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An unexplored route to the public equity market

A case study of Spotify's direct listing

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ABSTRACT

In this thesis, we analyze Spotify's choice of opting for a direct listing over a traditional IPO. We investigate the motivations and rationale behind the decision, provide insights from the process, and present some of the challenges that were faced. In order to fully understand the reasoning and the decision-making process behind the choice, we conducted a single case study. We find that the main motivations behind opting for a direct listing were that Spotify did not need to raise additional capital, since it was well-financed from the private market prior to its listing. Furthermore, Spotify wanted to avoid lock-up agreements and underpricing, which generally are associated with a traditional IPO. Adding to this, the ability to take more ownership of the investor education, and the importance of transparency and equal access for Spotify played an important role in ultimately opting for a direct listing. The most relevant challenges of the process were: the rules and regulation allowing for a direct listing of this scale had to be established, the absence of underwriters in the process left a greater degree of uncertainty around ensuring that there would be a liquid market following the listing, and lastly, the investor education had to be carried out so that investors would get sufficient information on Spotify, while satisfying legal requirements.

Keywords: Direct listing, IPO, price discovery, investor education, lock-up

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1 Introduction

On April 3rd, 2018, Spotify listed its shares on the New York Stock Exchange ("NYSE") through a direct listing, marking the first time a company of this size opted for a public listing without an underwriter. The process took over one year of dedicated work from the company and its advisors to work out a suitable framework around the direct listing.

In just over 10 years, Spotify had gone from having a few hundred users, to becoming a multi-billion dollar enterprise present in 61 countries, with over 159 million monthly active users. During this period, Spotify had raised more than $2 billion in financing in the private market, making it sufficiently capitalized to execute on its strategic growth plan. With enough capital, in combination with a highly experienced and newly appointed CFO who questioned the Initial Public Offering ("IPO") process, Spotify started to explore alternative routes to the public equity market.

As a billion-dollar technology company, Spotify was the first company to opt for a direct listing in this context setting the stage for an alternative path of going public. Since the listing, not much research has been done on the topic, and we wanted to capture the underlying motivation and rationale for Spotify's choice by answering the following research questions:

Why did Spotify opt for a direct listing instead of a traditional IPO with an underwriter?
What were the main risks of opting for a direct listing?

We find that Spotify opted for a direct listing over a traditional IPO due to a combination of factors. The fundamental reason was that Spotify did not need to raise additional capital in the foreseeable future as it was well-financed from the private funding it had, but still wanted to become a public company in the near future, due to expectations from its investor collective. For this reason, Spotify's CFO Barry McCarthy did not think paying for an underwriter would be in the company's economic self-interest, as this would entail a hefty fee and a risk for an underpricing of Spotify's shares in conjunction with a traditional IPO. Adding to this, Spotify wanted to have a transparent and a democratic listing process, which a direct listing would allow due to the market-based price discovery process, flexibility around lock-up periods, and complete ownership of the investor education.

1.1 Purpose

There are three major purposes of this thesis. Firstly, we want to provide a deep insight into the rationale of opting for a direct listing over a traditional IPO. As we conduct this research through a single case study, it will be entirely focused on Spotify and its decision-making processes, which will give the necessary depth to enable robust results and conclusions. The results are also highly applicable to other firms considering going public, which will be discussed further in section *6 Discussion*.

Secondly, we want to shed light on this alternative way of going public and inspire further research on the topic. We argue that the direct listing will become a viable and more widely used path for companies considering going public in the future. As the number of direct listings will increase, there will be more research possibilities, which we give some suggestions on in the conclusion (section *7.1 Suggestions for future research*).

Finally, we want to provide the faculty at the Department of Finance at the Stockholm School of Economics with material that can be used to develop a case study for teaching purposes.

1.2 Contribution

At the time of writing this thesis, there is limited research on the topic of direct listings, since the phenomenon is relatively new. We will thereby contribute to the literature by providing one of the first academic research papers on this topic. By using a case study methodology, we will be able to give specific background information of the details of the first direct listing process in this context. Through our interviews with individuals involved in the process, we will provide the perspectives from management, board of directors, investors, financial advisors, legal advisors, and auditors. This will allow us to get a more complete picture of the decision-making process and provide a deeper understanding of the underlying factors behind the decision to opt for a direct listing, than a quantitative study would enable us to do.

1.3 Outline

Section 2 will cover the theoretical framework for this thesis, including a review of relevant previous literature. Section 3 will explain the methodology used for this study. Section 4 will establish the background for the case, followed by section 5 that presents the case. In section 6 the results and implications will be discussed. Lastly, in section 7 the conclusions from the study will be presented, together with suggestions for future research.

2 Theoretical framework

In this section, the theoretical framework for the thesis will be presented. This includes a review of the associated rules and regulations in the United States financial markets, and literature review on the topic of IPOs, including underpricing, the costs related to IPOs, and the phenomenon of declining number of public companies in the United States in recent years.

2.1 Rules and regulations

2.1.1 Rules and regulations within the United States securities market

In light of the stock market crash followed by the Great Depression, and to restore investor confidence, the United States federal government began an intensive effort to regulate the financial markets[1]. Two legislations that were issued after the Great Depression, and that still play a crucial role in the United States securities markets today, are the Securities Act of 1933 ("Securities Act") and the Exchange Act of 1934 ("Exchange Act").

The regulatory body responsible for these acts is the US Securities and Exchange Commission ("SEC"). The SEC has issued an extensive list of rules and regulations under these acts that have the force of law. It also provides guidance regarding the interpretation of these rules (Latham & Watkins, 2020).

2.1.2 The Securities Act

The Securities Act, often referred to as the "truth in securities law", generally governs the initial offer and sale of securities in the United States (Latham & Watkins, 2020). According to Keller (1998), the goal of securities registered under the Securities Act, which are subsequently offered for sale to investors, is full disclosure of truthful information. The SEC (2013) states that the Securities Act has two basic objectives:

- *"require that investors receive financial and other significant information concerning securities being offered for public sale; and*
- *prohibit deceit, misrepresentations, and other fraud in the sale of securities."*

Although the SEC requires that information provided is accurate, it cannot guarantee it. However, an investor who has purchased a security and suffered a loss has recovery rights given the investor can prove that there was incomplete and/or inaccurate disclosure of crucial information.

2.1.3 Section 11

Section 11 of the Securities Act imposes strict liability for material misstatements in registered documents. "Any person who […] participates" in a distribution of securities, is an "enumerated defendant under the statute". This includes the issuer and each individual who signed the registration statement, every person who, with his or her consent, is named in the registration

[1] 415 U.S.C. § 77k; S. Rep. No. 47, at 1 (1933) ("The purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.").

statement such as a director, experts (e.g. accountants) as well as underwriters. Nickerson (2018) states that Section 11 imposes liability on the underwriter to ensure that complete and accurate information are disclosed about the issuer to the public. A purchaser of the security may file a suit under Section 11, even if he or she bought the security on the secondary market.

2.1.4 Registrations statements

In general[2], under rule 404(a) of the Securities Act, securities issued in the U.S. must be registered (SEC, 2013). Generally, registration statements include a description of the company's business, a description of the securities that the company intends to offer, information about the management and the board of directors as well as financial statements verified by independent accountants. The most commonly used forms for the Securities Act registration statement include Form S-1 and S-3 for US issuers and F-1 and F-3 for foreign issuers (Thomson Reuters Practical Law, 2020).

2.1.5 The Exchange Act

The Exchange Act governs the regulation of the securities exchange market and the activities of companies listed on the various national securities exchanges (Keller, 1988). Under the Exchange Act, the SEC has broad authority over the major aspects of the securities market in the United States, including activities of public companies (reporting obligation, updating the market on material events) and the operation of market participants (brokerage firms, clearing agencies) as well as Self-Regulatory Organizations ("SRO") (Latham & Watkins, 2020). According to the SEC (2013), the Exchange Act also prohibits certain types of conduct in the market and has disciplinary powers to enforce. The Exchange Act registration forms for US issuers includes Form 10 and Form 8-A.

2.1.6 The United States Code: Chapter 11, § 1145. Exemption from securities laws

One of the closest analogies to a direct listing prior to Spotify's is the application of the exemption under section § 1145 of Chapter 11 in The United States Code. It applies to reorganizations, and states that under certain conditions there can be an exemption of Section 5 of the Securities Act of 1933, which requires that a registration statement is approved by the SEC (so called "effective") to offer or sell any securities. This mechanism enables securities, which have been issued in exchange for creditors' claims under a capital 11 reorganization plan, may be resold to the public

[2] Not all offerings must be registered. Exemptions exists including private offerings to a limited number of investors, offerings with limited size, intrastate offerings as well as offerings by municipal, state and federal governments.

indefinitely, (Budlong, 2010), and the offer or sale of securities of this kind is deemed to be a public offering (United States Code, Chapter 11). Between 2016–2018, the acceptance of applying § 1145 became more widespread, and was used by a number of companies during restructurings (ABI Journal, 2018).

2.2 Literature review

2.2.1 Cost of an IPO

Chen and Ritter (2000) conclude that gross spreads (including management fee, underwriting fee, and selling concession for the issuing company in relation to total issued amount) in IPOs have over time become more centered around 7% of the issued amount. During the late 1990s, 90% of the offerings where issuers raised between $20–80 million, had a spread of exactly 7%, triple the proportion a decade earlier. This trend has continued. Between 2001–2019, 96% of the IPO with offerings within the range of $20–80 million, had a spread of exactly 7% (Ritter, 2020). In IPOs of more than $100 million, there is more variation in gross spreads, with 7% being the most common gross spread in 50% of the IPOs between 2001–2019.

Besides the direct costs of an IPO, it is often argued that indirect costs can exceed the direct costs multiple times, because of the so-called "underpricing" of the IPO.

2.2.2 Underpricing

Theories on underpricing of IPOs have been studied for decades, including research from Logue (1973), Ibbotson (1975), and Ritter (1984), that showed how shares in an IPO tend to be underpriced, as the first-day returns are often positive. This increase in the share price during the first day of trading will leave, so called, "money on the table" that instead could have been captured by the investors and founders of the issuing firm. Since the 1970s, there has been a substantial amount of research confirming that IPOs tend to be underpriced on average. During the 1980s the average first-day return of an IPO was 7.2%, followed by 14.8% between 1990–1998, peaking at 64.6% between 1999–2000, and back to 14.8% between the years 2000–2019. This equals an aggregated amount of $172.1 billion as a consequence of underpricing between the years 1980–2019 (Ritter, 2020). Below is a summary of the most recent years' underpricing of IPOs in the US.

Table 1: Underpricing of US IPOs

Year	# of IPOs	Avg. first-day return	Underpricing in $
1980–2019	8,610	18.0%	$172.1B
2016	75	14.5%	$1.8B
2017	107	13.0%	$3.7B
2018	134	18.6%	$6.4B
2019	112	23.5%	$6.9B
2020 (H1)	58	31.0%	$7.8B

Source: Ritter (2020)

To gain some perspective, Loughran and Ritter (2002) suggest that the money left on the table on average is twice the amount of the underwriting fees paid in an IPO and equals more than three years of aggregate profit for the companies going public. However, Ritter and Loughran also claim that in most IPOs there is relatively little underpricing, and in the cases where the underpricing is significant, it is often due to a higher offering and opening price than anticipated. Thus, issuers that are losing wealth in the process, often find themselves to be wealthier than first anticipated, and are still satisfied with the overall outcome. This behavioral aspect was also studied by Ljungqvist and Wilhelm (2005), where they showed that IPO firms are less likely to switch underwriter for subsequent offerings when they are satisfied with their underwriter's performance according to Loughran and Ritter's claim.

