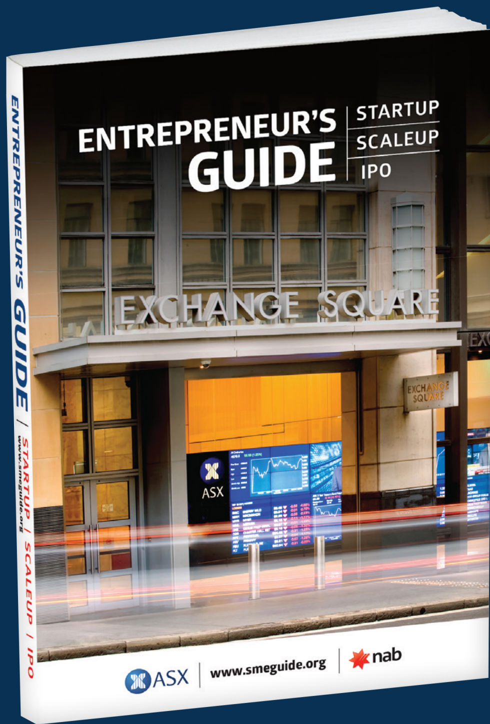


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# IPO READINESS: KEY CONSIDERATIONS FOR FAST-GROWING AUSTRALIAN BUSINESSES

TDM ASSET MANAGEMENT

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Your business is starting to scale quickly, with revenue growing more than 25 percent annually. You have already received local or international seed or venture capital, but as revenues race to $50 million to $100 million and beyond, invariably the attention of your founder, chief executive officer (CEO) and initial shareholders has turned to the question of how to fund this rapid growth. Initial public offerings (IPOs) are a potential source of capital, but is this the right choice for you?

Although the thought of tapping public markets for funding (and potentially a big payday for founders and shareholders) sounds enticing, how much work is required before this is, in fact, a reality, let alone a successful one? Moreover, another imposing strategic question looms—as a global business, do we list in Australia on the Australian Securities Exchange (ASX), or are we lured offshore and list on an exchange overseas? For fast-scaling tech businesses, the overseas exchange is usually Nasdaq or the New York Stock Exchange (NYSE).

At TDM, we firmly believe that ASX provides a compelling opportunity for your business to take the next step, and if you prepare adequately, there is no reason that listing on ASX cannot become a reality for your business. This view is without bias. Our unique investment mandate has no time horizon, and our ability to invest domestically and overseas in listed and unlisted companies provides a rare and objective view to make this judgment.

Presuming an IPO has been settled upon, before the question of 'where to list' is resolved, the onerous task of 'how' needs to be addressed.

## ARE YOU READY FOR AN IPO?

In our experience, IPO preparation takes at least 24 months. This timeline is not a consideration but a necessity on such a long journey. A timeline of this length will not only enable you to create long-term shareholder growth through a higher valuation multiple, but more important, establish a strong and supportive shareholder registry. Furthermore, a well-prepared IPO will lessen the burden on management during the formal IPO process and can significantly reduce transaction costs.

The IPO preparation process is intensive and will include (but certainly not be limited to) the following steps:

- *Choose the right growth equity partner at least two years prior to IPO.* Traditional post–venture capital/pre-IPO private equity partners can provide both beneficial financial and strategic support. However, their finite time horizon on investments can be a significant conflict to long-term value creation. It is important to understand what their post-IPO intentions are well before letting them fund your pre-IPO growth. The right equity partner will also take significant pressure (time and otherwise) off the management team and CEO by adding significant value and expertise throughout the transition process.
- *Develop a long-term strategic plan and financial model.* A four- to five-year high-level strategic plan and accompanying long-term financial model is critical to the IPO process. By now, you probably have a well-developed 12- to 18-month financial forecasting and budgeting model. However, we have found that most private growth companies have not developed a long-term strategic plan and financial model with the same rigour. These symbiotic pieces of work become critical to being able to scale your business effectively and will ease your transition to the public market. Investment banks and investors heavily scrutinise your long-term strategy and forecasts as part of the IPO process and hold you accountable to these post-listing. Table 1 outlines some of the differences in your company's 12- to 18-month budget model and the separate long-term financial model.
- *Be relentless in establishing your corporate governance.* Move to regular board meetings and finalise board composition. The importance of a high-quality and balanced board cannot be underestimated. It is vital that all board members are high-impact and add value to your business. In Australia, non-executive directors (NEDs) tend to be retired executives at the end of their professional careers. It is extremely challenging to find

