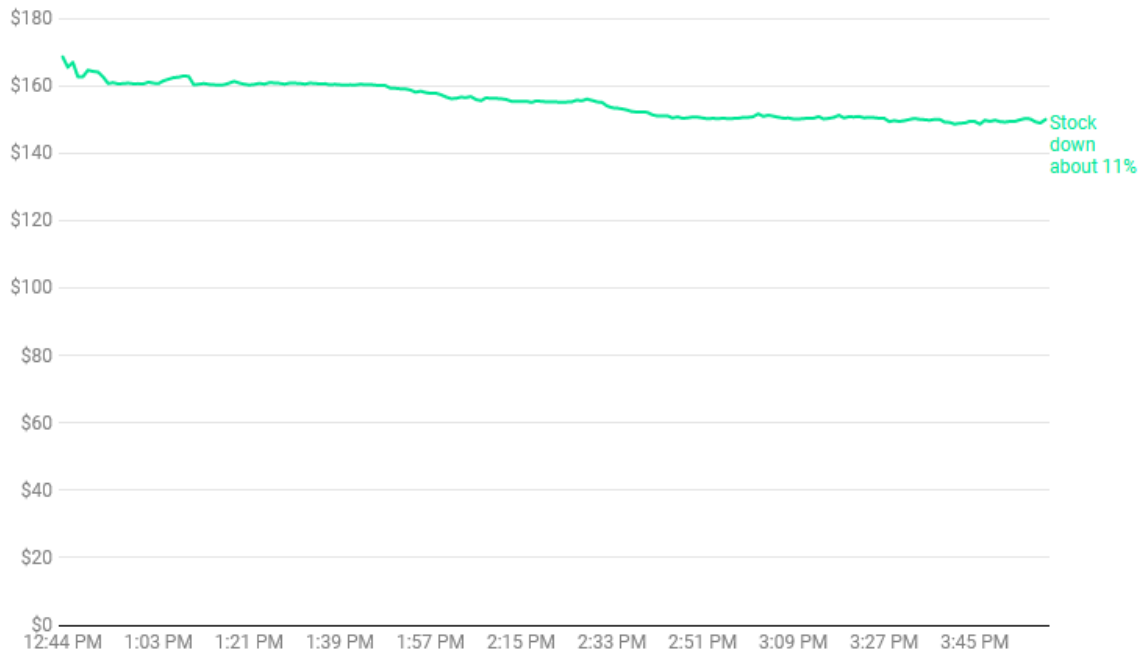
*Source: own work.*

With different assumptions I got valuations from 7 billion USD and up to 20 billion USD, depending on how optimistic I am about the future. Even small changes in variables can significantly affect the estimated value of a company. It is worth taking into consideration the company’s past financial results. Spotify was generating an increasing net loss of (84) million USD, (250) million USD, (255) million USD, (597) million USD, and (1.4) billion USD for five years in a row between 2013 and 2017, respectively (Spotify Technology, 2018). At the same time, their revenue growth was over 40 percent each year, growing from 0.9 billion USD in 2013 to 4.6 billion USD in 2017 (Spotify Technology, 2018). It is not uncommon for Unicorns to have a negative income, but it is hard to determine when and if the trend will change.

**3.6 Spotify after DPO**

On April 3, 2018, Spotify went public on New York Stock Exchange through direct listing with an opening price of 165.90 USD. Due to a novel approach using direct listing, Spotify’s first-day trading was highly volatile due to the unpredictability of the number of offered shares and market demand. As presented in figure 9, throughout the day Spotify’s stock had stable trading but in the afternoon experienced a fall and closed at 149.01 USD. Sill Spotify’s DPO was considered extremely successful, as its closing price was 13 percent higher than the estimated reference price of 132 USD. With a company valuation of 26.5 billion USD, Spotify ranked among the ten largest first-day valuation tech companies like Facebook and Alibaba in the United States (BBC, 2018).

