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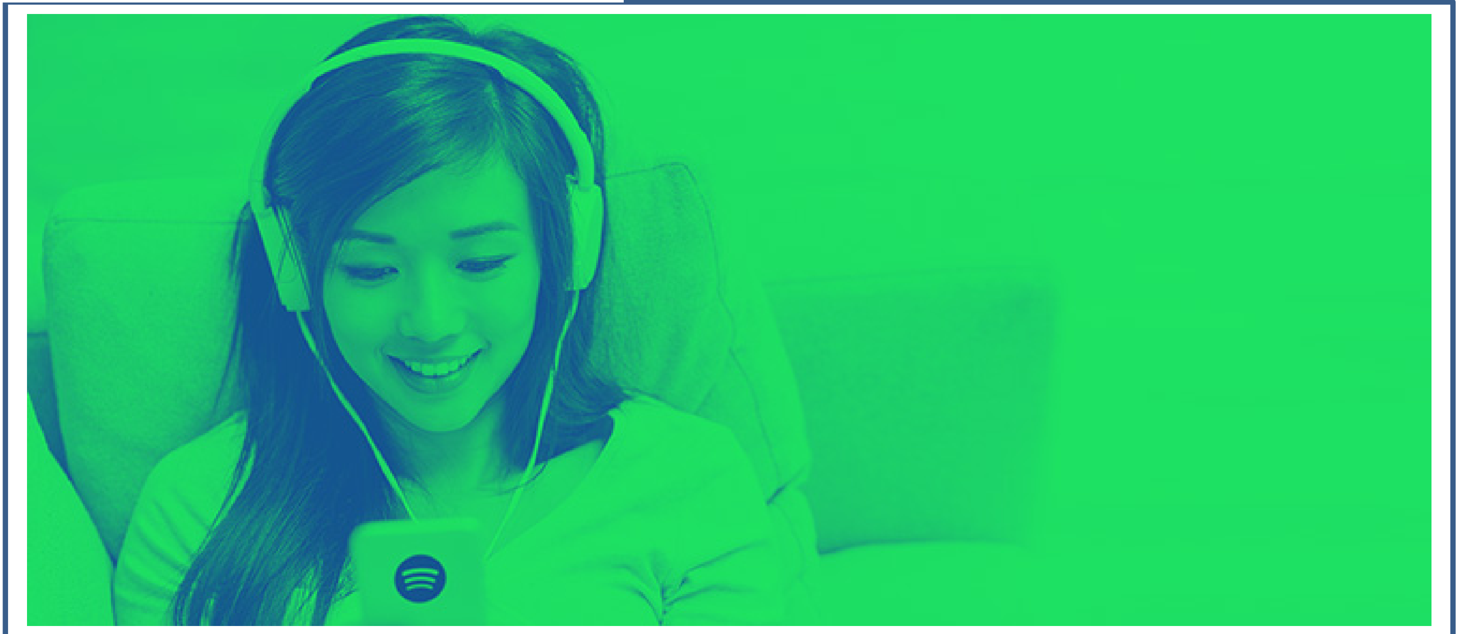

SPOTIFY GOES FOR GUTSY DIRECT LISTING ON STOCK EXCHANGE – HERE ARE THE WINNERS AND LOSERS

THE MOVE WILL BE A WORRY FOR THE BANKS AND DOESN'T GUARANTEE A NET BENEFIT FOR THE COMPANY

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When Spotify finally went public on the New York Stock Exchange on April 3 as SPOT, it did so in a very unconventional way. For one thing, there was none of the usual fanfare. The CEO didn't ring the opening bell; in fact, he didn't even show up. The media covering the event had to talk among themselves as no one from the company was available for interviews.

The initial public offering (IPO) was unusual in other aspects as well. To start with, it was a direct listing, meaning that the company didn't issue any new shares. Instead, all the existing shares were listed directly on the exchange for open trading with retail investors but with none of the typical involvement of investment banks. This approach caused some bafflement at the NYSE, as no one really knew how to price the shares. The consensus value was US$132, but after some confusion, the shares opened up around lunchtime at US$165.90, then closed the day at US$149.01, valuing the company at US$26.5 billion.

