

Entrepreneurial Financing



Business Harvesting Strategies

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Lecture 9

ENT 632

Entrepreneurial Financing



- a) Identifying types of financing that are associated with new venture exit. Identifying the more important harvesting alternatives.
- b) Explaining how a new venture going public.
- c) Identifying Other alternatives include private acquisition, management buyout, creation of an ESOP, and indirect approaches to public offering, such as reverse merger and roll-up IPO.
- d) Explaining advantages and disadvantages of Acquisition, MBOs, ESOPs, and roll-ups.
- e) Identifying how to make the correct choice in any instance .

- **Harvesting is the final stage of the entrepreneurial investment process.**
- **It also is a critical component of initial investment decisions.**
- Investors evaluate opportunities based on the expectation of a liquidity event that will enable them to realize a return and allow them to shift attention to other projects.
- To estimate exit value when they make the investment decision, investors must make assumptions about how and when the investment will be harvested and about the return they will realize.
- Harvesting is also of direct importance to entrepreneurs, but the issues may be different. Some entrepreneurs are like investors in their desire to harvest and move on to other endeavors.
- Others view the venture as a lifetime commitment and seek to earn returns through the continuing free cash flow of the venture or through partial liquidation of their holdings.
- Both types should be seeking to realize a return that compensates for the opportunity cost of their capital and effort.
- Going public and private sale of the venture to another firm (i.e., acquisition) are the harvesting alternatives that normally receive the most attention in business plans.
- Other important alternatives include a management buyout (MBO), sale of the business to employees or other members of the team, and continuing to operate the venture.

13.1 Going Public

- When a venture goes public, an ongoing public market is established for its common stock.
- **The issuing firm raises capital by selling new shares to public market investors.**
- The IPO is only the first step in the process of harvesting by going public.
- By placing freely tradable shares in the hands of investors, **the IPO enables investors in the stock market to establish a public market value for the equity.**
- The public market itself is predominantly a “**secondary market**” where market participants transact with each other.
- Thus, **secondary market transactions transfer ownership among investors; they do not generate new funds for the firm that originally issued the shares.**

13.1 Going Public

- **A venture that has already gone public can raise additional capital by issuing new shares in a subsequent primary offering.**
- Such an offering is called a “**seasoned offering**,” meaning that the issuer’s shares have already gone through a “seasoning” period of trading in the public market.
- **A seasoned offering is not the same as a secondary offering unless the shares that are sold in the offering are not newly issued.**
- In a secondary offering, the shares that are sold were issued previously and are being resold by existing investors.
- Sellers may include VCs and other early-stage investors, the entrepreneur, and others who acquired shares from the firm.
- Market value (or market capitalization) is the share price times the number of shares outstanding.
- It is determined by the price that equates secondary market demand with secondary market supply.
- Except for primary market transactions and first-time public sales of shares by entrepreneurs and others who invested before the IPO, secondary market supply (the “float”) is fixed.
- With supply fixed, fluctuations in market value result from changes in demand.
- Such value changes reflect changes either in expectations about future free cash flows or in the rate of return required by investors.

13.1 Going Public

Equity investors can harvest their investments in public companies in four ways:

1. *Secondary sale as part of the IPO.*

- Existing investors, including the entrepreneur and the VC, can sometimes harvest a portion of their investment by selling some of the shares they own in the IPO.

2. *Sale in the secondary market.*

- Once the public market is established, investors who acquired their shares before the company became publicly traded can sell small amounts of shares from time to time directly into the public market.

3. *Seasoned offerings of secondary shares.*

- Investors who acquired their shares before the company was publicly traded can sell larger quantities of shares in a formal secondary public offering after the IPO.

4. *Private placement of secondary shares.*

- Investors can use the public market value to benchmark the price and make a private sale to another investor, the entrepreneur, or the company.

