IPO Pros and Cons: Is This an Opportunity?

Executive Summary

The IPO market is hot again. Today's flavor – mortgage and related businesses. Following Rocket/Quicken's IPO, many are now considering it. Knowing this, investment bankers are moving quickly through the industry, seeking new and willing candidates. As a result, a wave of IPOs is likely to roll through an industry. Rocket triggered filings by Caliber Home Loans, Guaranteed Rate, Guild Mortgage, loanDepot and even AmeriHome Mortgage. An IPO can have many benefits for the right company, but it is not the right decision for most.

IPOs often require complex decisions and difficult trade-offs. Many companies enter discussions about an IPO only to abandon the effort part way. Before proceeding along this path, it is important for the Management and the Board to carefully evaluate the pros and cons of all capital alternatives. In many cases, there are other options that better fit the company's needs. In general, an IPO is more often the right answer for a bank than for a mortgage company; more often for a large cap than a small cap; more often for a tightly controlled company than a flexible one.

Endurance believes that many of the mortgage banks seeking to follow Rocket/Quicken's lead would be ill advised to do so. Endurance Advisory Partners has worked with financial institutions to develop the internal discipline necessary to become a public company. Below are thoughts regarding the pros and cons of IPOs in the current environment.

Decision Process

Pros:

- Enhanced market visibility
- Diversifies investor base
- Broader access to equity markets to obtain growth capital; potentially broader access to more sophisticated debt markets
- Enhanced external and internal reporting requirements may result in improved financial reporting discipline
- Active market feedback on Company performance
- "Acquisition currency" for stock-based M&A deals
- Ability to provide stock and/or options as part of compensation may attract and retain key talent
- Enhanced transparency and information dissemination to employees, customers and vendors

- Opportunity for founders/investors to monetize investments and exercise financial exit strategies
- Vehicle for holding and transferring inter-generational wealth

Cons:

- Considerable amount of work to execute, and hence, can be an expensive and distracting effort
- Cost – the gross spread payable to investment bank is typically 7% of proceeds
- New layers of ongoing compliance requirements – SEC, SarBox, etc.
    - Increases compliance, investor relations and other personnel (minimum $2 million incremental cost when public)
    - Forces company to maintain compliance with exchange requirements (minimum number of shares available for trading, minimum share price, number of shareholders and number of market makers), making it impractical for companies raising less than $50 million
    - Requires investor attention which is difficult to obtain unless the market cap and float allow for active trading and adequate liquidity (even higher minimums, e.g. $200 million market cap and $100 million float)
    - Stringent audit standards which significantly increase the cost of annual audits
- Disclosures – financial and operational data is publicly released, including compensation for top officers. This may result in competitors taking advantage of the Company with targeted sales or recruiting efforts. The Company will need to disclose certain transactions with entities or persons related to officers, directors and significant shareholders.
- Volatility – most non-bank financial services companies have short-term valuation windows that offer little earnings visibility
- Short term focus – investors focus on earnings trajectory, which will often be discounted, thereby pressuring management to “hit” current period performance goals
- New fiduciary obligations to investors may limit the Company’s operating flexibility
- Restrictions on management and control regarding personal stock sales, pledging and trading – even when allowed, sales may send a negative message[1]
- Limits control and decision-making; increases accountability to outsiders
- Exposure to activist investors, short sellers or other nay-sayers/opportunists
- Potential for poor stock performance, particularly when:
    - The Company is not included in major indices or exchange traded funds
    - The sector can go out of favor regardless of fundamentals, which can trap the Company in a downward valuation spiral
    - There are few publicly traded comparables and/or
    - There are esoteric industry practices that are not widely known by potential investors
- Potential to lose control of the company
- Restrictions on management and control regarding personal stock sales, pledging and trading. These restrictions can make it hard to gain liquidity when needed or limit the potential upside:

[1] Personal financial planning and transitions are often complicated. Control shareholders in public companies must file 10b5-1 selling plan which can limit gains. Large positions are generally exited through a secondary or block trades (which result in more fees). These restrictions limit owner’s ability to take cash out of the Company.