By all standards, this was a successful IPO – the company shares rose above their assumed opening price, and demand was strong, even in an uncertain market where recent IPOs have struggled. Let's take a look at the main winners and losers.

Winners and losers

The clear winners are undoubtedly Spotify's shareholders, consisting of venture capitalists, music companies like Sony BMG, early investors like China's Tencent, and employees. They saw their holdings grow massively without having to share the gains with the usual gaggle of investment banks and institutional investors.

Others on the winning side were companies contemplating going public, but nervous about the traditional path. Spotify has shown that a direct listing approach can work.

Additionally, Spotify users and customers will benefit as well. Subject to the disclosure rules of the NYSE, Spotify will now be obliged to publish earning releases, insider trading transactions, executive compensation and other decisions which ultimately determine the sustainability of the company. Spotify's management is therefore submitting itself to the discipline of markets.

Retail investors have clearly benefited from the IPO mechanics. In a standard book-building process, the initial allocation of shares goes to institutional investors, who can then flip their shares in the secondary market and benefit from IPO underpricing. Since new retail investors have direct access to the shares originally sold, the underpricing proceeds (about US$17 per share) have been partly enjoyed by individual, not institutional, investors.

However, not everyone was a winner.

Investment banks and others that typically benefit from the listing of shares were largely cut out of Spotify's IPO (although the company did retain financial advisers). By pursuing a direct listing, Spotify probably avoided tens of millions of dollars in direct fees, and didn't have to give special deals to large investors. True to its Scandinavian roots, Spotify chose an egalitarian route.

Wall Street banks, already nervous about Initial Coin Offerings (ICOs), crowdfunding, and other avenues to raising capital, will be nervous about Spotify's approach to going public. Google tried a similar route in 2004when it tried to sell shares directly to the public through a "Dutch auction" process and without underwriters. Ultimately, it surrendered to the Investment Banking industry and ended up hiring advisers to help with its IPO. The Spotify IPO marks a new era in IPO underwriting as market participants now have direct access to information about companies that seek financing. Investment banks are no longer necessary.

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What about Spotify itself?

If the investment banks were the losers and early investors the winners, where does that leave the company itself? We think that Spotify is in a worse position now compared to when it was private. While its IPO has been great for its investors, we don't think it's been as good for the company. There are three reasons for this.

First, the company raised no new capital. By listing directly, all the gains went to investors and none to the company itself. By contrast, Alibaba raised US$21 billion and Facebook raised US$16 billion when they went public. This means that Spotify must rely on existing sources of capital and ongoing operations to fund its growth. Unfortunately, it is losing money (it has never made a profit), and will thus need to become more efficient, raise its prices, or both. Without new capital, it will be harder for the company to compete.

When companies go public without raising funds, they usually do it to issue "acquisition currency", that is, to either make it easier for potential acquirers to buy the company now that it is publicly listed (through a tender offer); or to allow the company to embark on acquisitions in the home market – a stock-for-stock acquisition in the US is only possible if the acquirer's shares are listed on US markets. In either case, the Spotify IPO marks a new growth strategy that is focused, not on organic growth and innovation, but on combining its platform and customer base with other larger and smaller companies.

Second, and as mentioned earlier, Spotify will now be subject to all the rules and regulations required as a publicly listed company. It will also need to be transparent in its financial position, and subject to much more media, analyst, and investor scrutiny. Management will have to spend more time managing shareholders. This will make the company more transparent, but also less agile.

Third, private companies generally have more freedom to think in the long term. Spotify will now have to cater more to the short-term whims of investors.

The day before the listing, Daniel Ek, one of Spotify's founders and company CEO, published a blog about the IPO. He said: "Spotify is not raising capital, and our shareholders and employees have been free to buy and sell our stock for years. So, while tomorrow puts us on a bigger stage, it doesn't change who we are, what we are about, or how we operate."

But as a public company, Spotify will undoubtedly have to change who it is. It will become less flexible and more restricted in how it operates. And, it took on these additional constraints without the benefit of raising capital. While direct listing was a gutsy move that tempered the greed of Wall Street, we are not convinced that it resulted in a net benefit for the company.

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