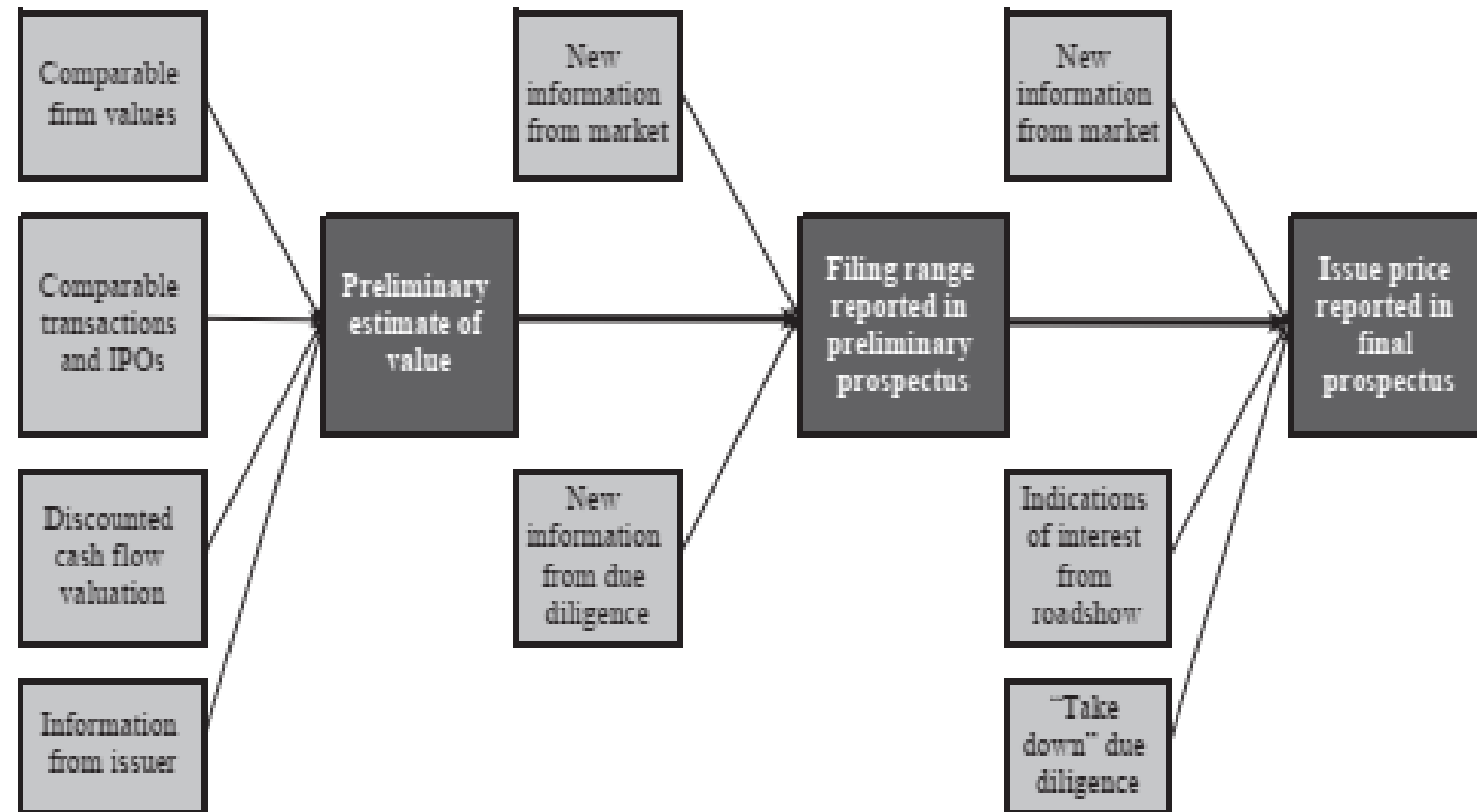
The IPO Process

- A firm-commitment general cash offering is the process for going public that is used most often in the U.S.
- In some countries a rights offering process, is more common.

Selecting The Underwriter.

- A management team that is considering a public offering normally begins by selecting an investment banker or team (syndicate) of investment bankers to underwrite the offering.
- The selection process, sometimes referred to as a “bake-off” or “beauty contest,” can include multiple contestants.
- **The selected underwriter** is responsible for forming the underwriting syndicate, advising the issuer, distributing the shares, and underwriting the risk of market price fluctuations during the offering.
- A broader notion of the term “underwrite” is that the underwriter also makes explicit and implicit representations about share value.
- The choice of investment banker involves matching underwriter capabilities with the issuer’s specific interests and objectives.
- Investment bankers have different capabilities and different approaches for carrying out the offerings. Some, for example, focus on institutional brokerage clients, whereas others focus more on retail.
- This focus affects the kinds of investors with whom the underwriter is likely to place the stock.
- Some investment bankers have established reputations and expertise for handling offerings in particular industries.
- Some have more limited capabilities but may be able to underwrite small issues at lower cost.
- These different capabilities explain why **the issuer may select a lead and co-lead underwriter and may go further by using a syndicate of underwriters to help market the offering.**

FIGURE 13.1
IPO issue pricing
process for a
firm commitment
underwriting



The Cost Of Initial Public Offerings

- **Going public is expensive.**
- The costs associated with an IPO include the fee or spread charged by the underwriter, the out-of-pocket costs of the issuer, and the effective cost of underpricing.
- **Underpricing** is normally measured as the initial return ((first aftermarket closing price – issue price)/issue price).

Why are IPOs so expensive, and why do both fees and underpricing tend to be larger percentages of proceeds for smaller issues?

- One reason is that there are significant fixed costs associated with underwriting a new issue.
- Much of the cost of preparing the prospectus, for example, is fixed.
- Fixed costs contribute to the negative relationship between issue size and the fee percentage.
- Furthermore, due-diligence costs depend on how fully the issuer hopes to price the offering.
- Conducting proper due diligence prior to taking a company public is a key step for all parties to ensure that all information in the registration statement is accurate and thereby reduce your liability.

