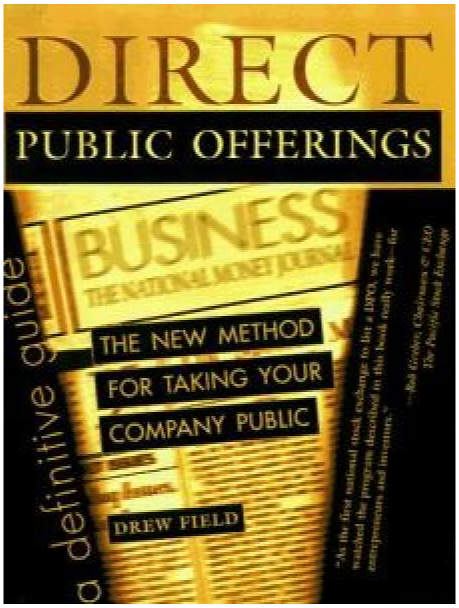

Book **Direct Public Offerings**

The New Method for Taking Your Company Public

Drew Field
Sourcebooks, 1997

Recommendation

Drew Field wrote this book in 1997 to encourage entrepreneurs to bypass Wall Street and float their shares directly to individual investors. In hindsight, we can see that almost everything that Field predicted in the book was wrong, but it is precisely due to the enormity of his mistakes that this book is relevant now. Field's premise was that brokers were ignoring equity issuance and individual investors in favor of big-ticket, M&A-style transactions and institutional deals like securitizations. This shift had created an imbalance in which struggling entrepreneurs were cut off from the capital that they needed to get their businesses off the ground. Of course, what happed in reality was exactly the opposite: A boom in venture capital and the stratospheric rise of the IPO market created an equity bubble of epic proportions, and many start-ups that should never have made it past the garage door raised hundreds of millions of dollars. All of this brings us to the present day, when an IPO backlash has dashed the funding hopes of many public wannabes. To the founders of these companies, *BooksInShort* asks: Direct Public Offering, anyone?

Take-Aways

- Direct Public Offerings (DPOs) are needed because individual investors are commonly shut out of the ordinary IPO process.
- Due to changes on Wall Street, fewer brokers sell to individuals.
- Institutional money managers sell to larger investors and organizations.
- Now, investors have more DPO opportunities because more entrepreneurs are starting companies.
- The growing electronic stock exchange will help facilitate launching a DPO.
- To decide if public ownership is right for you, ask yourself questions that show if it fits your corporation.
- You can check nine key factors to determine if a DPO is suitable, including whether you have a history of profitable operations.
- The advantages of a DPO include the ability to choose your shareholders.
- When you launch a DPO, you can control the pricing of your shares at the outset
- You can launch a DPO more easily if you have natural affinity to groups of people with discretionary income.

Summary

Taking it From the Street

This is a good time to go public. Increasingly, individuals favor saving and investing over spending and incurring debt. As investors, people now prefer the vision of entrepreneurs to the bloat of large bureaucracies. Finance will increasingly break away from Wall Street's control and into "direct relationships between corporations and investors" as technology makes it easy for individuals and corporations to communicate directly, quickly and efficiently.

Direct public offerings take advantage of today's worldwide shift to individual share ownership, a trend that began in the mid-1970s and continued into the 1990s. This trend has been fueled by many factors, including the worldwide increase of micro-lending, in the U.S., Europe and even in the developing world.

> "The traditional underwritten IPO is not working to let most people invest in new issues."

Corporate shares have been marketed directly to particular markets in special ways for many years through various vehicles. These include employee stock purchase plans and rights offerings that prioritize selling new shares to current shareholders. Additionally, some corporations have programs that allow an investor to become a shareholder through direct investment, although the individual has to discover these programs and how to buy shares on his own. Since 1996, more than 130 companies - including Citicorp, Sears, McDonald's and Wal-Mart - have created "Direct Stock Purchase Plans."

> "Individuals who buy stocks, based on their own information and judgment, more often use discount brokers - not the firms who are underwriting syndicates."