The research is clear on the fact that underpricing exists, but regarding underlying reasons for underpricing, there are diverging views. According to Ljungqvist (2007), the underpricing theories can be divided into four broad groups: asymmetric information, institutional explanations, ownership and control, and behavioral explanations. Of those, empirical data supports the former, but the empirical evidence for the rest of the groups are mixed. Therefore, the main focus in this section will be on the information frictions associated with an IPO, and the most relevant models to explain this.

One of the earlier and most well-known asymmetric models is Rock's (1986) application of *the winner's curse* on the IPO market. Rock argues that there are investors who have an information advantage regarding the "true value of the offered shares", superior to other parties involved in the IPO process, including the issuing firm itself, and other investors. According to this theory, the more informed investors will only participate in IPOs priced at or below its expected value but will withdraw from the market in "unattractive" offerings, while the uninformed investors will participate in all types of IPOs. This leads to an excess demand for the attractive offerings, leaving the uninformed investors with a disproportionate number of shares from poorly performing IPOs, as they will be crowded out by the informed investors in the better performing ones. Consequently, the IPO has to be underpriced to some extent in order to guarantee that the uninformed investors will participate in the offering.

The presence of the winner's curse has also been confirmed in several studies in different settings where rationing has been present. For example, Koh and Walter (1989) tested the model in the Singaporian market, Levis (1990) in the UK market, Keloharju (1993) in Finland, and Amihud, Hauser, and Kirsh (1993) in Israel. Similarly, Aggarwal et al. (2002) compared the returns of retail and institutional investors, concluding that institutional investors gain higher returns due to higher allocation in underpriced issues. They also find that this is positively correlated to private information obtained by institutional investors, provided either internally or by the underwriters.

Beatty and Ritter (1986) develop two propositions on the topic of underpricing. First, they show that higher uncertainty of the value of the issuing firm, leads to greater underpricing. Thus, there could be incentives for the issuing firm to reduce this uncertainty, by voluntarily disclosing information. Second, they show the relationship between the investment banks' reputations and underpricing, concluding that the underwriter must balance the pricing to satisfy both investors and issuers. If the underwriters price the IPO too high or too low, they risk losing either potential investors or potential issuers. Thereby, there is reputation capital at stake for the investment banks in an IPO, making them enforce the underpricing equilibrium.

Dunbar (2000) reaches similar conclusions; the investment bank has to price the offering at an equilibrium price that neither hurts the investors or issuer, i.e. not underpricing or overpricing too much. Nanda and Yun (1997) also emphasize the necessary balancing act performed by underwriters. In their study, they conclude that overpricing has negative effects on the underwriters, while some degree of underpricing can have positive effects.

As previously discussed, underpricing can be costly to the issuers, and it is therefore in their interest to reduce the asymmetric information, and consequently the underpricing. Habib and Ljungqvist (2001) show this, and to what extent issuers are willing to reduce the underpricing. They conclude that "issuers will take actions to where the marginal cost of reducing underpricing further just equals the marginal benefit", where the benefit is defined as the decrease in wealth loss. However, this underpricing reduction will statistically lead to a net benefit of zero for the issuer.

Ljungqvist (2007) discusses ways of reducing the information asymmetry that have been studied, for example, by the choice of a prestigious underwriter or reputable auditor, as they work as a form of quality certification of the issuer. The empirical evidence is mixed, and highly dependent on the period studied. Beatty and Welch (1996) prove with data from the 1990s that the more prestigious underwriters tend to underprice more, as opposed to the reversed relation two decades earlier. Ljungqvist comments that the underpricing in this sense could be a form of risk compensation, as the top investment banks have lowered their criteria for selecting IPOs to underwrite.

The method of strategically choosing underwriters and auditors, is a form of signaling, a concept first mentioned in the IPO literature by Ibbotson (1975). Another theory on signaling is that a high-quality firm can afford to be underpriced in its IPO, as the money left on the table will be regained in subsequent offerings, when the company has "proved itself" and shown the market its true value. A low-quality firm would not be able to follow this behavior, as they would not be able to redeem the lost value, unless they prove to be a high-quality firm. If the firm knows that it is low-quality, it will be very costly to underprice, and thus, the underpricing can be a credible signal of firm quality. The signaling model has been studied by Allen and Faulhaber (1989), Grinblatt and Hwang (1989), and Welch (1989), among others.

Another perspective presented by Loughran and Ritter (2002) is that underpricing can be viewed as a form of indirect cost to the issuing firm. This allows the underwriter to achieve a higher total compensation than if the costs would have been adjusted as higher fees, since issuers often find the opportunity cost of leaving money on the table less important than the direct fees.

Lastly, some theories argue that the underpricing works as insurance against possible litigation by investors. According to Hughes and Thakor (1992), this risk of litigation increases with the offer price, meaning that underwriters must trade-off the costs of underpricing and the costs of litigation. They point out that there is a linkage between litigation and underpricing, but it is not the sole cause, as underpricing still exists in settings where litigation risk is not a factor.

There are several other theories on what underlies underpricing of IPOs, but they will not be discussed further given the scope of this thesis. For a more comprehensive view on underpricing, see Ljungqvist (2007).

2.2.3 Decline in number of US public companies

In 1989, Harvard-professor Michael Jensen wrote that the publicly held corporation "has outlived its usefulness" in several sectors of the economy and "is being eclipsed". Instead, he argued that new corporations are taking its place. These are companies that have no public ownership and are not listed or traded at national stock exchanges. Jensen stated that the new corporations are not owned by households but by large institutions and entrepreneurs.

In 2012, the United States had 14 percent fewer exchange listed firms than it had in 1975. In relation to other countries with similar or lower overall GDP growth and overall quality of institutions, the United States has abnormally few listed firms. Doidge et al. (2015) called this the "U.S. listing gap". In addition, companies are waiting longer before they go public. For instance, between the period 1980–1996 the median age for a technology company doing their IPO was 8 years, compared to 10.5 years during the period 2010–2019 (Ritter, 2020).

This trend has gathered extensive attention both in academic literature and policy circles, as well as in media. While its direct causes and consequences remain unclear, focus has been on, among others, the following three trends: regulatory burden of public companies, technological advancements lead to larger companies are more interested in acquiring smaller companies as well as the emergence of a more sophisticated and liquid private market.

When an issuer intends to raise capital through the sale of securities to any potential investors in the public capital market, the issuer must generally register the offer with the SEC. This is a process that requires extensive production of information, unless an exemption from registration is available.

In the last fifteen years, public companies have experienced an overall marked increase in terms of federal securities regulation. This is largely in the form of the Sarbanes-Oxley Act, which, following fraud scandals among public companies, increased public companies' disclosure obligations. This has led to companies having to spend more capital and resources simply following regulatory requirements of a public company. As a percentage of revenues, these compliance and regulatory costs have especially had a burdensome effect on small firms (Crain, 2011). However, critiques point to the fact that the number of IPOs began to fall prior to Sarbanes-Oxley (Gao et al., 2013).

Gao et al. (2013) argued that the declining number of IPOs is not due to increased regulatory burden of public companies, but that for a private firm the "advantages of selling out to a larger organization, which can speed a product to market and realize economies of scope, have increased relative to the benefits of operating as an independent firm".

de Fontenay (2017) believes that a potential explanation for the declining number of public companies can be attributed to the liberalization of regulations concerning companies raising capital privately (for more information, see section *4.3 Private placement market*).

3 Methodology

In this section, we will describe our research design and data collection process, as well as the reliability and validity of our collected data.

3.1 Research design and data collection

To understand Spotify's choice of going public through a direct listing, we chose a case study methodology. Case studies have frequently been criticized as a research method, with claims it can be hard to generalize the results and present them in a scientific manner (Yin, 2009). Nonetheless, several scholars have supported the use of case study methods to understand the interaction of a phenomenon and its context, including Siggelkow (2007), and Dubois and Gadde (2002).

Siggelkow (2007) argues that "a single case can be a very powerful example" in explaining a phenomenon; he also claims that "case data can usually get much closer to theoretical constructs and provide a much more persuasive argument about causal forces than broad empirical research can." Dyer and Wilkins (1991) support this in claiming that it is possible to get a deeper understanding of a particular setting when using a single case study. In accordance with these findings, we believed a single case study would be the most appropriate method to capture the rationale and reasoning behind Spotify's direct listing. This was reinforced by our assessment that the sample size of direct listings in this instance (n=5 as of 2020-11-17 (Ritter, 2020)) was too small, and the time since the first direct listing (2.5 years) was too short, to be able to conduct a meaningful quantitative analysis with robust results.

The first step in our research process was to gather all relevant public information on Spotify's direct listing, as well as the necessary background information. This included theory and statistics on IPOs, information on the development of the private placement market, opinions on direct listings in general, and the regulatory framework relating to it. The information related to Spotify's direct listing mainly consisted of interviews by people involved in the process, articles and reports written on the topic, Spotify's Form F-1 filing to the SEC, and the information provided by Spotify during its Investor Day. Gathering and analyzing relevant, publicly available information helped us get a clear picture of what data we would need to assess to obtain a comprehensive understanding of the process, including the rationale and the arguments for and against Spotify's direct listing. For the interviews we planned to conduct, we prepared conversation topics around areas we identified as information gaps in the publicly available data, which we tailored to be specifically relevant to each interviewee's field of expertise.

To get a deeper understanding of the underlying motivations behind the direct listing, we interviewed individuals that were directly involved in the process but had different responsibilities. This allowed us to obtain several different perspectives, providing the most comprehensive possible view of the process. When choosing interviewees, we made our selection based on their role in Spotify's direct listing, as well as their availability. We wanted to cover the internal perspective from Spotify, the investor perspective, and the advisor perspective, including legal, financial, and accounting, as well as independent practitioners. The set of interviewees therefore consisted of board members, investors, advisors and independent professionals, which are presented in the table below.

Table 2: Interviewees

Interviewee	Company	Role in Spotify's direct listing process
Fredrik Cassel	Creandum – General Partner	Investor
Rizvan Dhalla	Morgan Stanley – Managing Director	Financial advisor
Phyllis Korff	Mayer Brown – Partner	N/A
Stefan Lundberg	EY – Partner	Auditor
Woody Marshall	TCV – General Partner	Investor & Board Member
Pär-Jörgen Pärson	Northzone – General Partner	Investor & Board Member (until 2017)
Greg Rodgers	Latham & Watkins – Partner	Legal advisor

During the interviews, we followed the methodology described by Merriam (1994) as semi-structured. We prepared a set of questions and topics we wanted to cover, but did not follow any set order or phrasing, and would let the interviewee answer freely to gain a more organic insight on their experience, thought process, and perspective (Merriam, 1994). For each interview, our areas of focus differed based on the interviewee's role in the process; however, there was some overlap in our line of questioning in part to get different views on the same situation, but also to verify the information we were receiving from different sources. Our interviews were complemented with the relevant public data, mainly from Barry McCarthy, who was Spotify's CFO during the process and has done many interviews and written several articles on the topic, but was not available for a personal interview for the purpose of this thesis. We also gathered information from publicly available interviews with other people that played a role in Spotify's direct listing.

All interviews were conducted in virtual meetings, both due to Covid-19 precautions and the increased flexibility this method allows. The interviews were recorded and transcribed, allowing us to revisit the material for analysis and to find relevant quotes and interesting focal points for further research and discussion. Information obtained from the interviews that were to be used in the thesis was then sent to each interviewee for verification, to ensure that we had understood and interpreted the content accurately.

The interviews, combined with the publicly available material, allowed us to gain deeper insight and a fuller picture into the process and rationale of Spotify's direct listing. This was instrumental in answering our research questions.