- Lockup periods – large investors and insiders are prohibited from selling for 90-180 days following an IPO, and 180 days to 1 year following a SPAC IPO. The end of lockup periods can result in a drop in stock price even if no insiders sell.
- Insider sales may send a negative message[2].
- Moving large blocks of stock may require a secondary offering or large block trade, which comes at additional expense (up to 5% of proceeds).

Enhanced Market Visibility

The "public" part of being a public company is a double-edged sword.

On one hand, the Company's annual report and investor presentations provide an opportunity to go beyond strictly financial reporting to tell the Company's story – how the business works and what sets it apart from the competition. **A good strategy and story make for better visibility and prestige**.

The downside of this disclosure is multifaceted. First of all, disclosure is the opposite of confidentiality. It obviously makes it impossible to hide strategic decisions from competitors and makes it harder and harder to stay one step ahead. In addition, once pertinent operating data is disclosed, investors expect it to continue. This leads to the third point: management can lose control of the narrative. It is impossible to ignore publicly disclosed statistics, even when they are no longer particularly relevant. **Disclosure makes it more difficult to be flexible and shift strategic direction**.

Notably, the issue of disclosure and market visibility is muted for banks. Banks already file quarterly call reports, putting most information in the public domain for competitors, vendors and investors to see. As a result, an IPO has relatively little impact on the market visibility and loss of confidentiality for a bank.

Diversification of Investor Base / Access to Capital

Access to growth capital is often the primary reason for an IPO. Especially in financial services, companies can only grow revenue and assets as fast as they are able to grow equity. Any company with opportunities that exceed its ROE will need to raise equity.

An IPO unquestionably diversifies the Company's investor base while meeting the primary need for equity capital. Public companies have public investors – both individuals and institutions who can't or won't invest in a private company. That said, private companies also have equity and have the ability to sell equity to private investors. The big question is really to embrace outside equity investors or not.

There are many similarities between an IPO and a <u>private</u> equity offering. In both cases, the Company needs to get its house in order, put together offering materials and go on a roadshow to meet with potential investors.

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Of course, in the IPO scenario all of this work is made public and, for better or worse, is available to customers, vendors and competitors. One key difference is that in a private equity offering, you only get one bite at the apple – if the investor isn't convinced now, there is no ongoing market providing second chances.

There are ancillary benefits to having the discipline required to bring in outside investors, whether public or private. Companies with outside investors tend to have better control regimes and better governance. Public companies have the added benefit of transparency. Public reporting provides a mechanism for a company to tell its story. This transparency extends the Company's access to debt capital, particularly more sophisticated lenders.

Active Market Feedback

Stock prices are a remarkable feedback loop, grading management on every public statement; stock prices are also subject to wide fluctuations based on changes in broader markets without any news from the Company. As with all criticism, consider the source.

But market feedback is only relevant if investors understand the business. To the extent that market participants have good comps and experience with the industry, great. If the business fundamentals aren't well known, it can be problematic. Banking is widely analyzed and well understood, especially relative to the other segments in the financial services space. By contrast, mortgage banking is far more esoteric.

Considering investors' experience, banks make better IPO candidates than mortgage banks. For example, valuations of servicing operations and origination operations often move in opposite directions but mortgage banks that primarily service like Mr. Cooper and Ocwen are compared directly to origination machines, albeit ones that also service, like Rocket/Quicken and Caliber. Even within originations, there is a huge difference in margins between correspondent (AmeriHome) and retail (Rocket/Quicken); operations also differ materially, yet the multiples on all of these companies will be compared endlessly. Market feedback is only a "pro" if it is relevant.

Historically, the volatility of the mortgage business has resulted in poor stock price performance. During boom times like the current refinancing wave, companies trade at very low PE multiples. These low PEs are reasonable because investors are looking not just at this year's earnings but at the prospects for a huge decline when the party is over. Unfortunately, a low PE is a red flag on the company.

Acquisition Currency

Public stock can broaden M&A options for companies. Companies pursuing growth via M&A rather than internal growth find it valuable to have the option to offer stock (a merger) rather than only cash (an acquisition). Of course, in M&A, cash is king, but when you need to use stock (e.g. there are tax reasons for sellers to consider stock), it is important to have a fair market valuation. Any seller taking stock needs to know how much it's worth. Post-IPO, the market price on any given day, for better or worse, is the value of the Company's stock.

