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Dual-class Share Structure: Weighing the Risks and Rewards

Dual-class shares have been a long-time fixture in the public equity markets and have held a special appeal for companies controlled by families, well-known leaders and founders of hot tech-sector start-ups. With their outsize voting rights relative to ownership, dual-class share structures can allow the owners of fast-growing companies to tap public equity markets without having to cede complete voting control to outside shareholders.

With the initial public offering (IPO) market roaring back to life in recent months, particularly in the tech sector, issuers may find themselves in the enviable position of deciding whether to consider a dual-class, or supermajority, share structure as part of their public offering. The allure of raising capital without relinquishing control can be intoxicating, but the potential benefits and disadvantages of a dual-class listing should be carefully considered to align the company's long-term strategy and its capital requirements.

"We're seeing many more companies considering IPOs trying to weigh whether a dual-class listing might benefit their future growth and how it could be perceived by outside stakeholders," says Sandy Pfeffer, a director at Deloitte & Touche LLP, who specializes in IPOs. "The structure has its advantages, but there are potential downsides that can negatively impact capital markets access and value in the long term. Some dual-class listings have been effective, but others have been less so. Before deciding on the structure, issuers should think hard about what they would gain from a dual-class structure relative to what they would give up, typically value," Ms. Pfeffer adds.

With a dual-class share structure in place at the time of an IPO, a founder or other owner can maintain more control, relative to other shareholders. This level of control can provide relief from the distraction of short-term performance requirements and allow management to focus on long-term value creation. In the event of a potential takeover or strategic threat, the dual-class structure can be especially attractive as it offers some protection. Having such protection can be a significant advantage in an era of increased shareholder activism.

Valuation Implications

"Ordinary shares in a dual class structure tend to trade at a discount relative to single-class shares because of their inferior voting rights relative to the supermajority. In our experience, this spread tends to narrow or even disappear in bull markets or when investors perceive they have an opportunity to co-invest alongside a business or tech luminary," says Chris Ruggeri, a principal with Deloitte Financial Advisory Services LLP and M&A Services leader for that group. Consequently, investors may not be overly concerned about the possible downside of such structures when weighed against the potential benefits of investing in a hot company run by a well-known executive or founder. In more tepid markets, or in the absence of a "rock star" CEO, issuers should consider the merits of a dual class structure relative to the discount that may be required to place the shares.

From the point of view of the supermajority holder, there are also valuation considerations. The value of supermajority shares is theoretically higher than ordinary shares because of their superior voting rights. This value, however, may be illusory. "An important consideration for an owner of supermajority shares is how he or she will exit the shares and at what value," Ms. Ruggeri adds. For example, some shareholder agreements require that supermajority shares automatically convert to ordinary shares when sold. This affords protection to the ordinary shareholders. In a change of control transaction, this means that the control premium will be shared by all shareholders. On the other hand, if a supermajority owner were to sell, say, a small portion of his holdings, he may do so at a price that reflects the value of the ordinary shares and at an implied discount to single-class shares.

Other risks that arise from dual-class shares, for both the company and the executive holding them, tend to take effect over the long term, well after the IPO. Because of the limitations on general shareholder rights that are part and parcel to dual-class shares, some institutional investors, including pension funds, won't consider them. While it is difficult to determine how this most recent trend toward dual-class shares will impact share prices in the future, the company's shares may suffer a long-term drag on share price because of not having broad institutional ownership.

At the same time, some institutional investors tend to hold their shares over a longer time horizon than other types of investors, and they may have more patience with management strategies that require a long view. That could be a positive benefit for young and innovative companies that may be punished by other investors for short-term misses.

Another issue to consider carefully before using a dual-class listing is access to additional capital in the future. "Having a supermajority share structure could impair a company's ability to tap either the debt or equity markets if the structure falls out of favor among investors due to a change in market conditions," says Ms. Ruggeri. "One of the common mistakes I often see with newly public companies is assuming that capital markets conditions today will remain constant. They won't. If market conditions deteriorate, it may be more difficult to raise debt or equity with a dual-class structure in place. If the capital markets are a consideration in the future, due consideration should be paid to how a dual-class listing could impact capital markets access and at what price."

Challenges for the Board

From a corporate governance perspective, dual-class shares present challenges. The major exchanges require that a dual-class structure be put in place at the time of the IPO—not afterwards. Because a dual-class structure can reduce the role of the board of directors and hamper its ability to execute its fiduciary responsibility to shareholders, a company may have difficulty attracting certain independent board members. "The board has a fiduciary responsibility to shareholders to maximize shareholder returns and shareholder value, among other things," says Nicole Sandford, partner, Deloitte & Touche LLP, and leader of the National Governance Services practice. "Knowing what might be in the best interest of the shareholders can become more difficult when shareholders do not have equal rights and benefits," says Ms. Sandford.

Applying a Sunset Provision

In spite of the challenges of a dual-class structure, an option worth considering for a company seriously contemplating one is to adopt a sunset provision within its governance structure. "When the sunset is triggered at a predetermined date or upon reaching some strategic or growth milestone in the future, the supermajority shares automatically revert to ordinary shares. Consequently, the provision can help reduce some of the longer-term issues dual-share structures might face," says Ms. Pfeffer. Such a move can also alleviate some corporate governance concerns, opening the door for greater institutional interest at the time when the shares convert.

Related Resources

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- The SEC's Social Media Guidance: Issues and Risks to Consider
- Closing the Gap Between Management and Investor Views of Company Value
- Closing the Gap Between Management and Investor Views of Company Performance—Two Case Studies

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