Other Approaches To Public Offering

- The approach we have described is a firm commitment general cash offering.
- The term “firm commitment” means that the underwriter commits to buying all of the issued shares at the net price in the prospectus.
- The underwriter’s compensation is realized by reselling at a higher price. The difference between the gross price and the net price is the underwriter’s fee or spread.

- There are other ways to issue public equity:

1) Best-efforts offering.

- An offering can be done on a best-efforts basis.
- In a best-efforts offering, the investment banker acts more like an agent of the issuer and does not guarantee net proceeds.
- You might expect that issuers would select best-efforts offerings when they wish to raise capital but do not have specific concerns about the amount that is actually raised.
- However, the best efforts approach also suggests that the issuer is concerned about achieving a high price and that the issuer and the underwriter may disagree about the value of the shares.
- In a best-efforts offering, the underwriter provides distribution services but does not certify the price.
- **The evidence on best-efforts offerings is not positive; generally, it appears that issuers could have achieved more success with a general cash offering.**

2) Rights Offering.

- The term “**general cash offering**” signifies that the shares are sold to the investing public at large in exchange for cash.
- In contrast, in a “**rights offering**,” the firm offers shares to existing shareholders, in exchange for cash and warrants.
- Rights offerings are more common outside the U.S.
- In a rights offering, an issuer that is already publicly traded raises equity by issuing warrants to existing shareholders.
- The **warrants** are separately tradable call options that enable the shareholders to purchase new shares at a fixed price for a specified period.
- **Shareholders who do not wish to exercise their rights can sell the warrants to others.**
- Assuming that each new share requires one warrant, the effective price of a new share is the exercise price of the warrant plus the market value of the warrant.
- The issuing firm receives the exercise price, and existing shareholders receive the market value of the warrants.
- If the issuer is not yet public, a public market for the shares can be created by first allowing the warrants to trade and then allowing the shares to trade.

3) Auction Method Offering.

- In the auction method, **any investor can bid for the price and quantity of shares sought in the IPO.**
- After all bids have been collected, the underwriter (in conjunction with the issuer) can determine the offer price at which the quantity of shares offered will equal the quantity of shares demanded by investors.
- **The rationale for the auction method is that it can reduce or eliminate underpricing and the practices of flipping and spinning.**
- General cash offerings involve intentional underpricing, such that the aftermarket price is expected to be above the issue price.
- This indicates that at the issue price, there is more demand for the shares than there are shares available.
- Underwriters respond to excess demand by rationing the shares in ways that appear to favor preferred customers, such as those who are willing to buy even when an issue seems overpriced, and who refrain from “flipping” the shares to make a quick profit, or who may be sources of future business (“spinning”).
- On the one hand, underpricing may be an efficient aspect of the offering process that contributes to the certification efficacy of the underwriter and reduces costs of due diligence and marketing.
- On the other, it may be an unnecessarily good deal for the underwriter’s preferred customers.
- As an alternative, a few companies in the U.S. have gone public using an auction method.

4) Reverse Merger.

- A reverse merger (also called a reverse IPO) is an alternative way for a private company to become public.
- A **reverse takeover, reverse merger, or reverse IPO** is the acquisition of a public company by a private company so that the private company can bypass the lengthy and complex process of going public.
- Sometimes, conversely, the public company is bought by the private company through an asset swap and share issue.
- In a reverse merger, an existing public company nominally acquires the shares of the private company and possibly then changes its name to that of the private company.
- The public company is usually nothing more than a shell—often a remnant of an unsuccessful public company.
- Its only remaining value is that its shares are publicly registered and tradeable, making it a target for a firm that wants to establish a public market but does not need to use an IPO to raise capital and does not want to incur the expense of a public offering.
- The notional acquirer (the public company shell) does not need to have any resources to accomplish the acquisition.
- Rather, the owners of the private company simply exchange their shares for shares of the public company.
- Normally, at the same time, they will change the name of the acquiring public company shell to that of the acquired formerly private company.
- **Reverse merger does not require an underwriter**, avoids the cost of an IPO, and can be accomplished relatively quickly.
- As there is no certification of value, the aftermarket capitalization may be less than if the company were to go public via IPO.

5) Direct Public Listing.

- Direct listing is a rarely used alternative to a traditional IPO that offers benefits similar to reverse merger.
- Direct listing involves registering existing private company shares for public market trading on an exchange such as NASDAQ or the new york stock exchange (NYSE).
- In a direct listing, the firm issues no new shares and does not normally engage the services of an underwriter.
- The main functions of direct listing are to enable existing shareholders to harvest their investments through aftermarket public sale and to establish a public market value for the shares.
- Direct listing in the U.S. Requires financial disclosures similar to those required in an IPO, and the firm is subject to the sec's ongoing reporting requirements.
- Spotify is the most significant recent example of direct listing.
- Historically, most direct listings have been by small companies.
- Spotify is an exception and may pioneer this approach for other firms that are interested in public market visibility but are not in need of the capital that would be generated through an IPO.