3.2 Research quality

Considering the case study approach is sometimes criticized as a scientific method, we have adapted our methodology in several ways to ensure the highest possible research quality. To evaluate the quality of qualitative research, it is common to address its *validity* and *reliability,* and Yin (2009) divides the validity into three separate tests: construct, internal, and external.

The construct validity is about "identifying the correct operational measures for the concepts being studied." Tools to increase the construct validity include collecting multiple sources of evidence, as well as establishing a chain of evidence for the studied phenomenon. We have used both these tools in our data collection process. We started with a diverse set of interviewees and complemented our findings with public data to get a clear chain of evidence, which should be easy for the reader to follow and understand in context.

The internal validity is about establishing causal relationships, ensuring the results capture the reality of the phenomenon. This is an especially important consideration in this type of case study, since the event will not be directly observed, but rather, the results will be based on interviews and documentary evidence. Inevitably, there will be an interference of the researcher who will have to interpret the event from the subjective view of the interviewee, which could be a potential issue (Yin, 2009). There is no certainty the interviewee will be completely transparent, and they will most likely not be completely unbiased either, especially regarding potential negative aspects, or their own respective shortcoming in the process. To increase the internal validity of our case study, we have mainly used source triangulation, by interviewing individuals with different relations to the process to get many different inputs, as well as using multiple sources to understand the process fully.

The external validity is a test if the study can be generalized outside the direct context of the case study. Here, it is important to make the distinction between *analytic* generalization and *statistical* generalization. Since the case study methodology will not use a large sample to achieve statistical significance, it will rely on the analytical generalization, where the researcher will try to generalize the results into a broader theory. According to Merriam (1994), one way to increase the external validity is to determine how typical the case is in relation to similar events within the same category. For the purpose of this thesis, the question will be whether Spotify's rationale behind pursuing a direct listing is applicable to other companies, which will be covered in the discussion section.

Lastly, the reliability pertains to what extent the study can be repeated with the same results. Stenbacka (2001) argues that the general concept of reliability has no relevance for qualitative research, due to the structure of the study, where one cannot differentiate between researcher and method. However, the purpose of the reliability, to reduce errors and biases in the research, clearly remains important (Yin, 2009). To increase the reliability of a case study, it is important to thoroughly describe the whole research process, which can be referenced above for our case.

4 Case background

4.1 IPO and direct listing processes (US)

In this section, the most relevant parts of the IPO and direct listing processes are briefly summarized. All information in this section is referred to in the New York Stock Exchange's *IPO Guide* (2013)*,* Andreessen Horowitz (2019), and Fenwick (2019) if no other source is mentioned. In Table 3, a summary of differences is presented.

Table 3: Traditional IPO vs. Direct listing

	Traditional IPO	Direct listing
Underwriter/Financial advisor	• Company sells shares to underwriter who then sells them to investors • Underwriter organizes and participates in communication with investors • Liable under Section 11 (Securities Act)	• Advisory role only • No book building process • No engaging in allocations
Share registration and distribution	• Old or new shares are sold by existing investors / company	• No new shares issued and no capital raised
Stock pricing	• Purchases by investors made at IPO price set by the company • Book building during roadshow • Existing shareholders generally subject to lock-up (180 days)	• Prospective buyers place orders with brokers at price at which they are interested buying • Market driven price discovery • Existing shareholders may sell (no/partial lock-up)
Investor education and guidance	• Meeting with institutional investors in conjunction with roadshow • May not provide financial guidance due to liability concerns • Work closely with equity research analyst prior to commencement of trading	• Company owns investor education process • Investor Day (publicly streamed) • Ability to provide public company style financial guidance • No detailed information sharing with research analyst

4.1.1 The IPO process and the role of the underwriter

An average IPO process takes approximately six months (Rodgers, 2020-10-26). The project usually starts with organizational meetings, where all key members of the project are present to discuss specific questions related to the offering, workstreams and main responsibilities for each party. Then the company will, with assistance from its advisors, start preparing a registration statement.

The registration statement is filed and will be reviewed by the SEC, followed by adjustments from the issuing firm. This iterative process will continue until the SEC has no further comments, and the issuing firm will file a "red herring," or preliminary prospectus. For a more detailed review of the relevant rules and regulations that apply to the IPO process, see section *2.1.1 Rules and regulations within the United States securities market.*

The company, based on advice from its underwriters, will determine an initial price range for the offering by conducting a comprehensive valuation of the firm. Once the red herring is filed, executives from the issuing firm, along with underwriters, will travel on a roadshow to present the company and receive feedback from investors regarding the "initial price range". The roadshow is typically targeted at institutional investors, such as large pension funds and mutual funds. At the roadshow, prospective buyers will indicate to the underwriters whether they are interested in participating in the offering, and if so, at what price and volume. The underwriters will use these non-binding bids to determine an "offering price". They will then buy shares from the company that they, in turn, sell to institutional investors at the offering price.

Following the allocation of shares, during opening day, the stock exchange will do a market-based matching to set the "opening price" of the shares. The opening price will be based on the supply and demand during opening day, and is independent of the offering price, which only functions as a reference. This is similar to how the closing price of a public stock functions as a reference when opening the next day, but does not directly affect the price.

In an IPO, several tools are used to ensure a stable initial price development. In order to have sufficient control of the sell-side in an IPO, pre-existing shareholders are often subject to certain restrictions regarding sales of company shares following the first day of trading. These restrictions, referred to as a "lock-up" typically last for a period of 180 days. Furthermore, the underwriters have the opportunity to help stabilize the price in the aftermarket. With a "greenshoe option," underwriters have the right to issue additional stock (up to 15 percent of the offering) at the offering price to reduce volatility in case the stock is trading too high above the offering price. In contrast, if the stock is trading below the offering price, underwriters can place a stabilizing bid by buying back shares to satisfy the supply.

4.1.2 The direct listing process

The direct listing process contains elements from the traditional IPO process, such as the filing of a registration statement. There are also differences in terms of workstream. The main differences between a traditional IPO process and a direct listing include: the role of the investment banks, the investor education process, the market-based pricing, the flexibility regarding lock-ups, the ability to raise capital, and the stabilization activities once the shares are trading.

Financial advisors. In a direct listing, the firm going public will select investment banks as financial advisors. The most important difference between a financial advisor and an underwriter is that the financial advisor, as part of its advisory role, is not liable under Section 11 of the registration statement, meaning it will not be a part of any share allocation and, hence, will not sell shares. Financial advisors still play an essential role in the direct listing process, by, among other duties, giving the company investor-related advice on positioning and due diligence, as well as assisting the company with filings.

Due to the advisory function, financial advisors' compensation structure differs from that of underwriters. In a direct listing, financial advisors are compensated with a flat fee, in contrast to underwriters in the IPO process that are compensated through a gross spread of approximately 7 percent (see section *2.2 Literature review*).

Investor education. Due to the financial advisor's limited role in the investor education process, the company will take full responsibility for its investor education activity in a direct listing process. Tools used to give investors sufficient information about the company that have been used in direct listing processes (but are not explicit parts of the process, as it could be applied in a traditional IPO process as well) include (i) the company choosing to meet with individual institutional investors in a traditional roadshow manner (without the investment bank's presence), (ii) and/or the company hosting an "Investor Day," which has become common practice. During the Investor Day, the company will present its business model, management, key growth drivers and its industry to investors, similar to how a public company communicates with investors. The Investor Day is available to the general public via online stream.

Price discovery process. On the day of the listing, the price discovery process functions the same way for the company doing a direct listing as any public stock opening for trading on the exchange that day. The trading price will be set by the market, where the designated market makers (DMMs), and floor brokers are responsible for matching the supply and demand, and thereby, finding a market-based price. The financial advisors are involved through consultation with the DMMs, as this is required by the NYSE exchange rules.

> In the direct listing process, you are removing steps, because once you do an IPO you do the exact equivalent of a direct listing opening the next morning. [In a direct listing] you remove that step of the hand-allocation and hand-pricing and jump straight to the market. (Gurley, 2019-10-06)

Lock-up periods. In a direct listing, there is flexibility regarding lock-up periods, and a company can either remove it completely, allowing anyone to sell once the company is public, or add a partial lock-up for some of the shareholders. This is an important difference compared to a traditional IPO, where some degree of lock-up undertaking from existing shareholders is a common practice.

Raising capital. Under the current stock exchange rules, a company cannot raise capital in conjunction with a direct listing. The company has the option to raise capital in a seasoned equity offering once it has gone public. As of December 2020, there is a proposal pending with the SEC from both Nasdaq and the NYSE that suggests allowing capital raises in conjunction with direct listings (for more information on capital raising in conjunction with a direct listing, see section *4.2.4 Direct listings with a primary offering of shares*).

Stabilization activities. After an IPO, an underwriter will also assist the company with stabilization measures. In a direct listing, there are no direct stabilization activities, and there is little intervention from intermediaries. The DMM has the formal responsibility of ensuring facilitation of sound trading and the financial advisor will provide the DMM with information from buyers and sellers. Apart from this process, the price development will be completely market-based, relying on a good match between supply and demand.

4.2 Stock exchanges and direct listings

4.2.1 Nasdaq and the NYSE

Nasdaq and the NYSE are the two most well-known trading exchanges in the world. They account for a significant percentage of all stock trading, market capitalization(s) and IPOs (as well as proceeds from IPOs) worldwide. Nasdaq is the largest venue in terms of liquidity for US listed companies (Nasdaq, 2018). Nasdaq has been able to attract many of the world-leading companies operating in the software, internet and electronics space. Some of the highest profile Nasdaq IPOs include Apple (1980), Microsoft (1986), Amazon (1997), Alphabet (2004) and Facebook (2012). The stocks listed at Nasdaq are considered more volatile and more growth oriented (SmartAsset, 2019). Nasdaq is a dealer's market, where market participants are not buying and selling directly to one another, but through a dealer, which in Nasdaq's case is a market maker (SEC, 2004).

The NYSE is a stock exchange located in New York City. It is the largest equities-based exchange in the world, based on the total market capitalization of its listed companies. Dating back to 1792, the NYSE has listed some of the most influential US companies in the world, including Berkshire Hathaway, JP Morgan Chase & Co, VISA, Walmart and Johnson & Johnson. The NYSE differs from Nasdaq in that it is an auction market, where individuals are buying and selling securities between one another. In an auction market, the highest bidding price will be matched with the lowest asking price (NYSE, 2019).

4.2.2 Listing requirements

Companies seeking to list securities on Nasdaq or the NYSE must meet minimum listing requirements, including specified financial and corporate governance criteria. Once listed, companies must meet continued listing standards relating to ongoing shareholder communication and disclosure, among others. While both Nasdaq and the NYSE have their own specific requirements, there is plenty of overlap between the two. National securities exchanges, such as Nasdaq and the NYSE, are bound by the Exchange Act (1934), as SROs. SROs are subject to regulatory oversight by the SEC. Each SRO has its own rules pertaining to its broker-dealer members and listed companies. The Exchange Act provides that SROs must submit to the SEC any proposed changes to the current rules before it becomes effective. Before the SEC acts on the proposal, it generally publishes it so the public can comment on it. Put differently, any changes with regards to the current rules governing SROs, cannot be done without SEC approval.

Nasdaq has four sets of listing requirements (Nasdaq, 2020). To grant approval of admission, a company must meet at least one of the four requirements set, as well as the main rules for all companies. The standards are based on earnings, capitalization with cash flow, capitalization with revenue, and assets with equity.