The growing power of electronic stock exchanges contributes to the possibilities of a DPO. With existing software, anyone with a computer and modem can have access to all bid and ask quotes, as well as a description of a company's trading history and other published information. You can now execute buy and sell orders directly, without the need for a broker. In fact, entire brokerage firms are dedicated to executing sales exclusively through the Internet.

This development is good for society, since it helps distribute wealth fairly and allocate capital in accordance to market forces. It allows more people to participate directly in the market. It also allows an individual to get away from working only for money, because a DPO provides another income source. Saving and earning interest is slow and gambling has poor odds, but stock investing is ideal, since it holds out the possibility that we can eventually work to feel good about ourselves and not just work for the money.

Should You Go Public?

While the timing may be right for taking your company public, you have to know if public ownership is right for you. To start, ask yourself a series of questions, including these:

- Does public ownership fit your corporation? For example, is your corporation independent from other companies or family businesses?
- Do your auditors and lawyers support going public?
- Are you ready to let others own your company with you? Can you separate the company from your identity? Are you willing to have a board of directors that can outvote you?
- Will your company appeal to investors? Can you explain your company's purpose in a few words? Would an investor see a double or triple growth in value in a couple of years?

> "In the direct marketing of corporate shares, an entrepreneur is offering a chance to participate - as an owner and a voting member."

Once you feel psychologically ready to go public, here are some of the commonly mentioned advantages of going the DPO route:

- You can choose your fellow shareholders.
- You can control the pricing of your shares at the outset.

- You will have a more stable trading market for your shares.
- Your exposure to liability is limited.
- You will have less interference in how you run the business, because institutions won't be your company's dominant owners.
- You will spend less to go through a DPO than an IPO for a similarly sized company because the direct marketing costs are less than paying a broker a commission, and you are managing the spending and the process yourself.

Do You Meet the DPO Test?

Nine key factors make a company suitable for a direct public offering. These are:

1. Will your business excite prospective investors, so they want to be shareholders?
2. Do you have a history of profitable operations under current management?
3. Is your management honest, competent and socially responsible?
4. Can inexperienced investors understand your business?
5. Does your company have natural affinity groups, composed of people with discretionary cash that they can risk to achieve a long-term gain? To determine this, look at the demographics of prospective investors, such as people attracted to your products or services, and consider whether they would be likely to have a large amount of cash on hand they might want to invest, rather than spend or save.
6. Will the members of these affinity groups recognize your company's name and consider your offering materials?
7. Do you have affinity group members' names, addresses, phone numbers and demographic information in your database?
8. Do you have a company employee who can spend half time for six months as the project manager in charge of the DPO?
9. Does your company have (or can your company obtain) audited financial statements for at least the last two fiscal years?

Assembling a Professional Team

When corporate owners launch an underwritten IPO, they sell part of the company to an underwriter who resells it in much smaller pieces. Typically, the underwriter managing the sale divides this sale among other security firms to create an underwriting syndicate.

> "Cybernetics is the new economic engine."

In this case, you would seek an underwriter to handle the sale for you, negotiate the terms and prepare the appropriate documents. Commonly, you will find this underwriter through your security firm, which manages IPO's. Usually, the commission is fairly standard - 7% for an IPO of more than $10 million and 13% for a smaller IPO. These commissions are divided between the managing underwriter (20%), the underwriting syndicate (20%) and the firm whose broker gets the order (60%). Commonly the broker gets 60% and the firm gets 40%.

Then, you will need lawyers to prepare the prospectus, the document that will be sent to investors. Attorneys also file the prospectus with the Securities and Exchange Commission and with your state's securities regulators. If any amendments are needed, they will handle that also. The entrepreneur's role is generally limited to just the price, timing and expenses - and canceling the sale if you decide not to go through with it.

> "The technological breakthrough will come in cybernetics - the computer, communications and mechanical systems that will do the tasks we humans now perform. Capital for these entrepreneurs will come from individuals, from people who share the vision and have enough faith to take a risk."