6) Direct Public Offering.

- Direct public offering (DPO) is not the same as direct listing.
- It is a type of offering that allows companies to raise capital by selling securities directly to the public.
- It eliminates the intermediaries that are often involved in the offering process, thereby cutting down the costs of raising capital.
- It is a way for companies to become publicly traded without a bank-backed Initial Public Offering (IPO).

Harvesting In The IPO

- For early investors in a company that later goes public, the IPO is only the beginning of the harvesting process.
- The entrepreneur, VCs, and other early investors do not normally sell shares during the IPO.
- There are three reasons for an investor, such as a VC, to refrain from selling during the IPO of a portfolio company.
- **First**, potential public market investors are likely to perceive insider selling as a negative signal (though not when the VC is facing expiration of the fund).
- A **second reason** is that the investor expects to continue to add significant value to the venture.
- The investor would want to hold the shares until the ability to add value falls below what the investor could achieve by focusing on other ventures.
- **The third reason** is that shares sold in the IPO are likely to be underpriced. By waiting, the investor can usually obtain a higher price.

Harvesting after the IPO

- Typically, even if an early investor does not sell in the IPO, the investor's shares will be registered along with those sold by the issuing firm.
- **Registered shares are freely tradable in the aftermarket and can be sold.**
- **The main limitation** is that existing shareholders normally have agreed with the underwriter to refrain from trading, usually for 180 days after the IPO.
- **This “lockup period” serves at least two functions:**
- ***First***, it removes the need for an underwriter, who normally supports the market during an offering, to purchase shares that are being sold into the market at the same time by existing shareholders.
- ***Second***, it allows enough time to pass so that the sellers cannot easily be accused of trading on the basis of information that should have been disclosed in the prospectus.

3.2 Acquisition

- While many entrepreneurs aspire to going public, by far **the more common successful exit**, especially after 2000, **has been acquisition or merger.**
- When investment in a venture is harvested by acquisition or merger with another company, the transaction can take any of several forms.
- **The acquirer can purchase the equity of the venture for cash or exchange it for shares of the acquiring company.**
- Alternatively, **the acquirer can purchase all or some of the venture's assets for cash or stock.**
- The choice is affected by a variety of considerations.

3.2 Acquisition

Purchasing Venture Equity For Cash

- By purchasing the equity, the buyer acquires ownership of the assets of the venture and assumes the liabilities.
- The parties enter a stock purchase agreement that sets out the terms and describes the assets and liabilities.
- The acquirer normally undertakes some level of due diligence to verify its assessment of value.
- In addition, sellers are normally expected to provide representations and warranties that go to issues of value.
- For example, the seller may warrant that the accounts receivable balance the purchaser will acquire was prepared in a manner consistent with GAAP; that the venture is the legal owner of any intellectual property being transferred; and that the sellers are unaware of any existing or prospective litigation.
- To an extent, due-diligence efforts and representations and warranties are substitutes.
- A seller may be hesitant to open its records to the review of a prospective buyer.
- This is understandable because if the transaction is not consummated, the buyer could have gained access to confidential information about the seller.
- In addition, if the venture is small, the cost of extensive due diligence can exceed the expected benefit.

3.2 Acquisition

Purchasing Venture Equity For Cash

- From the perspective of an investor, such as a VC firm, sale of equity for cash is likely to be the preferred form of transaction.
- However, it may be the most difficult form on which to agree.
- It may also be unattractive to the entrepreneur.
- For the investor, selling for cash facilitates harvesting because cash is easily distributed to limited partners.
- In addition, because many institutional limited partners are not taxed on their earnings, receiving cash does not give rise to adverse tax consequences.
- An entrepreneur who is selling equity in a venture may have a different perspective. If the sale involves a gain, the entrepreneur and members of the management team may be exposed to a significant immediate tax liability.
- On a more qualitative level, selling for cash has an aspect of finality that may not be to the entrepreneur's liking.
- For the purchaser, acquiring equity for cash involves the most risk.
- By acquiring shares and paying cash, the acquirer is giving up a safe asset and acquiring one that is risky.
- Furthermore, if the acquirer must borrow the cash, then leverage increases.
- The increase in risk is not particularly important in itself, but adding leverage can deprive the acquirer of financial slack that could be used for other opportunities.