**TABLE 1.** Differences between a company's 12- to 18-month budget model and a long-term financial model

| **Budget Model** | **Long-Term Model** |
|---|---|
| • Rolling 12–18 months forward<br>• Month by month (or daily)<br>• Highly detailed—including all revenue and operating expense lines (multi-sheet/workbook)<br>• Resource intensive to update—quarterly/semiannual process—used only within the finance team<br>• Used for<br>  ◦ planning short-term resources<br>  ◦ setting 12-month key performance indicators<br>  ◦ providing executive committee short-term incentives<br>  ◦ assessing the impact of short-term tactical changes | • 1–5 years forward<br>• Annually or semiannually<br>• Higher level—driven by key performance indicators (single workbook/sheets)<br>• Flexible to update and adjust scenarios regularly—relevant and usable by business development teams<br>• Used for<br>  ◦ planning long-term resources<br>  ◦ assessing long-term impact of strategic decisions<br>  ◦ planning long-term scenario modelling<br>  ◦ aligning the business around key long-term metrics<br>  ◦ setting long-term incentives |

NEDs that are passionate about helping your business and who think like owners. It can take years to find the right people who have these attributes and persuade them to join your board. We interview 50 to 60 potential NEDs for our portfolio companies every year. Less than five percent make the cut.

We believe the best boards will have a mix of NEDs who are successful current operators as well as retired executives, with vast networks that can be tapped into to help your business grow. Whilst board members who are currently in executive roles at other businesses tend to be shorter on time, their 'value add' can be significant because they can share their current experiences, challenges and successes with you.

Another key consideration, and perhaps the most important when it comes to the board, is finding the right chairperson. The chairperson must be highly engaged, with a diverse range of experiences, and most important, must be willing to act as a mentor and pillar of support to you as the founder and CEO.

Not only must your board be engaged to ensure the execution of your growth strategy and vision, but equally important, the quality of the board becomes a key driver for attracting high-quality investors once you do make the transition to the public markets. In our experience, your board must be experienced in the pressures and demands of listing, and it is crucial that they think and act as owners of the business.

We firmly believe that the formation of the board needs to be done well in advance of any IPO—preferably at least 12–18 months ahead, in our experience.

More crucially, as a rule of thumb, we believe that board members should hold *at least* five times their annual board remuneration in equity. This measure demonstrates a real commitment and belief in the business and enhances the principle that we seek to encourage—to 'think like an owner'.

- *Create the right incentives through a remuneration plan.* Successfully scaling a business is all about people and culture. A well-developed executive remuneration plan is critical for attracting the best people and fostering a great culture. In particular, a long-term incentive plan for management and new hires that rewards your team for the success that lies ahead is particularly important prior to IPO. In our experience, executive remuneration plans are usually 12- to 24-month projects, but every business is unique in terms of what it will look like.

  No doubt you already understand the power of long-term incentives on your employees who share your vision and passion for what your business will become. Like long-term investors, you need your employees to be thinking and acting as owners of the business.

- *Establish and practice your financial reporting framework.* It is essential that management develop and foster the skill of providing formal investor presentations and financial forecasts to current shareholders on a semiannual basis while in a private setting. In making your business ready for the public market, it is imperative that you practice the rhythm of not only preparing regular forecasts but also making a good habit of meeting or exceeding them. It is much better to make your mistakes and learn from them as a private company in this area. It is so important that you use this time to get into good habits around setting and meeting targets. The public market disproportionately rewards companies who have a track record for meeting or beating guidance and punishing those who miss them.

- *Establish investor relations and education.* Start now to raise awareness and understanding of your business among public market investors. We encourage our private portfolio companies to do one to two investor presentation events each year in the lead-up to the IPO. These events are usually hosted by investment banks that invite their institutional public market investor clients to attend.

  A well-supported IPO that will optimise value is only possible if public market investors fundamentally understand what critical problem you are solving, where your competitive advantage lies and why your management team is worth backing. You will need to have a well-developed investor presentation and be well-practiced at delivering it in an interactive group forum. In particular, using these opportunities to learn how to deal with a public market investor 'Q and A' session is invaluable for getting you ready for the scrutiny of the listed company environment.

This situation is particularly pertinent if no close comparable business is listed in Australia, which can often be the case in the technology space. We have seen fantastic Australian businesses be misunderstood and thus undervalued upon IPO.