Figure 9: Spotify's stock price on its first trading day



Source: Schleifer & Molla (2018).

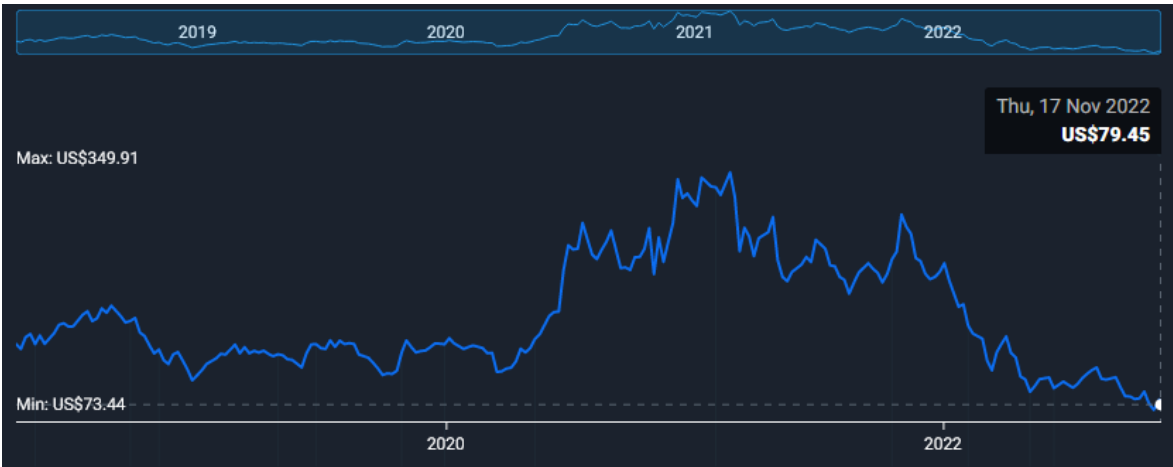
From 2017 to 2022 Spotify's earnings grew on average almost 42 percent per year, which is twice faster compared to the industry (Simply Wall St, 2022). On the other hand, its revenues are growing on average by 24 percent year over year. Since the beginning of 2017, the streaming company generated a positive net income in only six quarters, two of which were in 2021 (Zandt, 2022). So far Spotify's most successful periods were quarter four of 2018 with generated 552 million USD in profit and quarter three of 2019 generating 270 million USD (Zandt, 2022).

Looking into the trend of new subscribers, Spotify's number of users is growing steadily. We can observe a 7.6 percent growth in new subscribers between October 2020 and January 2021 as a consequence of the world pandemic and strong restrictions during winter months (Zandt, 2022). Nonetheless, the company did not show a profit for this period. In quarter two of 2021, Spotify did operate with a profit as their operating expenses were lower due to the COVID-19 pandemic. As they reported recruitment was slowed down and the company spent less than planned on travel, events, and campaigns (Götting, 2022b).

In the third quarter of 2022 streaming company is still operating with a negative margin and generating losses. Whilst unprofitable, Spotify's free cash flow is stable. We can assume that Spotify is continuing with the growth-first model instead of focusing on being profitable, as investors continue to support it. Spotify managed to raise significantly more funding compared to its competitors and future company valuations are mostly optimistic. Even Spotify's CEO Daniel Ek has confirmed that their plan currently is not to focus on profitability, but rather focus on long-term investment plans (Zandt, 2022). They are

continually investing in other business opportunities such as releasing the Audiobooks project in the United States, acquiring the music trivia game Heardle, and launching an official partnership with FC Barcelona (Zandt, 2022). The longer goal of the streaming service company is to reach one billion subscribers by 2030, while it is currently growing by an average of 5.7 million subscribers per year. As per Ek, they are expecting to see a turnaround from these investments and positive gross margins by 2023 (Zandt, 2022). Spotify has placed a strong focus on podcasts and will continue to do so. They are one of the most popular podcast providers in the United States. As per the habits of podcast listeners in 2022, Spotify has overtaken Apple Podcasts in terms of monthly podcast listeners in the United States (Götting, 2022a).