3.2 Acquisition (CONT.)

Exchanging Venture Equity Or Assets For Equity Of The Acquirer

- Some transactions are structured as exchanges of the acquirer's stock for either the stock or assets of the venture.
- Exchanges of stock for assets are difficult because the seller is left with the liabilities and may not have the liquidity to service the debt.
- Accordingly, **we focus on exchanges of stock for stock.**
- In such exchanges, **uncertainty about value exists on both sides.**
- **Not only must the buyer conduct due diligence, but sellers must also value the shares they will receive.**
- **The problem is particularly difficult if the acquirer is not a public company.**

3.2 Acquisition (CONT.)

After The Acquisition

- **In some transactions, the acquirer would like to retain members of the venture's management team.**
- **Employment agreements protect the acquirer from loss of value resulting from resignations by team members.**
- The acquirer may also seek to align the incentives of team members with the interests of the acquirer.
- Approaches include asking team members to accept restricted shares of the acquirer (so their ability to trade and defeat incentive alignment is limited), compensating team members with equity claims or options on the acquiring firm, or offering incentive pay.
- **The acquirer may also be concerned that once the venture is sold, team members will decide to reenter the market as competitors.**
- Accordingly, sellers are sometimes asked to accept noncompete agreements and incentive compensation that increases the return to selling founders for the success of the enterprise that results from their continuing involvement.

3.2 Acquisition (*CONT.*) : After The Acquisition Agreeing To Disagree

- When sellers are more optimistic about the venture than is the acquirer, reaching agreement on fixed terms of exchange is difficult.
- **The parties can try to address the difference** by devoting resources to due diligence or by strengthening representations and warranties.
- **If the seller has stayed on as an employee, then the employee's bonuses can be tied to firm performance.**

13.4 Management Buyout

- **Harvesting opportunities are critical to VCs and other outside investors.**
- They may be **less important to the entrepreneur and key members of the management team.**
- Recognizing that harvesting is a source of potential conflict, the **parties normally negotiate harvesting options at the time of the initial investment.**
- **A management buyout** is a form of acquisition in which a company's existing managers acquire a large part, or all, of the company, whether from a parent company or individual.
- A **management buyout (MBO)** proposal can be a response to investor insistence on exercising demand registration rights or rights that could trigger an acquisition.
- Suppose investors have located a potential buyer.
- Members of the management team, however, wish to continue involvement with the venture and value their status as equity holders; perhaps they believe the venture has more potential than is reflected in the transaction terms under consideration. One response is to counter with a buyout proposal.

13.4 Management Buyout (Cont.)

- **MBOs are usually financed with debt.**
- The investors' equity is valued and borrowing is arranged so that the venture, the entrepreneur, or other members of the management team can repurchase the investors' shares.
- Regardless of how the transaction is implemented, **the venture normally ends up with a capital structure that is more highly leveraged than before the MBO.**
- **An MBO is feasible only if the venture is reasonably successful.**
- Value must be high enough to justify the price the investors receive.
- In the case of a leveraged transaction, the venture must be capable of generating enough cash flow to service the debt.

13.4 Management Buyout (Cont.)

Valuing MBO Transactions

- **The advantage of an MBO** is that the buyer (the management team) already knows almost everything there is to know about the venture. Because due diligence is not necessary, the transactions cost can be low.
- Generally, **the rationale for an MBO is stronger if management expects that capital market investors will recognize and accept its assessment of value within a short period, enabling a subsequent public offering or partial private sale.**

13.5 Employee Stock Ownership Plans

- **Employee stock ownership plans (ESOPs)** are used widely in public corporations to allocate ownership to employees for a variety of purposes.
- The ESOP, however, was originally conceived as a means of providing liquidity to owners of private businesses, in lieu of alternatives such as public offering or acquisition.
- ESOPs can also be **used in private businesses to help align incentives or to enable employees to defer some of their compensation.**

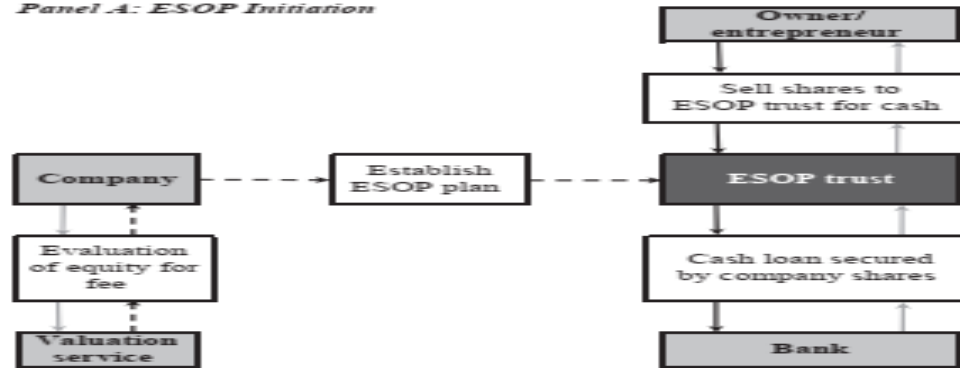
Valuation Considerations

- Although the ESOP provides the liquidity needed for certain critical transactions, **the company remains private.**
- The entrepreneur's under diversified position can be improved by liquidating some of the holdings and reinvesting the proceeds.
- The values at which shares are purchased and transferred to the ESOP and to employees usually reflect discounts from public market value.
- Discounts are appropriate because employees are relying on a valuation estimate rather than a verifiable market transaction and because an employee's retirement portfolio is under diversified.
- **Even if the company is public, employee investments of retirement funds in company stock are normally made at discounts to reflect under diversification.**