- *Select your advisors carefully.* With a scarcity of great IPO opportunities each year, a range of advisors will be clambering to be a part of one. Investment bankers and legal and accounting firms all have a valuable role to play in the IPO process, but it is important to understand the potential perverse incentives that can emerge. For example, investment banks are consistently trying to strike a balance between delivering a fair price for existing shareholders and a cheap price for their public market institutional clients who are looking to invest in the IPO. High-integrity bankers will manage this challenge, but it is important that you are aware of these potential conflicting outcomes. Having the right capability on the board to navigate the process of advisor selection is critical.
- *Develop the ability to scale all systems and processes very quickly.* After well over a decade of investing in newly listed, fast-growing public companies, we have found that the vast majority have underinvested in their back-end systems and processes. While taking on the new challenge that is becoming a successful public market company, your business will be expected to continue to grow rapidly. Developing a highly scalable operational infrastructure will not only enable you to effectively support and manage this growth but will also be a source of significant competitive advantage as the business scales and you win market share. This multiyear effort usually requires an overhaul of financial, human resources and operational systems and processes. We have seen so many fast-growing companies hit a wall as they pass through $100 million of revenue—lack of investment in scalable back-end systems and processes is often a key contributor. If you have invested well ahead of your next phase of growth, public market investors will have comfort that the business is well positioned to succeed over the coming years.
- *Review your talent and the structures that manage it.* Up to this point, you have managed to retain a huge amount of talent and passion within your organisation. The reality, sadly, is this: practicalities will dictate that not everyone in the team has the necessary skills required to flourish during the next stage of growth. Having the ability to self-reflect objectively on the capabilities that you and your team have, without being blinded by the nostalgia of your successes, is fundamental. It is important to empower your human resources team by providing them with the necessary tools and mandate to make any required changes well in advance of any IPO preparation.

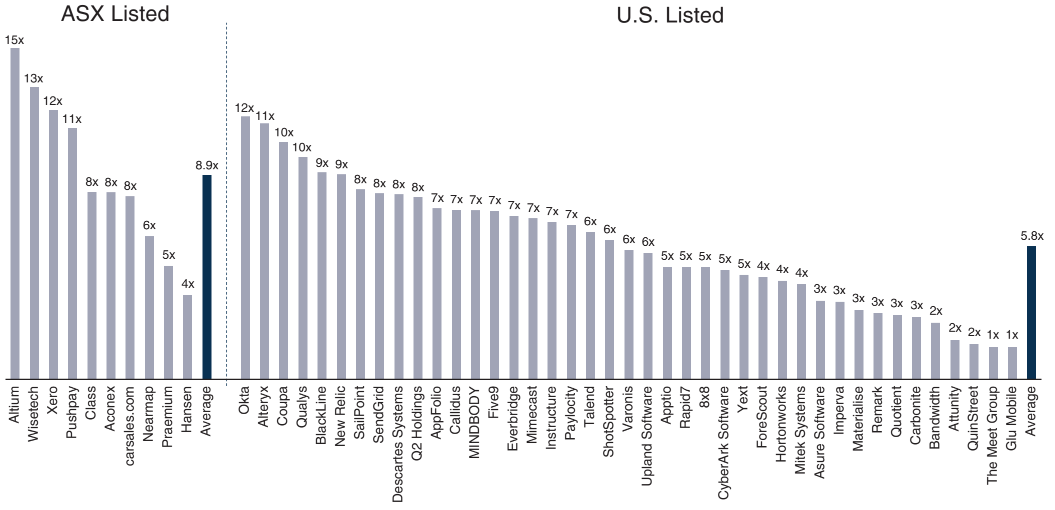
## WHY ASX?

Fast-growing, Australia-based businesses could reap many advantages by listing on ASX rather than on Nasdaq or NYSE. Although a multitude of myths exist regarding why you would choose to list overseas, the following sections will describe the facts.

### RATINGS

Fast-growing global businesses are generally not as highly rated in the U.S. as they are on ASX: there is a commonly held misbelief that U.S.-listed businesses trade at a premium to those listed in Australia. However, this is often not the case. For example, in Figure 1, we compare software and online businesses that are listed on

**FIGURE 1.** Next 12 months' enterprise value/revenue multiples of businesses listed on ASX and on NYSE or Nasdaq




Source: CapIQ Consensus Estimates (10th January 2018)

ASX and those listed in the U.S. on the NYSE or Nasdaq that met the following criteria:

- 2018 forecast revenue between $30 million and $500 million
- revenue growth in excess of 15 percent

**ASX-listed software and online businesses trade on an average enterprise value/revenue multiple of 8.9x, whereas comparable U.S. businesses trade at 5.8x.**

It is worth noting that even if this value gap closed between the U.S. and Australia, we still think it is beneficial to list on ASX.