In addition to M&A, public stock also plays into recruiting strategy. It's not just a corporate acquisition currency, it's a way to acquire employees. Public companies benefit when recruiting employees by using stock options or restricted stock. While private companies can offer equity or "phantom stock" linked to performance, there is no substitute for stock and/or options in a public company. Somehow, new recruits ascribe more value to equity-linked compensation from a public company than comparable value in a program from a private company.

Transparency and Financial Reporting Discipline

Financial reporting discipline tends to improve performance. They say, "if you can't manage it, you can't monitor it." Well, financial reporting discipline increases the universe of what is monitored. Any company that brings in outside investors, whether public or private, needs the ability to provide sufficient information about its operating and financial performance to satisfy those investors. This reporting undoubtedly improves management's ability to make decisions. Of course, even private company managers analyze data – the important data – to optimize the business. While there is lift in performance by establishing the financial discipline of a public company, that lift isn't very high.

On the other hand, nothing is free – including financial disclosures. This other side of the equation can quickly become material. At a bare minimum, a public company must fire staff in compliance and investor relations functions. Together with increased vendor costs (higher prices on external audits), most companies experience cost increases of at least $2 million. In addition to the cash cost, the Company must also factor in the impact of distracting key executives for 4-6 months.

Personal Wealth Management/Exit Strategy

Personal financial planning is the last issue that is often cited as the key rationale for an IPO. As mentioned several times above, an IPO is first and foremost an equity offering; once sold, the risk of the performance of that equity shifts to the new investor. This outcome is often the real reason for the IPO – the owner needs to diversify or otherwise reduce the concentration of his personal net worth invested in the Company. For companies without a clear succession plan for the equity owners, an IPO provides a great exit strategy. The stock can be monetized without swapping out the management team. Of course, the opposite may also come to pass.

It is critical to thoroughly evaluate both personal tax and short/long-term financial goals. Pre-IPO is the time to grant low basis stock to a family limited partnership, irrevocable trusts, or grantor retained annuity trusts for estate planning purposes and tax management.

Losing control is often an unintended consequence when the IPO route is chosen to raise capital, not to exit. This unintended consequence may hit both the management team and the owners. In addition to losing control over the company's narrative, an IPO can trigger a change of control. An IPO and subsequent trading set a fair market price for the equity. The board, with its fiduciary obligation to shareholders, is obligated to consider offers for the Company and, hence, potential for unwanted suitors. Even worse, public companies are subject to harassment from shareholder activists, short sellers, and other parties. There are also selling restrictions for management.

Final caveats, costs and restrictions: While an IPO provides a market for current owners to monetize their investment, that public market comes with excess baggage. First of all, there is the cost of the IPO itself – 7%

to the investment bank plus the cost of legal counsel and accounting support. Then there is the soft cost of living with the restricted sales windows afforded to management and key insiders. Finally, there is the intangible cost of meeting the public's expectations even when that isn't what's right for the Company.

Summary

An IPO is one of the most complicated decisions any company faces. As shown above, there are numerous issues that must be addressed and prioritized. In some cases, the bigger stage afforded to a public company is complementary to the rest of the business strategy. If so, an IPO is the only answer. For most companies, however, there are viable alternatives: public vs. private equity, equity vs. preferred or debt, and so on. Endurance is a trusted advisory capable of working with you to evaluate all of your options.

For the right company, an IPO is the public culmination of years of hard work. In these cases, the "pros" far outweigh the "cons," and the choice is clear. For a surprising number of companies, however, pursuing an IPO is a mistake. Unfortunately, it's also a mistake that few advisors are able to counsel against.

Endurance Advisory Partners can help you decide what is best in your situation. We serve as an independent advisor who will work alongside the Company to assist with IPO planning:

- Provide a detailed gap assessment of the Company, identifying key changes which need to be made to facilitate a successful IPO
- Assist with development of corporate strategy, risk management plan and key selling points for investors
- Provide support for dual-track strategies such as private equity and other M&A transactions
- Assist with regulatory dialogue
- Help assemble the right IPO team – including prospective underwriters, accountants and key employees
- Identify prospective independent directors to complement pre-IPO directors

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