IPO INSIGHTS

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Preparing for an IPO

Good Disclosure Requires Careful Consideration of How You Present the Drivers of Your Business

The process of conducting an initial public offering ("IPO"), from the initial planning until the first sale of shares to the public, is lengthier than many would expect. Companies considering an IPO should begin planning months in advance, as several steps need to be taken well ahead of the completion of the IPO.

The IPO market continues to be very active, particularly in the technology and the life sciences areas. This note, however, is about a much earlier stage in the IPO process, and a frequently neglected area of disclosure — the first five to ten pages of management's discussion and analysis, also known as "MD&A."

In preparing for an initial public offering, the first six to eight drafting sessions are often focused on the description of the company's business — its markets, its offerings and its competitive strengths. While important messaging points to solidify, these discussions are often at the expense of careful consideration of the company's key financial and business drivers, as well as known trends and risks. Since these additional elements contained in MD&A are crucial to an investor's understanding of the company and its prospects, we'll highlight certain considerations one should contemplate while preparing MD&A.

A key insight to keep in mind while drafting MD&A comes from the guidance statement issued by the SEC where it stated that:

"MD&A should be a discussion and analysis of a company's business as seen through the eyes of those who manage that business. Management has a unique perspective on its business that only it can present. "

MD&A continues to be a significant focus of the SEC staff, and is often an area that regularly causes the company and its underwriters, auditors and attorneys to tear their hair out while trying to respond to SEC comments. The staff has proved quite adept in recent years in finding weaknesses in disclosure and areas where, shall we say, companies would prefer to allow a bit of ambiguity in the description of their businesses.

Key Business Drivers

We generally tell management teams sitting down to prepare MD&A that they need to think first about what levers they pull to drive business results. How do they evaluate their business? How do they report to their board about their results? It is NOT a discussion of revenue recognition or accounting policies. Consider the overview along the lines of a review you would give to a new director to explain your business. It should be your reporting dashboard explained in text. A discussion of those key operating levers evolves into the overview of MD&A.

Known Trends and Uncertainties

Disclosure of known trends and uncertainties, which is expected to be addressed in MD&A overview, is another area on which the SEC has focused much attention. The goal here is to think "What are the macro trends that keep me awake at night, and how are we thinking about them or organizing our business to combat them?" These are things that need to be pondered and carefully discussed. If, for instance, a company is selling computers, there might be a known trend that costs continue to decline, putting pressure on margins. Or, there might be a known trend that Best Buy and Circuit City are in trouble or gone, and that online retailers are controlling more of the market. In software, similar trends could affect sales of on premise solutions because of the growth of mobile and cloud computing. Any significant trend or uncertainty that management is closely monitoring, has identified in risk factors or discussed with the board should be evaluated for disclosure.

Key Metrics

Finally, it's important to consider how investors evaluate the company. The way most companies provide information to investors about their business or financial model is with "Key Metrics" or "Key Performance Indicators," which provides a description of important data, such as operating or financial metrics, that might not be immediately apparent from financial statements. Key Metrics disclosure has taken on greater importance in the last five years, as many important insights about your company come in this discussion. The Key Metrics are critical in helping analysts build their valuation models. Often the Key Metrics are things management is focused on already—Adjusted EBITDA, or some variant of monthly or annual recurring revenue, user growth or other volume metrics.

There are sometimes measures that investors want to focus on, which the private company management team hasn't calculated or thought about with rigor. For instance, in SaaS companies, one measure of customer retention, often titled "monthly recurring revenue retention rate," is used by management to help show the visibility management has into future results. But, there are many ways the retention rate can be calculated, so it can be hard to know if this retention rate gives a valid picture of the company's business. What if it's distorted during hyper-growth? Or what if it overstates the downside in a time of slowing growth? Is there another measure like backlog that works better?

Key Business Operating Levers

Questions to Reflect On

- **How do we make money?**
  Do we sell to lots of consumers? Sell ads? Sell to large enterprises?

- **How do we drive growth?**
  More products? More sales people? Is "land and expand" a key part of our strategy? (in other words "We generally sell a small subset of our solution to customers, and then focus on selling more modules over time.") Do we have to do a lot of marketing to lay a foundation, or is our focus more on targeted sales?

- **What are the risks that we are worried about?**
  Is it a crowded market? Or is it the opposite — are we so new that people don't know how to think about us yet? Do we have interest rate risk? Are we susceptible to overall economic downturns? How have we mitigated those risks (hedging, R&D spend)?

- **Do we drive results by buying new products or technologies, or are we all about organic growth?**

It's important to be cautious and evaluate the implications of including certain measures, to ensure the company does not disclose sensitive information. There are certain important measures that management teams use internally, which could provide TOO much information to competitors because they make it too easy to reverse engineer pricing or margins. It's beneficial for the group to consider how metrics are perceived and whether there are comparable metrics that could help investors evaluate the business without potentially harming the company competitively.

Another important consideration when setting up Key Metrics is whether you are comfortable updating them quarterly. Once the investors have been provided the data, they will expect to continue receiving it regularly.

Conclusion

All of these disclosure discussions take time, data and careful thought. To ensure your MD&A is well drafted and provides a solid reflection of your company, it is important to have the discussion early with the underwriters about how to present the company's business drivers and Key Metrics, and to carefully consider the risks and benefits of disclosing them. Putting some time and thought up front into MD&A will help in many ways, including encouraging the team to think early about the model you'll have to build for the analysts, as well as framing the discussions you'll have on the roadshow and in earnings calls. The overview and key metrics discussion is your opportunity to help set the terms upon which the company's performance will be judged for years to come.

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