Figure 10: Price History and Performance



Source: Simply Wall St (2022).

Examining Spotify’s share price trend from the day of its direct listing we can observe a steep increase in share price between March 2020 and February 2021 as a reflection of a worldwide pandemic and market trend. Since the beginning of 2022, there is a declining pattern in share price, hitting a record low on 7<sup>th</sup> November at 73.44 USD per share. On November 18, 2022, Spotify’s stock was trading at 76.99 USD with a market capitalization of 14.9 billion USD. Comparing Spotify’s shareholder return of (70.3) percent it is way below the industry which returned (51.9) percent over the past year. From analysts' forecast and recent trading activities that shows obvious shareholders' disappointment, it is doubtful for Spotify to become profitable in 2023.

**CONCLUSION**

For many years companies preferred going public with the initial public offering. There were already known alternative ways of entering the public market in the past, nonetheless, companies continued with the traditional IPOs. This could be because IPO is a well-established and regulated method. It provides an opportunity for the company to gain

increased visibility, credibility, and liquidity for its shares. Additionally, the process of going public through an IPO can help a company to mature and professionalize its operations, as it is required to disclose financial and other information to the public as part of the process. Traditionally, IPOs were invented as a way of raising capital. Especially young companies would go public to get the needed funding. But through the years the number of new IPOs in the US started to decline. We could observe that companies were able to find capital without going public, for instance through private equity, venture capitalists, and angel investors. Therefore, the reason for going public today is not necessarily raising capital.

One of the alternative ways is a DPO. There are a few reasons, why a company would choose a DPO over an IPO, for example, one of them is costs. A DPO may be less expensive and less time-consuming than an IPO, as there are no underwriter and legal fees associated with going public. One such example was Spotify. They decided to go public with a direct listing, as the company did not require new capital but rather wanted to provide liquidity to existing shareholders. DPO allowed Spotify to avoid the traditional underwriting process and associated costs. Compared to average IPO costs for companies with such valuations, Spotify did save resources with a direct listing and would need to pay at least twice the amount if going public with an IPO.

Some studies have shown that IPOs create undervalued shares. This could be due to various factors such as market conditions, investor sentiment, and information asymmetry. One of the reasons is the underwriting process and underpricing. Companies hire investment banks as underwriters for their IPO. These underwriters are responsible for setting the initial offering price and determining the number of shares to be sold. They also act as market makers, buying shares from the company if there is not enough demand from other investors. To cover the risk associated with the new issuing, and to attract investors, underwriters use underpricing practice, which means that shares are sold to initial investors at a price lower than their true value. On the first day of trading underwriters and early investors make a profit, as there is a tendency for stocks to rise. This phenomenon is known as "first-day pop". As Spotify went public with DPO and no new shares were issued, the company did not need to hire an investment bank to underwrite. Accordingly, Spotify did avoid underpricing and one of the risks of undervaluation of their shares.

It is difficult to make a general statement about whether a DPO creates better shareholder value than an IPO as the outcome depends on various factors such as the company's financials, market conditions, investor sentiment, and the specific structure of the DPO or IPO. However, in specific situations, DPOs can offer certain advantages over IPOs that may lead to better shareholder value. For example, a company can go public without diluting existing shareholders' ownership. With DPO the primary investors can cash out with great returns or preserve their value. Additionally, when a company goes public with DPO, its ownership structure can be retained. It can be beneficial for a company to maintain control. Spotify's owners did keep their ownership in the company and continued with their original

vision, management, operations, and strategic direction. Such strategic consistency could be interpreted as an advantage to the shareholders.