To be listed on the NYSE, the company must meet the standards with respect to earnings or market capitalization, as well as distribution standards including number of shareholders, minimum share price, publicly held shares, etc. (NYSE, 2020). Section 102.01B in the Listing Manual sets forth minimum standards for listing on the NYSE. According to section 102.01B, a company must demonstrate, at the time of listing, an aggregate market value of shares of $40 million or $100 million, depending on the type of listing.

4.2.3 Direct listings – Rule change

Traditionally, a company would list its common shares on a national securities exchange in the United States in conjunction with an underwritten public offering, upon transfer from another market or in connection with a spin-off (Brady et al., 2018).

Prior to 2017, the NYSE permitted, on a case-by-case basis, companies to list that had not previously had their shares publicly traded, given that the NYSE could determine that such company had met the $100 million aggregate value of publicly held shares requirement. This would be based on a combination of "(i) an independent third-party valuation of the company (a

"Valuation") and (ii) the most recent trading price for the company's common stock in a trading system for unregistered securities operated by a national securities exchange or a registered broker-dealer ("Private Placement Market")" (SEC, 2018).

In 2017, the NYSE filed with the SEC to propose changes in the rules. The proposed changes included (i) removing of the private market trading requirement given that a third party could provide a valuation of at least $250 million, (ii) requirement that the company's financial advisor work with a DMM to determine the opening price of the share (on the first day), and (iii) eliminating the requirement for the company to file a Securities Act registration statement in conjunction with the listing (Nickerson, 2019). In February 2018, the SEC (2018) approved a revised proposal that included only the first two proposed changes. The Commission received two comments on the proposed rule change, with both comments supporting the proposal.

Just over a year later, Nasdaq also filed with the SEC, proposing a rule change to adopt listing standards for direct listings. Clarkin et al. (2019) stated that Nasdaq, by adopting the proposed rules, has now aligned key aspects of its listing rules to accommodate direct listings, with the requirements previously adopted by the NYSE. Consequently, companies that wish to provide liquidity for their shareholders, have satisfactory capital, and do not have an immediate capital need may now consider similar listing requirements for both exchanges (Nasdaq and the NYSE) if they determine to proceed with a direct listing.

4.2.4 Direct listings with a primary offering of shares

On August 26th, 2020, a major difference between a traditional IPO and a direct listing was removed when the SEC gave approval on a NYSE proposed rule change (Paul Weiss, 2020). The new rule would allow private companies to sell newly issued shares into the opening auction on the first day of trading without the use of underwriters. This would enable companies to raise capital in conjunction with a direct listing, while at the same time allowing prior shareholders to sell their shares.

However, on August 31st 2020, the Council of Institutional Investors filed a notice with the SEC, stating that it intends to petition for a review of the NYSE's proposed change, leading the SEC to issue a notice to the NYSE stating that it will stay the approval of the rule change until further notice. This has created uncertainty regarding when and in what form direct listings with a primary capital raising will be approved (National Law Review, 2020). See section *9.2 Direct listings with a primary offering of shares (cont.)* in the Appendix in for a more detailed description.

4.3 Private placement market

As an alternative to raising capital in the public market, companies can raise capital in the private market through "unregistered" (private) offerings, which, in general, requires a less extensive disclosure burden compared to an offering in the public market. The historical regulatory environment has, however, limited companies to raise significant amounts of capital in the regulatory market. For instance, with the adoption of Rule 144 in 1972, securities purchased in a private placement were not allowed to be sold until the end of a two-year holding period, and following this holding period, the investors were only allowed to sell up to a certain percentage of the shares. Beginning in 1997, the SEC began to liberalize the rules applicable for investing in the private market, including lowering the required holding period to six months. Furthermore, a Qualified Institutional Buyer ("QIB") was permitted to immediately sell acquired shares to another QIB.

According to the Bauguess et al. (2018), capital raised through private placement of securities has increased substantially during the period following the 2008 financial crisis. Amounts raised through unregistered securities offerings have outstripped the amounts raised though registered offerings. This could potentially be explained by the increased amounts raised by late-stage private companies that had contributed to the raising amount of capital through private placements (Morrison & Foerster LLP, 2016). The aggregate amount of private capital raised by late-staged companies has increased substantially, from $1.3 billion in 1995 to $7.7 billion in 2000, a cumulative increase of 498 percent. In 2010, the same figure was $14.1 billion and in 2015 it was $33.0 billion (Ewens and Farre-Mensa, 2017).

The private market was once viewed as a steppingstone for companies before they went public. However, the growth of the number of private companies, along with the fact that they are choosing to stay private longer (Ritter, 2020), has led to private investments becoming an increasingly important asset class for institutions and high net worth individuals. According to the Investment Bank Scenic Advisement (2017), private markets play a more important role today than they ever have in the past, and these investments can no longer be ignored by institutional investors. More recently, the development of trading markets for privately placed stock has further contributed to a more sophisticated secondary trading market for non-public securities. For instance, in 2015 Nasdaq acquired SecondMarket, an early pioneer in private secondary market trading, in order to further facilitate the exchange of shares for private companies (TechCrunch, 2015). Institutional investors can find an exit path through these markets, without having to stress for an IPO, although a liquidity discount may be expected compared to the public market.

Start-ups raising more than $100 million from investors, known as "mega-rounds" in Silicon Valley, used to be rare. That has now ceased to be the case. Start-ups must move faster and expand their ambitions, thereby needing more investment than ever. When Airbnb raised $1.5 billion in the private market in 2015, several institutional investors, now known as public cross-over investment funds, invested in the round, including Wellington Management, T. Rowe Price Group and Fidelity Investments (Wall Street Journal, 2015). "If your competitor is going to raise $150 million and you want to be conservative and only raise $20 million, you are going to get run over," said Bill Gurley, Managing Partner at Benchmark Capital (New York Times, 2018).

4.4 Spotify background

Spotify is a digital music, podcast, and video streaming service that gives its users access to millions of songs and other content from creators all over the world. Spotify offers two types of membership, a free version with limited basic features, and a premium version with full access. As of September 2020, Spotify had 320 million users globally, 144 million of which were paying subscribers, and the service was available in 92 national markets (Spotify, 2020).

4.4.1 The founding of Spotify

On the 7th of October 2008, Spotify launched its digital music service, making it available to the public for the first time. But the story of the music streaming giant started two years earlier, in 2006 in Stockholm, when founders Daniel Ek and Martin Lorentzon registered their newly founded company. Ek and Lorentzon first met when Lorentzon's previous company Tradedoubler bought the internet-based advertisement company Advertigo, founded by Ek. They quickly realized they "shared a passion for search engines and converting online traffic into money [...] what we needed was a traffic source that we had control over", Lorentzon explained. In other words, they needed something to attract users which they then could sell advertising to, and thereby convert their traffic into monetary payoffs. This "traffic source" later became a music streaming service, and the first beta version of Spotify was made available in May 2007 to selected users, followed by the public launch in 2008 (Fleischer and Snickars, 2018, p. 15–21, 56).

The timing of Spotify's launch coincided with a rise in the file sharing and piracy debate, especially in Sweden. Close to 20 percent of the population was engaging in file sharing in 2008 and this number had been increasing for several years (The Swedish Internet Foundation, 2008). Adding to this, the file sharing search engine The Pirate Bay, which allowed users to search and download entertainment content for free, became a hotly debated topic, and Spotify offered a solution to the piracy problem (Fleischer and Snickars, 2018, p. 27–28). Stefan Lundberg pointed out the key challenge for Spotify in the earlier stages was to convince record labels that they offered an alternative solution: "You essentially took something that the courts previously viewed as illegal, as seen with Napster, and made it work, and convinced the record labels that this was the right way forward" (Lundberg, 2020-10-27).

4.4.2 The beta version and initial funding

During its beta-only period, Spotify secured its first funding from the Swedish venture capital firms Creandum and Northzone, with the responsible partners being Fredrik Cassel and Pär-Jörgen Pärson, respectively (Crunchbase, 2020). Pär-Jörgen Pärson was first approached by Ek and Lorentzon in early 2007, after previously having invested in Lorentzon's company and having had Ek as an employee at one of his portfolio companies. "I knew that they were very capable in every way, and they complemented each other very well [...] they had great ambitions and possessed the necessary knowledge to succeed." (Pärson, 2020-10-21)

Spotify raised a total of $21.6 million[3] in their Series A round in 2008 (Crunchbase, 2020). This initial funding was used to pay for technical development and necessary licenses for legal music distribution from the record labels. The negotiations with the record labels were both tough and costly, and Spotify paid for some of its licenses with equity in the company. The capitalization table at the time thereby consisted of the founders, venture capital investors, and the major record labels (Fleischer and Snickars, 2018, p. 66–67).

4.4.3 The Series B round and the freemium model

During the fall of 2009, Spotify secured $50 million in funding in a Series B round at a valuation of $250 million. The round was led by Hong Kong-based Horizon Ventures. Other series B investors included pan-European venture capital firm, Wellington Partners, and Chinese billionaire, Li Ka-shing (Crunchbase, 2020). Up to this point, Spotify's business model was still centered around the service being free and financed by advertisements, but now, Spotify turned its focus to getting their users to pay a monthly fee for the premium version (with no ads), popularizing the concept of *freemium* (Fleischer and Snickars, 2018, p. 70–75, 101–102). The road map for the freemium concept was to offer a basic service for free, accumulate an extensive user base, and then entice users to sign up for the premium account.

[3] Dollar is used as currency in the context of capital raising, which was predominantly carried out in the United States. Euro is used as currency for accounting/financial reporting, according to Spotify's financial statements.

4.4.4 Entering the US market, and becoming a unicorn

As of 2010, Spotify was negotiating with the big record labels regarding an entry into the US market. The main topic of the negotiations was Spotify's compensation model as several parties did not like the freemium concept. However, this had been an essential part of the development in Europe. Amid these negotiations, in early 2010, Spotify raised $12.3 million from Sean Parker, who also took a seat on the Spotify board, through his venture capital firm Founders Fund (Crunchbase, 2020).

In a blog post in the spring of 2011, Ek declared that Spotify had one million paying users, which were in the interest of the big record labels, but they needed more proof. Spotify also had to adjust its subscription model for the US entry. They did so by putting restrictions on the free version, before they were approved by the last of the big four record labels, Warner Music Group (Fleischer and Snickars, 2018, p. 106–108). The US launch was financed by a $100 million Series D round, led by Accel, and included DST Global, Kleiner Perkins, and Access Technology Ventures (Crunchbase, 2020). The valuation of Spotify was now over one billion dollars, giving the company its official "unicorn status." Spotify continued its expansion, and by the fall of 2011, Spotify available in nine countries, having over 10 million users, with more than 1.6 million paying customers.

4.4.5 TCV invests, and the first acquisition are made

In November 2012, it was announced that Spotify was raising another $100 million in funding, with Goldman Sachs as the lead investor. Other investors included The Coca-Cola Company and Fidelity. Spotify's valuation jumped to three billion dollars, with its latest reported revenue of $236 million, and a loss of $56 million for 2011 (New York Times, 2012). The next funding round was almost exactly a year later, with Technology Crossover Ventures ("TCV"), investing $250 million at a $4 billion valuation, to equip Spotify with the funds needed to become a true global media giant (Wall Street Journal, 2013). Following the round of funding, Barry McCarthy was elected to the board of directors at TCV's mandate, which came to be an important event in the Spotify story (Fleischer and Snickars, 2018, p. 120–121).

Another major event happening during 2013 was Spotify's first acquisition, namely the music discovery app Tunigo. This was the start of the music discovery emphasis for Spotify, that has since been a central part of its evolution. Spotify had not, with the exception of the acquisition of Echo Nest, completed any significant acquisitions prior to its listing. They had mainly acquired the people and ideas behind the target companies (Lundberg, 2020-10-27). For a detailed overview of Spotify's acquisitions, see *Table A3* in Appendix.