With a direct public offering, you sell your company's securities directly to large groups of prospective investors, but you are still governed by the same securities laws as IPO's. You still have to show a market for trading your securities and you still have to furnish regular reports to shareowners and securities regulators. You will need auditors and accountants to provide financial information for these reports and to handle taxes.

Doing the DPO Deed

A first step in your direct public offering is to hold a decision-analysis seminar, in which you gather your company's managers, closest advisers and key employees. As a group, review the capital formation alternatives that seem reasonable. Look into private financing, a reverse merger and traditional underwriting to help you decide whether a DPO is the way to go.

> "Readiness for public share ownership begins with the values and attitudes of the entrepreneur."

Next, look at how to price the DPO. Ask, "How much of our company do we want to give up to raise the capital we want." Decide what you can sell to new investors. As part of this determination, estimate the amount of the offering, the percent of ownership you are selling, the percentage for the founders and the total ownership market value. Additionally, consider your costs of launching the DPO. Commonly, these costs will run $100,000 to $200,000 or more.

Then, to get your company ready for a DPO, engage in some corporate clean-up work, such as sprucing up your company's image and reconsidering who is on your board of directors. Additionally, assemble your DPO marketing team to reach out to investors. This should include a project manager, financial person, DPO advisor, outside auditor, advertising and direct marketing person, market research person, training director and shareowner relations manager. Seek allies to aid your campaign, such as securities brokers and financial planners. Then, your DPO team should price your offering, develop a marketing program, announce your offering, plan a trading market and start selling shares.

The Need for Direct Public Offerings

Currently, U.S. households have billions of dollars available for investment in direct shares. However, most people in the U.S. have not participated in share ownership because traditional IPO underwriters don't market to them, even though direct marketing tools could be used to reach them. Basically, Wall Street is no longer a readily available way for money to flow from individuals to businesses, so consumers are ready to be sold on direct investing.

> "It takes a particular mix of personality traits to go from sole ownership to sharing 'your' corporation with a thousand strangers, who expect you to take care of their investment as you do your own."

This lack of fit between IPOs and individuals can be attributed to several reasons. First, only a few entrepreneurs get through the underwriter process. Secondly, those who do go public mainly sell their shares to a few big institutions and speculators. Several factors shut out the individual investor. First, investment bankers find it more profitable to engage in buy-outs or to take apart and rearrange big companies. Second, while fewer brokers are selling to individuals, an increasing number of institutional money managers are selling to larger investors and organizations. New financial instruments, such as options, now compete with common stocks. At the same time, the securities industry itself has been declining. Due to liquidations and mergers, the number of brokerage firms has dropped since the 1970s.

> "[Stock investing] holds out the possibility that we can eventually work to feel good about ourselves and not just work for the money."

Ironically, though, individual U.S. households have enough money to invest in IPO's, since the total assets of U.S. households as of 1996 was nearly $10 trillion, and discretionary income has increased. At the same time, individuals are increasingly cashing out investments in corporate shares, so they are taking more out of the stock market than they are investing.

Meanwhile, the conditions are ripe for appealing to individual investors. A growing number of entrepreneurs need start-up capital. They aren't getting funding, due to the mismatch between supply and demand because the old market mechanism has broken down. The old underwriting syndicates no longer have the financial power they used to have. Traditionally, some 50 firms employed about 20,000 brokers. But these numbers have been eroded as firms have disappeared and brokers have begun selling many products besides stocks. As a result, institutions dominate today's markets. The small broker has almost disappeared and the large investment firms are not interested in small issues.

About the Author

Drew Field, a securities lawyer and CPA, has provided direct share marketing advisory services since 1976. His articles have appeared in more than ten banking journals in the U.S. and in *Management Review, Business Horizon* and *San Francisco Business Times.* He has been published or cited in *in Inc., U.S. News and World Report, The Wall Street Journal, The Los*

Angeles Times and The San Francisco Chronicle