As companies' needs and reasons for going public are changing, SEC is actively managing regulations in this area. It is already possible for a company to raise capital with a direct listing. Such an offering allows the company more control over the offering process and to target specific investors. Specifically, a company can raise capital directly from its customers and community, rather than from institutional investors. This can help the company maintain a strong relationship with its customer base and potentially increase brand loyalty. Hence DPOs can be particularly beneficial for larger companies that have a well-established investor base. Nevertheless, this is a new regulation that should be researched further.

Overall, the direct listing process appears to have been a success for Spotify. Although it is a very specific case, we should not generalize its results to other companies or industries. It is important for each company to evaluate the pros and cons of the DPO process and to choose the method that is the best fit for their specific circumstances. To conclude, DPO seems to be the right way of going public for well-known companies that would like to retain control over the company and have a large number of existing shareholders who would potentially like to cash out. Further research is needed to understand the long-term implications of direct listings.

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## **APPENDICES**





## Appendix 1: POVZETEK

Dolga leta so se podjetja odločala za vstop na borzo s prvo javno ponudbo (IPO). V preteklosti so bili že znani alternativni načini vstopa na javni trg, kljub temu pa so podjetja nadaljevala s tradicionalnim IPO-jem. To je morda zato, ker je IPO dobro uveljavljena in regulirana metoda. Zagotavlja priložnost, da podjetje pridobi večjo prepoznavnost, verodostojnost in likvidnost svojih delnic. Poleg tega lahko postopek vstopa na borzo prek IPO-ja pomaga podjetju, da postane bolj zrelo in profesionalno, saj je med procesom dolžan javnosti razkriti finančne in druge informacije. Tradicionalno je bil IPO ustanovljen kot način za zbiranja kapitala. Zlasti mlada podjetja so kotirala na borzi z namenom, da bi pridobila potrebna finančna sredstva. Toda z leti je število novih IPO-jev v ZDA začelo upadati. Opazili smo lahko, da so podjetja uspešno zbrala kapital brez kotiranja na borzi, na primer preko zasebnih vlagateljev, tveganega kapitala in poslovnih angelov. Danes tako glavni razlog za vstop na borzo ni nujno zbiranje kapitala.

Poznan alternativni način kotacije na borzi je na primer neposredna javna ponudba (DPO). Obstaja nekaj razlogov, zakaj bi podjetje izbralo DPO namesto IPO. Eden izmed teh so stroški. DPO je lahko cenejši in manj zamuden kot IPO, saj ne vključuje izdaje novih delnic in stroškov investicijske banke. Prvo veliko podjetje, ki je izbralo DPO za kotacijo na borzi je Spotify. Za vstop na borzo z neposredno kotacijo so se odločili, ker družba ni potrebovala novega kapitala, temveč je želela zagotoviti likvidnost obstoječim delničarjem. DPO je Spotify-ju omogočil, da se je izognil tradicionalnemu postopku prodaje novih delnic in s tem povezanim stroškom. Celotni stroški DPO-ja so bili za Spotify vsaj dvakrat nižji, kot bi v povprečju bili za podjetje s podobno vrednostjo v primeru IPO-ja.

Nekatere študije so pokazale, da IPO ustvarijo podcenjene delnice. To je lahko posledica različnih dejavnikov, kot so tržni pogoji, razpoloženje vlagateljev in asimetrija informacij. Eden od razlogov je postopek sistematičnega znižanja cen s strani investicijskih bank. Podjetja najamejo investicijske banke, da le-te določijo začetno ponudbeno ceno in število delnic za prodajo. Delujejo tudi kot vzdrževalci trga in zavarovalnica, saj so v primeru premajhnega povpraševanja obvezane kupiti vse neprodane delnice. Da bi pokrile tveganje, povezano z novo izdajo, in hkrati pritegnile vlagatelje, investicijske banke uporabljajo prakso podcenjevanja, kar pomeni, da se delnice prvim vlagateljem prodajo po ceni, ki je nižja od njihove dejanske vrednosti. Tako prvi dan trgovanja zgodnji vlagatelji ustvarijo dobiček, saj obstaja tendenca rasti delnic. Ta pojav je znan kot "pop up". Ker je Spotify kotiral na borzi z DPO in niso bile izdane nobene nove delnice, podjetju ni bilo treba najeti investicijske banke. Skladno s tem se je Spotify izognil prenizki začetni ceni in enemu od tveganj podcenjenosti svojih delnic.