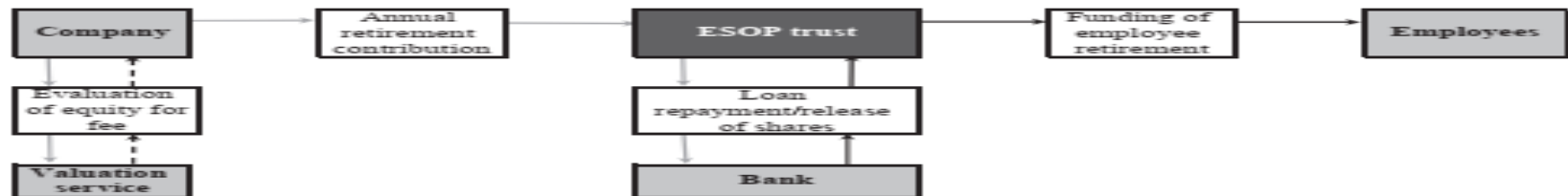
FIGURE 13.4
Structure of a private leveraged ESOP

Black arrows designate flow of shares; gray arrows designate flow of cash; dashed arrows are other flows.

Panel A: ESOP Initiation



Panel B: Annual Retirement Contribution Funding



Panel C: Share Redemption at Employee Retirement



13.6 Roll-up IPO

- A roll-up IPO is **in which a shell company goes public while simultaneously merging with a number of other companies that operate in the same industry.**
- A company that is too small to go public by itself, it may be able to do so by combining with others to create an organization that is large enough to make efficient use of the public offering process.
- A **roll-up IPO** is a device that enables this to occur.
- Figure 13.5 illustrates the process.
- **Normally, a roll-up combines several smaller firms that are similar in orientation.**
- The owner of each firm exchanges existing shares for shares of the new company.
- Each seller may also receive cash and frequently enters an employment contract that ties her to the new company for several years.
- **The new company goes to the capital market with an IPO based on the consolidated financial statements of the rolled-up companies.**
- The new company may operate essentially as a portfolio of the smaller companies, or some centralization may be sought.
- Funds from the IPO provide any cash that is distributed to owners of the rolled-up companies, and the IPO leads to a public market.