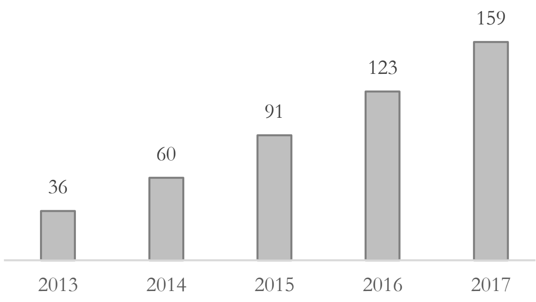
4.4.6 The Series G round and convertible bond

In June 2015 Spotify raised its then largest round of funding with an investment of $526 million, led by Goldman Sachs and including an investor consortium of 17 investors (Crunchbase, 2020). Swedish telecom giant, Telia, made an investment of $115 million, which gave them a 1.4 percent stake, meaning the valuation of Spotify was now $8.53 billion (The Wall Street Journal, 2015).

In March 2016, Spotify raised approximately $1 billion in convertible debt from private equity firm TPG, and hedge fund, Dragoneer Investment Group ("Dragoneer"), contributing $750 million, and clients from Goldman Sachs the remaining $250 million. The motive for the financing round was that Spotify wished to have financial power in case a consolidation opportunity within the industry would arise (The Walls Street Journal, 2016).

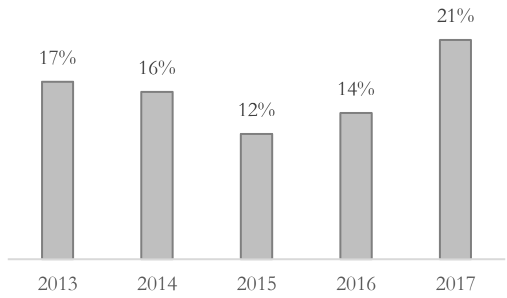
Below is a summary of Spotify's development of monthly active users (MAUs), gross margin, free cash flow, and revenues during the years 2013–2017.

Table 4: MAUs of Spotify (million)



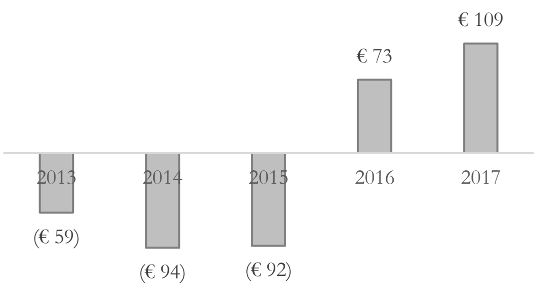
Source: Spotify F-1 Statement

Table 5: Gross Margin (%) – 2013–2017



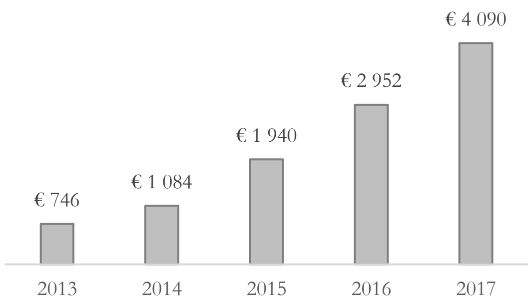
Source: Investor Day 2018 – Spotify

Table 6: Free Cash Flow[4] (€m) 2013–2017



Source: Investor Day 2018 – Spotify

Table 7: Revenues (€m) 2013–2017



Source: Investor Day 2018 – Spotify

4.5 Preparing for an IPO

As preparations began for a traditional IPO, Spotify realized that senior management had to be complimented as there was critical work to be done. As a first major step, Barry McCarthy, who since 2015 had been a board member of Spotify on the venture capital firm TCV's mandate, took over the role as Spotify's CFO. Barry McCarthy had extensive and relevant industry and public market experience, being the CFO of Netflix for over ten years, where he also played an important role in Netflix's IPO. He had also served on the board of Pandora, an early competitor of Spotify, between 2011–2013.

[4] "Free Cash Flow" is defined as net cash flows (used in)/from operating activities less capital expenditures, and change in restricted cash (Spotify, 2018)

> Daniel [Ek] was starting to get quite eager to bring in that kind of seniority, who had already done several IPOs and also done it with Netflix, which was a bit of a role model company for him back then. After Barry [McCarthy] took over as CFO, it took about two more years before Spotify was stock market capable, so it was a pretty long process. The initial idea was just to do a [traditional] IPO and raise capital, much like everyone else does who wants to become a public company. (Pärson, 2020-10-21)

Barry McCarthy's duties as CFO would be to "professionalize the finance part of the organization, [...], build the infrastructure, the analytics, among other things, to not only help scale the business but also to help the company prepare itself for an eventual public listing." (Marshall, 2020-11-03). Several areas had to evolve so Spotify would have a solid foundation that could be built to scale the business further, as well as living up to the standard that the public market requires. A robust and well-functioning Financial Planning and Analysis (FP&A) was an area identified as an important foundation for Spotify's future potential success. Spotify had grown enormously, and many internal systems and processes had to be updated for Spotify to properly predict cash flows and make internal projections and targets (Lundberg, 2020-10-27).

McCarthy recruited Paul Vogel, a Wall Street veteran, as Spotify's Head of Investor Relations and FP&A (Spotify, 2020). Other key recruitments included Luca Baratta as VP of Finance, who previously worked in Silicon Valley at Twitter (Lundberg, 2020-10-27), and Horacio Gutierrez from Microsoft as General Counsel (Spotify, 2020). With the addition of senior managers with extensive experience, Spotify's finance function became a critical part of the organization along with the overall accounting function, FP&A, and treasury, which were all made more efficient during 2016–2017 under McCarthy's leadership (Lundberg, 2020-10-27; Marshall, 2020-11-03). Between 2016–2017, Spotify increased its gross margin from 14 to 21 percent, and started to deliver positive cash flows during 2016 (Spotify, 2018).

5 Spotify: The case

5.1 Public markets – the next natural step for Spotify

Since its founding in 2006, Spotify had shown remarkable growth, evolving from an advertisement-based service building on file sharing technologies (Fleischer and Snickars, 2018, p. 44), into full-fledged global media streaming platform with artists, record labels, and creators from all over the world, with millions of daily streams (Spotify, 2020). Daniel Ek's and Martin Lorentzon's initial plan for Spotify was to build a long-term sustainable business that could grow organically in a private environment. A comparable company was the Swedish furniture group IKEA, which has managed to stay private since its founding in 1943 (Pärson, 2020-10-21). Nonetheless, to stay competitive Spotify needed to continue investing in both organic and acquisition driven growth, as well as recruiting highly competent staff, and to achieve this, external capital was necessary.

Up until mid-2015, Spotify raised over $1 billion, with investors including TCV, Accel, Founders Fund and Swedish venture capital firms Creandum and Northzone (Crunchbase, 2020). Extensive amounts of investor capital were available for Spotify, capital that advantageously was raised in the private market. Similar to Spotify's financing history, several other high-valued technology companies, including Snap Inc., Uber Inc. and Lyft Inc., postponed their respective IPO after raising enough capital in the private market (CNBC, 2019). If a company accumulates investors from the venture capital industry, there is a clear exit horizon, and if the company also still requires additional financing, a natural course of action would be to consider taking the company public. At large, Spotify and its investor collective began to see Spotify following that path in the not too distant future, especially considering that Spotify would need to raise additional capital in order to maximize its competitiveness. The industry had begun seeing increased competition, with presence from technology giant Apple (Fleischer and Snickars, 2018, p. 151–158).

> Spotify had raised quite a lot of capital until 2015, from a fairly broad circle of investors. [...] It was almost a compromise that they [Daniel and Martin] had to make in order to get qualified capital along the way, to promise some form of listing on a large exchange at some time down the line. (Pärson, 2020-10-21)

In order to foster growth, Spotify's ability to attract and retain competent and motivated staff was just as important as its access to capital. In private companies, key employees are commonly offered employee options. This strategy was applied at an early stage in Spotify's history, and employees were offered various forms of equity compensation (F-1, 2018). A potential listing at a public stock exchange would thereby not only provide value for partners and investors, but also for employees, as they would be provided an opportunity to realize the equity they had received when choosing to work for Spotify.

5.2 The convertible bond offering

In March 2016, Spotify successfully raised $1 billion through convertible debt offering with the assistance from Goldman Sachs (Crunchbase, 2020). The financing provided Spotify with necessary capital to take advantage of potential opportunities in an increasingly competitive industry. Raising capital in the form of debt allowed Spotify to raise capital without risking raising equity to a lower valuation than previous rounds, which in turn risked losing momentum and hampering the recruitment of additional staff. On the other hand, the investors in the convertible bond offering (TPG, Dragoneer, and clients from Goldman Sachs) were more or less promised that Spotify would become a public company in the near future (The Wall Street Journal, 2016).

The terms were formed so that Spotify would pay a payment-in-kind[5] interest rate of 5 percent per year (The Wall Street Journal, 2016). The interest rate would increase by 1 percentage point every six months after April 1, 2018, until the company went public or the interest rate hit 10 percent. As part of the terms for the convertible debt, Spotify promised TPG and Dragoneer strict guarantees tied to a future potential IPO. If Spotify decided to go public through a traditional IPO in 2017, TPG and Dragoneer would have the option to convert their debt into equity at a 20 percent discount relative to the IPO price. After a year, that discount would increase by 2.5 percentage points every six months. In addition, the convertible debt held by TPG and Dragoneer would be subject to a lock-up period of 90 days following Spotify's IPO, rather than the traditional 180 days.

Following the convertible bond offering and given the steadily shown improvement of its business model, Spotify was as capitalized as it needed to be, according to its established strategic growth plan (Cassel, 2020-10-12).

[5] Meaning that the interest rate would be paid in the form of additional debt

5.3 Routes to the public market

Spotify was now faced with a dilemma, as shareholders, bondholders and employees were expecting the company to go public in the near future. However, doing a traditional IPO would mean that Spotify would have to raise additional capital.

> We needed to become public, and we had $1.7 billion of cash on the balance sheet, and no debt. If we could find a way to do it without raising capital which we did not need and could not deploy, [...] It was in our economic self-interest to explore alternatives. (McCarthy, 2019-12-10)

An alternative route to the public market would be in the form of a direct listing. This path had mainly been used by companies filing for bankruptcy, or for public companies doing a spin-off and distributing it as a shareholder dividend (Nixon Peabody, 2018). Within the specific context of a large technology firm going public, a direct listing had never been done before.

5.3.1 Traditional IPO

For decades, the traditional IPO process has been, and still is, the primary avenue for companies to make their debut on the public market. The mechanics in a traditional IPO process are well-defined as it has been done so many times before. In 2016 alone, 79 companies raised more than $13 billion in the United States through IPOs (Ritter, 2020). Several other technology companies such as Snap, Yext, Shopify and Match Group had recently done their respective IPOs (PwC, 2016; TechCrunch, 2017) and could potentially, among other, serve as strong examples for Spotify. If Spotify did pursue a traditional IPO, McCarthy (2019-10-08) estimated that Spotify would have to offer 12–15 percent of the company to make a liquid aftermarket. McCarthy assessed that such a transaction would be within the range of $1.5–2.5 billion. Furthermore, the regulatory pathway was in place for a traditional IPO of this size. Spotify would have to file a registration statement under the Securities Act, as well as a registration statement under the Exchange Act.