Težko je podati splošno izjavo o tem, ali DPO ustvarja boljšo vrednost za delničarje kot IPO, saj je rezultat odvisen od različnih dejavnikov, kot so finančno stanje podjetja, tržni pogoji, razpoloženje vlagateljev in struktura DPO ali IPO. Vendar pa lahko DPO v posebnih situacijah ponudijo določene prednosti pred IPO, katere lahko posledično privedejo do večje

vrednosti za delničarje. Na primer, podjetje lahko postane javno, ne da bi zmanjšalo lastništvo obstoječih delničarjev. Z DPO lahko primarni vlagatelji prodajo svoj delež z velikimi donosi ali pa ohranijo svojo vrednost v podjetju. Poleg tega, ko postane podjetje javno z DPO, ima le-to možnost obdrži lastniško strukturo in ohrani nadzor, kar je lahko koristno. Lastniki Spotifyja so obdržali svoje lastništvo v podjetju in nadaljevali s prvotno vizijo, upravljanjem in strateškimi usmeritvami. Tako strateško doslednost bi si lahko razlagali kot prednost za delničarje.

Ker se potrebe podjetij in razlogi za vstop na borzo spreminjajo, SEC aktivno upravlja predpise na tem področju. Že zdaj je možno, da podjetje pridobi kapital z neposredno kotacijo. Takšna ponudba omogoča podjetju večji nadzor nad postopkom ponudbe in ciljanje na določene vlagatelje. Natančneje, podjetje lahko zbere kapital neposredno od svojih strank in skupnosti, in ne od institucionalnih vlagateljev. To lahko pomaga podjetju ohraniti trden odnos s svojo bazo strank in potencialno povečati zvestobo blagovni znamki. Zato so DPO lahko še posebej koristne za večja podjetja, ki imajo dobro vzpostavljeno bazo vlagateljev. Kljub temu gre za novo uredbo, ki bi jo bilo treba nadaljnjo raziskati.

Na splošno se zdi, da je bil postopek neposredne uvrstitve na borzo za Spotify uspešen. Vendar gre za zelo specifičen primer in njegovih rezultatov ne smemo posploševati na druga podjetja ali panoge. Za vsako podjetje je pomembno, da oceni prednosti in slabosti postopka DPO in izbere metodo, ki najbolj ustreza njihovim specifičnim okoliščinam. Za zaključek se zdi, da je DPO pravi način vstopa na borzo za znana podjetja z močnimi in prepoznavnimi blagovnimi znamkami, ki bi želela obdržati nadzor nad podjetjem in imejo veliko število obstoječih delničarjev. Za razumevanje dolgoročnih posledic neposrednih kotacij so potrebne nadaljnje raziskave.