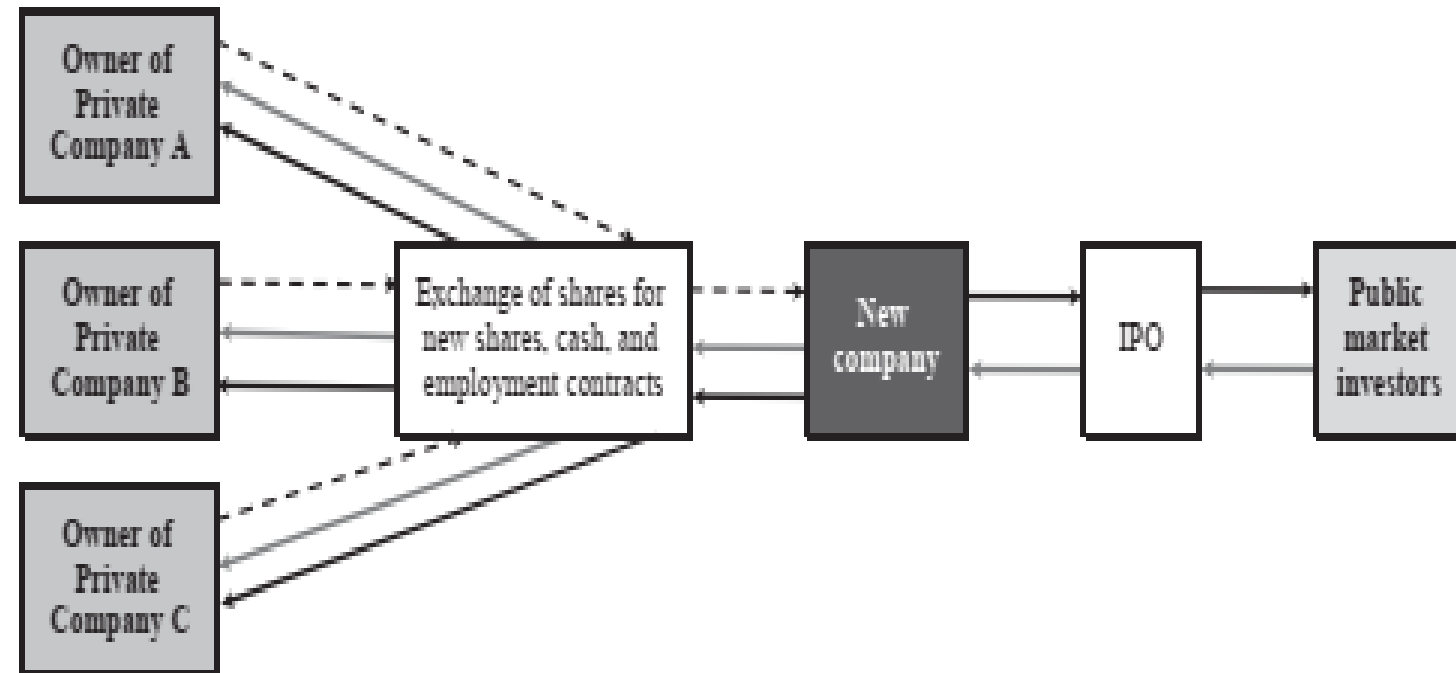


FIGURE 13.5
Roll-up IPO

Valuation Considerations

- Although most roll-up IPOs advertise the benefits and synergies the new company hopes to achieve, many of those benefits could have been realized through mechanisms short of consolidation.
- For example, the individual firms could have entered into reciprocal referral arrangements or consolidated their accounting operations without a formal merger.
- Thus, the driving force in a roll-up is not synergies but the value that may be created by transitioning from private and small, undiversified ownership to public ownership.
- Detracting from this is any loss of operational efficiency that may result from conversion of entrepreneurs to employees of a larger corporation.
- The concept of a roll-up is not new. Companies in the 1960s and early 1970s are sometimes criticized in finance textbooks for having played a “price/earnings multiple game.”
- A public company with a high P/E ratio would acquire smaller private companies, paying a substantially lower price relative to earnings.
- The hope was that the earnings of the targets would be capitalized by the market at the P/E ratio of the acquirer.
- The criticism of this argument is that it should not be possible to create value by simply transferring earnings from one company to another.
- The criticism is correct when both firms are already public; combining their earnings, without creating synergies, does not create value.
- If the target is private, however, value can be created by enabling the owner to achieve diversification.

13.7 The Choice Of Harvesting Method

- Historically, going public has generally been perceived to be the harvesting alternative that yields the highest valuation. More recently, the advantage of going public has become less clear.
- Whether to operate as a publicly or privately owned firm is a multifaceted decision.
- Because public ownership involves publicly traded shares, the owners have more liquidity.
- Also, public market investors can diversify easily; hence market value depends on systematic risk.
- The gain associated with transferring ownership to diversified investors argues in favor of harvesting by going public or merging with a public firm.
- However, **public ownership also involves more scrutiny, ongoing reporting requirements, and restrictions on corporate governance, and private markets have become more liquid than in the past.**
- Decisions regarding how and when to harvest are complex. In the following discussion, we review factors that bear on the decision.

13.7 The Choice Of Harvesting Method

Company Size

- **Public offering is more cost effective for large firms (with larger offerings) than for small ones.**
- Many of the costs are fixed, and some of the benefits of being public depend on the firm's ability to achieve a reasonable volume of trading activity.
- **A small firm can achieve liquidity for its investors if it is acquired by a public company.**
- Acquisition also involves significant fixed costs, but private contracting provides more ways to limit the costs.
- The parties can, for example, structure the transaction so that the seller's return depends on how the acquired firm performs after the acquisition.
- This is more difficult to achieve for a public sale of equity.

13.7 The Choice Of Harvesting Method

The Value Of A Public Market For The Shares

- The public market provides a continuous measure of value that facilitates the firm's use of its shares as a medium of exchange.
- A public market for the stock also facilitates using shares for incentive compensation and means that the company's managers are subject to the discipline of the market.
- **Going public, however, subjects a firm to periodic reporting requirements and the need to commit resources to maintaining relations with investors.**
- **Another benefit of going public is that the process may raise consumer and investor awareness of the company's products and enhance the company's image.**
- Public offering can also have strategic significance.
- Because public offering is expensive and because the offering prospectus commits the firm to a fairly specific course of action, going public is a way to credibly commit the firm.
- The commitment can be attractive to customers and suppliers and can discourage rivals.
- Going public also gives investors flexibility over harvest timing.
- In a private transaction, the ownership interests of the entrepreneur and early investors are bought out.
- **If the company is public, the entrepreneur can sell shares according to a schedule that she finds more attractive.**

13.7 The Choice Of Harvesting Method

Synergies

- Chod and Lyandres (2011) argue that because owners of public firms can be well diversified, such firms are able to take on higher levels of unique risk.
- Opportunities to create additional value by selling to a company that can make complementary use of the firm's resources and capabilities are not directly achievable via a stand-alone public offering.
- Generally, if synergistic benefits are significant, the harvesting choice is likely to be influenced by the owner's ability to capture as much of the gain as possible.
- **A private firm that should be merged with an existing public firm might, for example, go public as a way of establishing a public market value as a floor on the acquisition price.**