In a traditional IPO, Spotify would get assistance from an underwriting syndicate that, together with a legal advisor, would assist Spotify through the whole process. Those responsibilities would include organizing and participating in key aspects of the communication activities with investors, such as the roadshow. The underwriters would also be incentivized to help Spotify raise the funds necessary to create a liquid aftermarket. Underwriters responsibilities also included assisting Spotify to ensure that, once the shares start trading, there would be sound trading and sufficient liquidity.

In the traditional IPO process, equity analysts from the underwriting syndicate often get access to information from the management team (NYSE, 2013). Analysts often have the extensive public market experience necessary in order to explain in a detailed way the company's business model, key industry drivers as well as financial projections to potential investors. The effect that an equity analyst can have in the investor education process is difficult to assess. Certain larger institutional investors have the resources to internally develop financial models, and do not study the equity research analyst reports in detail. On the other hand, some investors assess the information the analyst communicates as critical (Rodgers, 2020-10-26). Nonetheless, the combined roles of the underwriters and equity analysts in the investor education in a traditional IPO, put less requirements on the internal capabilities of the company.

5.3.2 Direct listing

Although the IPO process had been widely used in the past decades, Barry McCarthy (2019-12-10) thought there were structural and, for Spotify, specific deficiencies in the traditional IPO process. He believed these deficiencies could potentially be overcome through a direct listing. Radical transparency and equal access were the essence of Spotify's organization, and through a direct listing, McCarthy argued that Spotify had a chance to apply this in the way that Spotify went public. This would encompass the equal treatment of shareholders, communications with investors and the equal ability to invest in the company, whether by an institutional portfolio manager or a small retail investor.

One of the primary arguments for pursuing a direct listing was that Spotify was not in need of additional capital in the near term, and the traditional IPO process would be associated with raising capital in conjunction with the listing (McCarthy, 2019-12-10). Listing its shares directly on the stock exchange would allow Spotify to become a public company, while avoiding the requirement to raise capital in the process.

> You can look at an IPO as two major events: it is a capital raising event and it is a liquidity event. A direct listing is a splitting of those events, focusing on the liquidity element. The company can choose to raise capital privately before a listing, or it can do it at a later point in time as a public company. (Rodgers, 2020-10-26)

Another argument for a direct listing was that Spotify would not have to let new investors buy shares in the company at a potential discount, which a traditional IPO could entail. The direct listing would not be tied to a capital raising event, and the pricing of shares would be entirely market-based. As McCarthy explained: "The real elephant in the room is the enormous discount that investors extract from newly-floated companies. Bankers told us that they try to price new listings so that they rise 36 percent once trading starts." (Spotify, 2018). Thus, pursuing a traditional IPO could lead to a very high cost of capital for going public, as the company would also need to pay an underwriter a significant fee for such an arrangement.

> Barry [McCarthy] thought after the convertible bond offering: "why should we pay an underwriter for something we do not really need?", and we did not need an underwriter because we probably would not need to raise capital. (Pärson, 2020-10-21)

In a traditional IPO process, existing shareholders are often expected to adhere to lock-up agreements, usually for a period of 180 days, in order to control the supply of shares following the offering. In a direct listing process, it is fundamental that enough shares are available for sale on the first day of trading, so that liquidity can be created. Naturally, a company opting for a direct listing would have the opportunity to have more flexibility around the lock-up agreements undertaken by existing shareholders, either by removing it entirely, or by using a partial lock-up. This attribute of the direct listing was highly valued by both Barry McCarthy and Daniel Ek, as it would give all shareholders the opportunity to become liquid at the same time (McCarthy, 2019-12-10).

A direct listing would also allow Spotify enhanced flexibility around communications towards investors due to the financial advisors' restricted roles in the process and the fact that Spotify would not make an offering of shares (McCarthy, 2019-10-08). Certain activities that were tied to the traditional IPO process, such as roadshows together with an underwriter would not be applicable in the direct listing process. This would allow Spotify to instead take full ownership of the investor education process. McCarthy saw several shortcomings in the communication aspect of the traditional IPO process, and thought public market practice was a better way of communicating with investors. "All public market companies do not have roadshows; they have Investor Days and they present their entire strategy over three to four hours." (McCarthy, 2019-10-08). The flexibility of the investor education was thereby a positive aspect of opting for a direct listing. On the other hand, underwriters would not be able to provide as much support in the education process, as there were legal limitations in terms of their activity in the process (Rodgers, 2020-10-26).

Another feature of the traditional IPO process McCarthy (2019-12-10) did not admire was that companies relied heavily on equity analysts to educate investors regarding future outlooks of the company, often due to liability concerns under the Securities Act. When equity analysts are involved in the investor education process, McCarthy thought there was potential for a fair amount of information to be lost in translation between the company, the equity analysts and ultimately investors. "If the market has no idea how you are going to perform, they will guess, and that guess will not be as accurate as your guess, and things would happen as a consequence" (McCarthy, 2019-12-10).

> Think about the game of telephone, you know what your numbers are, you try to communicate that with some conservatism to the bankers, and bankers can get aggressive, others can get conservative, it is all over the place, so the point was to take the time to tell the story and communicate the numbers yourself. (Marshall, 2020-11-03)

In addition, a key aspect of the direct listing process is that once the shares start trading, anyone can buy. According to McCarthy (2020-08-13), a traditional IPO would typically benefit a small group of institutional investors, whereas retail investors were generally not able to directly participate in the book building process that would take place before the company's share would be publicly traded. "The funds from traditional IPOs come from a group of roughly 200 institutional investors [...] if you are not a part of that group you essentially have no access at all." (McCarthy 2020-08-13). In a direct listing, the opening day of trading is identical to the way any other stock on the exchange opens for trading every day and "the market decides who buys and sells and the clearing mechanism is price. "(McCarthy, 2019-12-10).

5.4 Considering a direct listing

To take into account the shortcomings McCarthy associated with an IPO as well as Spotify's specific needs at the time, the company considered opting for a direct listing over a traditional IPO. However, there were several risks that had to be mitigated in the process. Spotify, together with its advisors, had to make sure that the regulatory and legal frameworks were in place for a direct listing of this scale (Rodgers, 2020-10-26). Another important consideration was to ensure that the investor education could be completed in a professional and efficient manner, while satisfying the legal requirements. Lastly, as the underwriters would not sell any shares in the process, it had to be ensured that there still was a liquid market on the first day of trading.

5.4.1 Regulatory framework

Considering that a direct listing in this context never had been done before, a clear regulatory pathway was difficult to assess from the start. Under the current rulebook of both the NYSE and Nasdaq at the time, changes would have to be made for Spotify's direct listing to be possible. The NYSE, for instance, allowed direct listings at the time (see section *4.2.2 Listing requirements)*, but Spotify did not meet those criteria because the trading activity in its private share did not satisfy the NYSE's requirements[6] (Gutierrez et al., 2018). Thus, for a direct listing to be a possibility, there had to be a change of the current rules of the stock exchange Spotify wanted to list its shares at. As stock exchanges such as the NYSE and Nasdaq are defined as SROs, any changes to their listing requirements must be approved by the SEC.

In addition, there were also issues from a legal perspective that Spotify had to address directly with the SEC. Major legal concerns included which registration statement Spotify should file in conjunction with the listing, how investor education would be managed so that Spotify's direct listing process would not be perceived as an "underwritten offering", and creating frameworks around Spotify's intention to provide forward guidance before the first day of trading (Rodgers, 2020-10-26).

5.4.2 Investor education

The investor education process would look different in Spotify's direct listing process relative to a traditional IPO process, in that the company would not be able to, along with its financial advisors, perform a roadshow in conjunction with the marketing efforts (Connolly, 2019-10-08). In addition, due to liability concerns under the Securities Act, equity analysts from the financial advisors would not get access to management financial model and could therefore not provide investors with any financial insights that might be gleaned from that (Rodgers, 2020-10-26). Because they would be removing these two important parts of the investor education process in a direct listing, Spotify had to make sure that there would still be sufficient understanding of the company from the investor collective. "If investors do not have a good understanding of the business, you are going to get more volatility in the stock price because of imperfect information, so that was a big question." (Rodgers, 2020-10-26).

[6] "(ii) the most recent trading price for the company's common stock in a trading system for unregistered securities operated by a national securities exchange or a registered broker-dealer". With respect to (ii), the NYSE looked for a sustained history of trading over several months.

5.4.3 Liquidity aspect

In a traditional IPO process, the price of which the offer was subscribed serves as a benchmark for the market once the shares start trading (even though the price at which the shares begin trading may deviate from the offering price). As Spotify would not make an offering before trading would commence, questions arose regarding what historical price should be used as a benchmark price. Spotify would also have to ensure that there was enough liquidity on the first day of trading. Without enough liquidity, there would be a significant risk that the price development could become extensively volatile. In the long-run, if there is not enough liquidity, the stock will be unattractive to investors, which would affect the value of the company negatively. To get sufficient liquidity, enough of the existing shareholders would have to be willing to sell their shares, as well as attracting satisfactory demand to buy shares. "No one shows up. That is the biggest risk, [...] the sellers do not show up, so there is no liquidity, or buyers do not show up." (McCarthy, 2020-08-13). Since a direct listing of this kind had never been done before, one could not be certain how the market would react.

The liquidity aspect would not only affect the short-term opening trading, but the way institutional investors would act in a direct listing. As Josh Kuzon, partner at New York based venture capital firm Reciprocal Ventures, stated in a TechCrunch interview (2019):

> Without a defined supply of stock, it can be difficult to generate meaningful buyside demand. A floating price and indeterminate quantity will dampen institutional interest, no matter how great the listing company may be. Institutions require size and certainty; not only do they desire to build large positions, but they need to know they can exit them if needed. […] A lack of institutional investors could be a very expensive long-term trade-off for a short-term gain.

5.5 The decision

Spotify carefully reviewed the arguments for and against opting for a traditional IPO versus a direct listing. The company concluded that the opportunities with the direct listing captured the shortcomings with the IPO process, and thus decided on this route (for initial feedback from management and shareholders, see section *9.1 Initial internal reactions of the idea of opting for a direct listing*, in the Appendix). The most important considerations in opting for a direct listing was that Spotify did not need to raise capital, it wanted to provide the existing shareholders with an opportunity to get liquid, and it sought to be radically transparent in how it communicated with both existing shareholders and external investors (McCarthy, 2019-10-08).

A team of advisors was appointed to assist Spotify with its mission of becoming a public company through the unconventional path of a direct listing. Goldman Sachs, Morgan Stanley and Allen & Co would act as financial advisors in the process, Latham & Watkins was appointed as legal advisor (Spotify, F-1), and EY would assist Spotify with the audit. The project went under the name *Project Polaris* (Rodgers, 2020-10-26).

Initial phases of the project would look a lot like a traditional IPO process, starting with the organizational meeting, where all key members of the project group attend to discuss specifics of the project such as timeline, workstreams, roles and responsibilities. Subsequently to that, due diligence was performed by the financial advisors, a process that looked much like that of a traditional IPO. "The financial advisors required about the same level of due diligence as the banks would do in a normal way IPO. They sent a battery of questions that Spotify had to go through." (Lundberg, 2020-10-27).

5.5.1 Regulatory framework

Early in the process, Spotify decided that it wanted to list its shares on the NYSE. Tom Farley, President of the NYSE, was already positive to the concept of direct listings, as he wanted to investigate how the NYSE could further develop the listing venue's function (Pärson, 2020-10-21). The NYSE filed a request for rule change to the SEC on June 13, 2017, and after two received comments and an elimination of one of the three proposed rule changes (see section *4.2.3 Direct listings – Rule change*), it was accepted by the SEC on February 2, 2018 (SEC, 2018), thereby creating a possibility to perform a direct listing for Spotify (Gutierrez et al., 2018).