## 'SCARCITY' VALUE

Fast-growing Australian businesses with a global presence that are listed on ASX are certainly not all that common. As such, a business with a great growth outlook and a fantastic management team will not be lost in the crowd in the Australian capital markets. Thus, it will be easier and much more likely for fund managers to fundamentally understand your business. It is a huge risk for institutional investors to not know you or understand your business, and this risk is only amplified by the volatility and scale of the North American market.

This factor also provides some justification for the data in regards to valuation—the ease of standing out from the crowd on ASX will certainly help you trade at a higher multiple.

To give you an idea of how scarce fast-growing global businesses are on ASX compared to U.S. exchanges, consider this:

**Only ten software and online companies are forecast to grow revenue at 20 percent or more over the next 12 months on ASX, compared to approximately 90 on the U.S. exchanges.**

## REPORTING FREQUENCY

Having to report only twice a year has some advantages. Companies listed on any exchange in the U.S. are required to report every quarter. Superficially, reporting only twice as often as Australian-listed companies may not seem like a big deal, but it can have the following significant repercussions for your business.

- Semiannual reporting allows you to continue to concentrate on growing your business rather than face the constant burden of compliance. Not only is the cycle of quarterly reporting an onerous one from a time perspective, but the pressure of hitting revenue and earnings guidance every three months is stressful and can encourage the prioritisation of 'short-termism' in your business decisions. These decisions will often be highly contradictory to what is best for the company over the long term.

- The trading volatility around quarterly reporting can significantly affect your business. In a self-fulfilling cycle, missing revenue guidance by small margins only for the market to react poorly can further encourage more short-term management to ensure that the next revenue guidance is met. Your job is to grow shareholder value—which often does not equate to maximising short-term growth measures—yet volatility in the market will lessen your ability to do this as effectively or as efficiently as you would like.

## A MORE STABLE SHARE REGISTRY

ASX provides an opportunity for a more stable share registry while still maintaining sufficient liquidity. Looking at the trading volumes across the NYSE and Nasdaq, on average, the free float (i.e., the shares owned by the public) of software and online companies changes hands over 2.5x a year in the U.S.! This situation implies an average holding period of less than five months. For ASX-listed software and online companies, the average turnover of free float is just 0.66x a year (with an average holding period of 18 months).

Moreover, the free float of the most highly traded U.S. software and online stocks turnover is more than 10x per annum—implying a holding period of only 35 to 40 days! The free float of the most highly traded ASX-listed software and online stocks turnover is between 1.0x and 1.5x per annum. This means a very significant time savings for CEOs and chief financial officers, who have to allocate many hours to meeting and educating investors.

This situation in itself provides much food for thought: owning a share is exactly that—would you like your 'owners' to have such short-term thinking?

Although this higher rate of ownership turnover on the U.S. exchanges may suggest a deeper liquid market, ASX certainly provides sufficient liquidity (in our opinion) to ensure no discernible disadvantage. The benefits of a stable share register are widely reported.

## LOGISTICS

The simple question is this—if you are an Australia-based company, even though it is possible to list in the U.S., is it practical to do so? Logistically, the relentless back-and-forward travel involved by management for investor presentations and conferences creates a huge real and opportunity cost burden.
Some questions you may want to ask when considering such travel are:

- Could your time be spent more efficiently?
- Will splitting management teams for prolonged periods have an impact on productivity?
- What is the real cost of having a satellite investor relations team?
- How much access will U.S.-based fund managers have to you and your management team based in Australia? If they will not have much access, how much will this affect your performance in the capital markets?

## CONCLUSION

Scaling quickly is undoubtedly exciting (and stressful). It is so important that you maintain a long-term view on how you are going to keep this momentum going as your company grows. Poor strategic decisions can cost you significant time and money.

Be well prepared and well informed. Good luck! We will be watching on with interest. If you feel that you need some help navigating this tough process or that you are not yet there and need some guidance, we would love to hear from you.

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TDM is a private investment firm founded in 2004 with offices in Sydney and New York. They invest in companies with attractive growth profiles run by outstanding management teams. Their flexible mandate allows them to invest in public companies globally, as well as Australia- and New Zealand-based private companies. TDM has a highly focused approach to investing, with a portfolio of no more than 15 investments globally. They typically deploy between $20 million to $75 million (maximum $100 million) per investment.