13.7 The Choice Of Harvesting Method

Track Record And Ease Of Valuation

- Going public at a reasonable valuation is not always possible.
- The most important factor affecting a venture's ability to go public is its record of accomplishment at the time of the offering.
- A venture with a history of steady revenue and earnings growth and predictable future growth is relatively easy for public market investors to evaluate.
- A less well-established venture that is at an early stage of development is hard for investors to value.
- For such a venture, small deviations from expected performance and small changes in the market or in competitive conditions can trigger precipitous changes in market value.
- The more difficult it is for public market investors to evaluate a company, the stronger is the case for private sale.
- In a private transaction, commercially sensitive information can be shared and the buyer may be particularly well suited to evaluate the company.

13.7 The Choice Of Harvesting Method

Timing

- **An IPO cannot be completed quickly.**
- From the time that a venture decides to go public until the offering occurs, market conditions can change dramatically and can drastically affect the market values of early-stage companies.
- **During expansionary periods, it is relatively easy to convince investors of a venture's need to raise capital.**
- However, if market values have declined and other firms have postponed or canceled their offerings, a company that proceeds with an offering may be regarded with skepticism.
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- During such periods, it can be advantageous to wait, or a private market transaction may be warranted.
- **The venture should be better able to communicate the reasons for its decision to a private acquirer than to the market at large and to better structure the deal.**

13.7 The Choice Of Harvesting Method

ownership and control

- **In an acquisition, the entrepreneur is almost certain to lose control to the acquirer.**
- **In a public sale, the entrepreneur may be able to maintain control, even if the entrepreneur's ownership share is significantly reduced.**
- Dual class ownership, where the entrepreneur's shares have superior voting rights, is increasingly common.
- For example, in its 2017 IPO, Snap Inc. offered nonvoting shares to public market investors, and the existing shareholders retained full voting control.
- Nonetheless, public firms are subject to the Sarbanes-Oxley Act of 2002, which sets standards related to company management and governance and for the accounting firms that provide audits of public companies.
- Even if public market investors have very limited control, they can exert influence over the venture by making some courses of action more expensive and time-consuming than they otherwise would be.
- Concentrated ownership by the entrepreneur is a way to preserve a high level of control with minimum outside intervention, but it can come at the cost of continuing underdiversification.

13.7 The Choice Of Harvesting Method

Taxes

- **For some investors, such as pension funds, tax considerations have little influence on the harvesting choice.**
- For the entrepreneur, however, the tax implications are likely to be important.
- It is difficult to generalize about the tax considerations.
- **An ESOP can yield a tax deferral**, but whether it does so depends on a variety of factors that are beyond the scope of this book.
- Private sale may or may not generate an immediate tax obligation.
- **Going public provides the entrepreneur with a tax-timing option, in as much as he can sell shares during periods when the tax consequences would be most favorable.**

Transaction Costs

- Generally, **private market transactions are less costly and have lower fixed cost components than going public.**
- Consequently, transaction costs and firm size are related.
- **Small firms are more likely to remain private or be harvested in a private transaction than are large firms.**
- The main exception is that if small firms can be consolidated without significant loss of operational efficiency, then a public offering may be possible.

Summary

- Harvesting is an essential aspect of entrepreneurial finance.
- Entrepreneurs and early-stage investors consider harvesting strategies when investment decisions are made and factor (issuing) harvesting into the valuation of financial claims.
- Harvesting provisions are often explicitly designed into deal structures.
- Often, the business model of a new venture with high-growth potential envisions an IPO within a few years after the first significant outside investment.
- However, **going public** is only one of several alternatives. For many kinds of ventures, it is an unlikely possibility.
- Other alternatives include private acquisition, management buyout, creation of an ESOP to provide liquidity to a venture where harvesting of the entire investment is not an objective, and indirect approaches to public offering, such as reverse merger and roll-up IPO.

- The costs and benefits of the alternatives differ markedly.
- Going public via the sale of newly issued shares requires an IPO, which is usually expensive as a percentage of proceeds received.
- Harvesting by going public, however, normally involves selling a small percentage of the venture's outstanding shares; therefore, IPO costs can be a small percentage of pre-money firm value.
- Furthermore, existing investors in the venture normally do not sell significant fractions of their shareholdings during the IPO.
- The actual cost of harvesting by going public depends on the process that is used by investors to sell their shares. Developing a public market has some distinct benefits that can influence the choice of harvesting alternatives.
- **Private acquisitions** also can be expensive. However, acquisition may enable the selling shareholders to realize some of the gains arising from synergies with the acquirer.
- **MBOs, ESOPs, and roll-ups** all have distinct advantages and disadvantages.
- The correct choice in any instance depends on factors such as transaction costs, firm size, track record, timing, tax implications, and regulatory oversight.



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