**Appendix 2: Spotify's Present Value of Future Cash Flow calculation, growth of revenue 40 percent (in million USD)**

		0	1	2	3	4	5	6	7	8	9	10	11
in million USD	<b>2016</b>	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>	<b>2022</b>	<b>2023</b>	<b>2024</b>	<b>2025</b>	<b>2026</b>	<b>2027</b>	<b>2028</b>
<b>Revenue</b>	3.268	4.622	6.470	9.059	12.682	17.755	24.857	32.314	42.008	54.610	70.993	85.192	97.970
<b>Revenue Growth</b>		41%	40%	40%	40%	40%	40%	30%	30%	30%	30%	20%	15%
<b>Cost of Revenue</b>	2.824	3.662	5.073	7.026	9.730	13.473	18.653	23.977	30.817	39.603	50.888	60.350	68.579
<b>% Cost of Revenue</b>	86%	79%	78%	78%	77%	76%	75%	74%	73%	73%	72%	71%	70%
<b>Gross profit</b>	444	959	1.397	2.033	2.952	4.282	6.204	8.337	11.191	15.007	20.105	24.842	29.391
<b>Adjusted Operating Margin</b>	(87)%	(31)%	(21)%	(11)%	0%	10%	20%	31%	41%	51%	61%	72%	82%
<b>Adjusted Operating profit</b>	(386)	(300)	(293)	(217)	(11)	425	1.254	2.544	4.567	7.670	12.346	17.812	24.101
<b>EBIT (1-t)</b>	(301)	(234)	(229)	(169)	(9)	331	978	1.984	3.562	5.982	9.630	13.893	18.799
<b>Sales / Invested Capital</b>	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18
<b>Reinvestment</b>		1.147	1.567	2.193	3.071	4.299	6.019	6.319	8.215	10.680	13.884	12.033	10.829
<b>Free Cash Flow to Firm</b>		(1.381)	(1.795)	(2.363)	(3.079)	(3.968)	(5.040)	(4.335)	(4.653)	(4.698)	(4.254)	1.861	7.969
<b>Discount Rate</b>			11,7%	11,7%	11,6%	11,6%	11,5%	11,5%	11,4%	11,4%	11,3%	11,3%	11,2%
<b>PV</b>		(1.381)	(1.607)	(1.895)	(2.215)	(2.561)	(2.922)	(2.260)	(2.182)	(1.984)	(1.620)	639	2.472

*Source: own work.*

**Appendix 3: Spotify's Present Value of Future Cash Flow calculation, cost of revenue 50 percent (in million USD)**

		0	1	2	3	4	5	6	7	8	9	10	11
in million USD	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
<b>Revenue</b>	3.268	4.622	5.546	6.655	7.986	9.584	11.500	12.650	13.915	15.307	16.838	18.521	20.373
<b>Revenue Growth</b>		41%	20%	20%	20%	20%	20%	10%	10%	10%	10%	10%	10%
<b>Cost of Revenue</b>	2.824	3.662	4.247	4.920	5.692	6.575	7.584	8.007	8.437	8.874	9.314	9.753	10.187
<b>% Cost of Revenue</b>	86%	79%	77%	74%	71%	69%	66%	63%	61%	58%	55%	53%	50%
<b>Gross profit</b>	444	959	1299	1735	2.295	3.008	3.916	4.644	5.478	6.433	7.524	8.768	10.187
<b>Adjusted Operating Margin</b>	(87)%	(31)%	(21)%	(11)%	0%	10%	20%	31%	41%	51%	61%	72%	82%
<b>Adjusted Operating profit</b>	(386)	(300)	(272)	(185)	(9)	298	792	1.417	2.236	3.288	4.620	6.287	8.353
<b>EBIT (1-t)</b>	(301)	(234)	(212)	(145)	(7)	233	617	1.105	1.744	2.564	3.603	4.904	6.515
<b>Sales / Invested Capital</b>	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18	1,18
<b>Reinvestment</b>		1.147	783	940	1.128	1.354	1.624	975	1.072	1.179	1.297	1.427	1.570
<b>Free Cash Flow to Firm</b>		(1.381)	(996)	(1.085)	(1.135)	(1.121)	(1.007)	131	672	1.385	2.306	3.477	4.946
<b>Discount Rate</b>			11,7%	11,66%	11,61%	11,57%	11,52%	11,47%	11,42%	11,37%	11,33%	11,28%	11,23%
<b>PV</b>		(1.381)	(891)	(870)	(816)	(723)	(584)	68	315	585	878	1.194	1.534

*Source: own work.*