Spotify was in close dialogue with the SEC early in the process as at the time, the regulatory framework mainly focused on companies going public through a traditional IPO. The SEC initially showed a willingness to cooperate with the company to create a legal framework around a direct listing in this context. The regime, which in large part consisted of ex-private practitioners at the division of Corporate Finance, regarded the idea favorably as a way for more companies to become public (Rodgers, 2020-10-26). There had been a decline over time in the number of public companies in the US, as more companies tended to stay in the private environment. The general view was that this was a societal matter, and it became one of the primary issues of the SEC's Corporate Finance agenda, as one of the SEC's key mandates is to facilitate capital formation in the United States. In order to invest in private companies, investors must achieve certain financial requirements, not attainable to the vast majority of US citizens. Anyone can, on the other hand, buy stocks in a public company

Registration statement. According to Greg Rodgers (2020-10-26), an early identified theoretical question from the SEC was whether Spotify planned to offer shares for sale. "Offering" is a term of art in the US and the laws around it are usually broad. Spotify's initial view was that they were not making an offering, but simply "making stocks available for sale, nobody was agreeing to sell, nobody was agreeing to buy, we were just creating a platform off of which sales could occur". The SEC, in turn, focused on the activities the company wanted to perform, including investor education and providing guidance, as well as the timeline of the events, and concluded that the event was indeed a registration event. Spotify would therefore file the same registration statement that it would have if they would have for a traditional IPO (Rodgers, 2020-10-26).

> That was really the first real major decision point and had pros and cons for the process. Probably predominantly pros in hindsight. It really put us in a structure that made sense to a lot of the practitioners. (Rodgers, 2020-10-26)

Private Litigation Securities Reform Act. Another important roadblock that was passed was when Spotify found a legally accepted way of giving forward guidance. This could be done after the registration statement had been effective, which would give Spotify the protection from an act called Private Litigation Securities Reform Act (Rodgers, 2020-10-26), which infers that a company should not be held responsible if it makes a prediction, regardless of the factors behind that predictions becoming true or not[7] (Davidson and Roake, 1996). This enabled Spotify to communicate their financial projections to the investment community two weeks prior the first day of trading, giving investors more information to value Spotify more accurately (Rodgers, 2020-10-26).

5.5.2 Investor education

As the financial advisors would not be able to participate in a selling process towards investors, Spotify would have to communicate its investment story directly to investors. The financial advisors assisted Spotify on positioning and preparing presentation material as well as what types of investors Spotify should consider visiting (Connolly, 2019-10-08). "Among other things, our financial advisors [...] helped us formulate key messages to the investor public, and they raised questions such as 'what does the business model look like?', 'what are the key growth drivers?',

[7] Given the plaintiff at the time of making the statement was not of actual knowledge it was false or misleading

‘what are key prospects?’ etc.” (Pärson, 2020-10-21). The financial advisors also anticipated what questions investors potentially were going to ask them (Connolly, 2019-10-08).

Spotify met with a number of investors directly, but the financial advisors were not attending those meetings (Connolly, 2020-10-08). Additionally, inspired by public market practice, on March 15, 2018, Spotify hosted a live streamed Investor Day, in which senior managers, including Daniel Ek, Barry McCarthy and Paul Vogel presented Spotify in depth (Financial Times, 2018). As the event was live streamed online, anyone could access and view the presentation.

> In the US, most public companies every quarter give some limited forecasting in areas that they are comfortable in. So, we replaced the analyst process with the public company equivalent, and the question was whether that would be enough information for the buy side. (Rodgers, 2020-10-26).

This allowed Spotify the most flexibility to be democratic while they were communicating their story, as opposed to fitting into a process that the financial industry has started to inhere to, based on past precedent (Marshall, 2020-11-03), and by using the power of the web to get investors engaged in the process (McCarthy, 2019-10-08). The activity was not necessarily tied to the direct listing process but was a result of the regulatory limitations that were set on the financial advisor’s role, and Spotify’s innovative way in how they wanted to communicate with investors.

> An investor day is the world’s largest roadshow. Instead of going to a conference room in Boston and meeting with Fidelity one on one, the company is live streaming it to everybody. You could do the same in a normal IPO but it makes more sense in a direct listing since your “buy side” is essentially everyone. (Rodgers, 2020-10-26).

The investor presentation provided investors with more detailed information around the company, much like a presentation that a private equity investor would expect to see when evaluating an investment. Spotify provided this detailed information to everyone, whether they were an individual investor or a mutual fund manager (Marshall, 2020-11-03).

5.5.3 The liquidity issue

Since Spotify had raised external capital in several rounds during the period between 2008–2015, one could predict that there initially would be a high supply of stocks from existing shareholders wanting to exit their investment, which could create an excess supply of shares in the initial trading period. However, there had been an open secondary market for a period, where investors were free to sell.

> You did have early investors, but early investors did not have 100 percent of their position, because there was an active secondary market. It was not like you had a significant demand from people that wanted liquidity. [...] There had already been some of the changeover in the shareholder base, which made the liquidity dynamic a much easier problem, as opposed to worrying about a massive wave of liquidity that is going to hit the market and drive the price down. (Marshall, 2020-11-03).

Morgan Stanley assisted Spotify's shareholders who wanted to open brokerage accounts to potentially sell their shares on the exchange (Dhalla, 2020-10-29), which also allowed Morgan Stanley to understand pre-listing selling interests (Gutierrez et al., 2018). Investigating the supply was important to get a sense of the liquidity situation, and to know whether potential tools for helping with the sale, such as block sales, would be needed (Pärson, 2020-10-21).

Morgan Stanley would also assist Spotify with gaining an understanding of demand by getting in contact with potential buyers (Gutierrez et al., 2018). Spotify also had an established relationship with key investors before the first day of trading. "Relationship building is happening regardless, and has been happening for several years, so by the time you go public you have already formed strong relationships with the people who are most likely to buy your offering" (McCarthy, 2019-12-10). The potential liquidity risk was not seen as a significant risk by Spotify's management (Marshall, 2020-11-03). "You needed to have a fundamental view that markets work – that the "wisdom of crowds" is a real thing" (Rodgers, 2020-10-26).

5.5.4 The price discovery process

To facilitate a sound trading, and due to lack of offering price that is used in a traditional IPO process, the NYSE (2018) requires in conjunction with a direct listing, that the designated market maker (DMM), work together with the company's financial advisor. In Spotify's process, Morgan Stanley consulted with the DMM in setting the opening public price of Spotify's shares on the NYSE as per the S-1 (Dhalla, 2020-10-29).

The reference price for Spotify before the first day of trading would be the last recorded trade in the private market (Andreessen Horowitz, 2019). Not having an initial filing range, as the market will have in a traditional IPO process, created more uncertainty around the pricing.

> In a [traditional] IPO we sell the shares, we have a price range, which is provided to investors in the prospectus. In a direct listing, there is no price range, and the market decides on the value of the shares. (Dhalla, 2020-10-29)

But the underlying belief that the market is to some extent efficient and will get to an equilibrium price without necessary intervention from intermediaries made this less of an actual issue. This view was shared internally in Spotify, where investors and board members emphasized the value of logic and market efficiency: "Wisdom of crowd trumps expert intervention. If you just eliminate all the friction that is been created over time you get to equilibrium very quick" (McCarthy, 2019-12-10).

> I am a believer in efficient markets. If a great company is going to trade at pennies on the dollar, somebody is going to see the value and buy it. If there are more buyers than sellers, the stock goes up, more sellers than buyers the stock goes down […] I just think you get to that efficient point of value, which obviously everybody will have a different perspective on. (Marshall, 2020-11-03)

5.6 Epilogue

On April 3rd, 2018 Spotify went public through a direct listing of its shares on the NYSE. The DMM, based on buy and sell orders collected from various brokers by the NYSE, ultimately established the opening price at $165.90, compared to the reference price set by the NYSE of $132.00. The share price closed at $149.01 the first day of trading, representing a market capitalization of $26.54 billion. Spotify's registration statement permitted the sale of 55,731,480 shares and on the first day, 30,526,500 shares were traded (Nixon Peabody, 2018).

The volatility during the first day of trading for Spotify was 12 percent, relatively low compared to the average volatility of "Jumbo IPOs[8]" of 29 percent (Morgan Stanley, 2020). Not only could one view Spotify as a success in the sense that it, in just over 10 years, had grown from zero to achieving a valuation of $26.5 billion, its direct listing could also be viewed as a success. By

[8] Defined as IPOs in which issuers raised more than $550 million during the period 2004-2020 (October)

sticking to its core principles and philosophies, Spotify dared to pursue something that had never been done before, and in the process it introduced an alternative route to the public market.

6 Discussion

In the following section, we discuss potential effects direct listings might have on the traditional IPO process, as well as the learnings from Spotify's direct listing, and the possible application on a broader set of companies.

6.1 Potential implications on the traditional IPO process

Companies have for an extensive period been listed on public market exchanges. During this time, however, the equity market has changed and so has the specific need for companies. The traditional IPO process has been, and still is, the primary avenue for companies in their debut in the public market (Ludwig, 2019-10-08). With the opportunity for companies to raise capital in a private environment, there now are companies that do not necessarily need to raise capital in conjunction with their public market debut, and naturally other forms of alternative paths to becoming a public entity have appeared to complement the traditional IPO process.

> You have businesses with the benefit of technology that is built to scale more quickly than they could have in the past, and you also have several companies that have made the choice to raise a significantly greater amount of capital in the private markets than they would have ever done before, and against that backdrop company needs and objectives are changing. (Connolly, 2019-10-08)

By being the first of its kind to opt for a direct listing, Spotify created an alternative route for companies in similar situations, and marking a historical shift in terms of the IPO-market in the US: "each of these changes is very significant based on the history offering regulation in the US." (Rodgers, 2020-10-26). The direct listing process for Spotify took, from initial meetings to listing, around thirteen months. In comparison, a traditional IPO process takes roughly six months for US companies (Rodgers, 2020-10-26).

Since Spotify's direct listing, several other companies have followed the same path. In June 2019, Software company Slack listed its shares on Nasdaq through a direct listing (CNBC, 2019), and during the fall 2020, Palantir, Thryv and Asana did the same (Ritter, 2020). Subsequent direct listing processes have taken roughly the same time as a traditional IPO process (Rodgers, 2020-10-26). In October 2019, Will Connolly (2019-10-08), Managing Director at Goldman Sachs, stated that he expected Goldman Sachs to advise at least five companies in direct listing processes during 2020. The actual total number of direct listings during 2020 has, as of December 2020, turned out to be lower. This could potentially be explained by the volatile stock-market in the wake of the Covid-19 pandemic, or simply because some companies that considered a direct listing at the time chose alternative paths. However, the interest for direct listing shows that more companies are considering it as a viable alternative path to the public equity market.

As Spotify had an innovative way of going about its direct listing, it provided practitioners with valuable information. Tools that Spotify used could have a potential positive impact on the traditional IPO practices as the only quintessential part of the direct listing is the price-based discovery on the first day of trading. All other tools could complement a traditional IPO process "As competition breeds innovation, certain improvements could be made to the traditional IPO process as a result of features pioneered in the direct listing" (Rodgers, 2020-10-26).

6.1.1 Flexibility regarding lock-up/larger free float

In both Spotify's and Slack's direct listings, in which no/partial lock-up agreements were implemented, intraday liquidity was higher, and volatility was lower than that of the average "Jumbo IPO" during the period 2004–2020 (Morgan Stanley, 2020). In Spotify's case, the intraday liquidity allowed for several meaningful long-term investors to acquire appropriately sized positions (since there were no volume restrictions), something that is hard to achieve in conjunction with a traditional IPO (Marshall, 2020-11-03). When comparing larger investors' abilities to accumulate significant positions in Spotify's direct listing with consumer internet enterprise Snap's $3.9 billion IPO, it shows that the five largest shareholders of Spotify had accumulated a position of 26.3 percent at quarter ending following the listing and 8.8 percent in Snap (Morgan Stanley, 2020).

In traditional IPOs, large institutional investors often do not get the applied for allocation (Morgan Stanley, 2020) and if the share price increases during intraday, there could be a lower incentive to buy shares in the aftermarket. For a comparison between Spotify's direct listing and Snap's IPO, see Table 8.

Table 8: Top 5 Institutional Holders Following Public Entrance

Spotify S.A.			Snap Inc.		
Market cap. at End of Day 1:	$26.5B		Market cap. at End of Day 1:	$28.3B	
First Day of trading:	April 3, 2018		First Day of trading:	March 1, 2017	
Direct Listing			**IPO Size: $3.9 billion**		
Top 5 holders	% TSO[9]	$M	Top 5 holders	% TSO	$M
Baillie Gifford	10.9%	$3,066	Fidelity	2.9%	$773
Wellington	5.8%	$1,641	T. Rowe Price	2.4%	$659
Schroder	4.0%	$1,128	Coatue	1.8%	$488
AMF Pension	3.0%	$836	Sands Capital	0.9%	$245
Coatue	2.5%	$715	JP Asset Mgmt.	0.8%	$219
Total	26.3%	$7,386	Total	8.8%	$2,384

Source: *Morgan Stanley, 2020*

Following Spotify's direct listing, flexibilities around lock-ups have been implemented in numerous IPO-processes (Fenwick, 2020) and this trend is expected to continue (Rodgers, 2020-10-26).

With support from institutional investors around the ability to accumulate a larger shareholding if conditions exist for a more liquid aftermarket, practitioners might also look at increasing the offering size in certain IPOs, from commonly sized 10–15 percent of market capitalization, to 15–20 percent. This adjustment would make a traditional IPO more similar to a direct listing in terms of liquidity intraday.

6.1.2 More transparent marketing to a broader investor base

As highlighted, a common practice in the traditional IPO process has been to directly meet with a limited number of investors directly. As part of the direct listing process and as a complementary tool for reaching out to more potential investors, Spotify live streamed an "Investor Day", where all investors had the chance to get a comprehensive presentation from the company. An Investor Day in a traditional IPO may be an interesting complement to the traditional roadshow in an IPO process, as it allows companies to provide more extensive presentations as well as reaching a broader audience. During the Covid-19 pandemic, live streamed roadshows have been widely practiced.

[9] Total shares outstanding

> We have actually seen more online roadshows in connection with the pandemic. Nobody could get on a plane and fly so people are just using video conferences, and it is actually extremely efficient. I think that is a feature we will see continue in a normal way when people could get on planes. They will still do some in-person meetings, because the in-person deal helps. I think we will see video conferences as a survivor of Covid-19. (Rodgers, 2020-10-26)

Increased transparency and disclosure of information through an Investor Day could potentially be a tool used to reduce underpricing in IPOs, which is in accordance with Beatty and Ritter's (1986) claim that a way of reducing underpricing is by reducing the uncertainty around the listing. It also provides a connection to Rock's (1986) *Winner's curse* theory, where an Investor Day could lead to a reduction of asymmetric information between informed and uninformed investors, as more information is available to the public.

6.1.3 Competition from direct listing may decrease IPO underpricing

As the direct listing process continues to evolve, particularly with the complement to raise capital in conjunction with a direct listing, it could present a viable alternative to the traditional IPO route. Although the traditional IPO routes still present several benefits, such as, receiving valuable assistance in the selling process from the underwriters, as well as the ability to raise more capital, there might be increased attention on the drawbacks of traditional IPOs, such as IPO underpricing, if companies could get market-based price discovery through a direct listing instead. This might incentivize underwriters to become more observant regarding the intraday trading of the company, and the pricing of the stock in conjunction with the book building process. This provides a clear connection to the reputational capital of underwriters, as discussed by Nanda and Yun (1997) and Beatty and Ritter (1986), where the introduction of direct listings might change the acceptance level of underpricing, for the benefit of future issuers. We expect potential direct listing/traditional IPO candidates to look closely at the average discount in a traditional IPO when evaluating which path the company should pursue.

6.2 Learnings from Spotify's direct listing and applications

As of December 2020, only a small number of companies have opted for a direct listing. Due to the lack of a significant sample size, it is difficult to make conclusions regarding best practices for direct listings. It is also difficult to give recommendations regarding what types of companies should opt for a direct listing over a traditional IPO. The public market might also trade subsequent direct listings differently as the phenomenon is being more widely used.

> Right now, they have a N of 2, and the N is going to grow and the market is going to learn and so the market will have a better ability to [...] change and modify their behavior and drive greater efficiency at the end. [10] (Connolly, 2019-10-08)

However, companies considering going public can evaluate specific learnings from Spotify's direct listing. This includes some of the important risk mitigations and some of the preferable company characteristics that Spotify had, which others might not have, and how this could affect the possibility of a successful direct listing.

6.2.1 Liquidity aspect

Conditions must exist for sound trading with the company's shares intraday. If there is an excessive supply of shares that the financial advisor and DMM have not accounted for, it could create an unsoundly high volatility. Too little supply from the pre-listing shareholders could also create high volatility, as there would simply not be enough shares available for the market to trade. In traditional IPO processes, underwriters could mitigate this risk by assisting the company with price stabilization activities following the listing. In the direct listings that have been executed as of December 2020, stabilization measures from intermediaries have not been implemented.

The above-mentioned scenarios could potentially be played out in smaller companies that have less resources to identify a rough price range in which supply will meet demand before the listing. Smaller companies might also have a harder time generating significant interest around the company, making their securities more illiquid relative to larger companies. To create the right conditions for a direct listing, the financial advisor will have an important task to both identify the potential supply of shares, as well as gauging interest from new potential investors. Another factor that facilitates the initial trading, is if the company has had an existing secondary private market, that would enable earlier investors to sell before the first day of trading in the public market, and thereby mitigate the risk for a potential oversupply of shares on the initial days of trading.

[10] Since October 2019, there has been an additional three direct listings (as of December 2020)

6.2.2 Capital raising

One of the main motivations behind Spotify opting for a direct listing was that it did not need to raise additional capital. This characteristic might not be specific to Spotify, as companies tend to stay private longer (Ritter, 2020), and as the private placement market has developed significantly in recent years (see section *4.3 Private placement market*). For companies in need of additional capital, there could be a benefit to raise capital before and after the listing, as Barry McCarthy explained:

> Here's how we'd do it at Spotify if we needed to raise additional equity capital. We'd execute a secondary or follow-on transaction, pay a 1% transaction fee and price our shares at about a 4% discount to the closing price on the day we priced our secondary offering. This is much less expensive "financing" than a traditional IPO with underwriter fees ranging from 3–7 percent and the underwriter's discount of ~36 percent to the full conviction price for the offering. (TechCrunch, 2019)

However, companies that want to become public, but are in a need of constant additional capital raising might find a direct listing route difficult to successfully execute, especially if they are not able to sufficiently shorten the period when out of the capital market. "The question is does the company need additional capital in that window when they want to become a listed company, if the answer is yes, then the company should consider a traditional IPO." (Rodgers, 2020-10-26).

> When we discuss with companies that want to become a public company, we often focus on three main routes: traditional IPO, direct listing and SPAC. We have a list of pros and cons of each alternative, but a major decision point between an IPO and a direct listing is do the company need to raise capital. (Rodgers, 2020-10-26)

While potential solutions for a company that is in need of capital exist, it remains a hurdle if the capital requirement is too extensive in the short-term. In that scenario, a traditional IPO would be the preferable public market route.

6.2.3 Brand recognition and business model

Arguments for Spotify being a good direct listing candidate include that Spotify had a well-known brand, a business model that investors could understand, and that it had raised extensive amounts of capital from industry-relevant investors. The company also received attention from media and capital market observers which could further explain why investors were interested in Spotify.

It is important to distinguish two key points in order to create conditions for a successful direct listing: (i) investor interest, and (ii) a general understanding of the company. While a well-known brand and a business model that investors can easily understand might be preferable, it is not necessarily a pre-set requirement for a successful direct listing. The question is whether or not the company can achieve awareness and understanding through its investor education. "Given today's technology, it is hard to defend the argument of needing to have a brand name to do direct listings. The possibilities to guide and educate investors are basically limitless." (Gurley, 2019-09-24).

6.2.4 Investor education

Spotify's success in educating its investors came in hand with the management team being highly competent, and McCarthy's extensive experience from the public market, as well as the support from legal and financial advisors in the process. Through its live streamed Investor Day, Spotify reached thousands of potential investors. Spotify also, just like a public market company would, provided financial guidance two weeks prior to the listing to provide the market with more information about the company, including a realistic path to sustainable profitability.

With greater flexibility in the direct listing process around investor education, also comes greater responsibility for the company. In conjunction with a direct listing process, the company must ensure it has the resources and knowledge to educate the investors in a sufficient manner. The advisors in a direct listing will also play a key role in assisting and guiding the company in the process.

While Spotify had the advantage of extensive internal experience, a less well-equipped company must leverage the accumulated experience of its advisors in order to create conditions to achieve a similar outcome.

6.2.5 Market efficiency beliefs

The market-based price discovery process is one of the main mechanisms for achieving a more democratic and transparent pricing and allocation in a direct listing, but it also comes with greater uncertainty. Despite investigating the interest, and being in contact with potential buyers and sellers, as well as successfully educating the investors, there is still some degree of uncertainty up to the point at which the shares start trading.

To cope with this, it is helpful to have some degree of belief in efficient markets: "You needed to have a fundamental view that markets work" (Rodgers, 2020-10-26). That was the perspective that was created by Barry McCarthy: "I had this core belief that wisdom of crowd trumps experts" (McCarthy, 2019-10-08).

The company will have to take a step back trust that the market is efficient and that it will find an equilibrium through the process. This was a shared belief internally at Spotify, which made the market-based process less of an obstacle and issue. For a management team that does not have this belief, the direct listing process can become a rather uncomfortable experience, with little control and much uncertainty of the pricing and allocation.

7 Conclusion

When Spotify went public through a direct listing in 2018, there had been no prior research on the topic, as a direct listing of that scale had not been done before. Approximately two years later, available research on the topic is still limited. Our ambition in conjunction with writing this case study was to contribute to the existing limited literature on this topic, by analyzing the motivations and rationale for a company to pursue a direct listing, through our stated research questions: *Why did Spotify opt for a direct listing instead of a traditional IPO with an underwriter? What were the main risks of opting for a direct listing?*

Our work shows that Spotify opted for a direct listing over a traditional IPO for multiple reasons. Firstly, Spotify was not in immediate need for additional capital, as that had been adequately raised in the private market. Secondly, Spotify wanted to give its early investors and employees the opportunity to get liquid at the same time as new investors by avoiding lock-up agreements that traditional IPOs often are associated with. Thirdly, the company wanted to take inspiration from public market practice to educate investors in a more efficient and accessible manner, thus having more flexibility around the investor education than that of a traditional IPO process. Lastly, Spotify wanted to have a generally more democratic listing process, by giving all investors equal access to Spotify's shares, whether it is a fund manager or a retail investor, as well as a market-based price discovery, which the direct listing entails. All these factors contributed to the direct listing being the ultimate path for Spotify, given that the company had promised to become a public company in the near future.

The most important considerations for Spotify in pursuing a direct listing included ensuring that necessary regulations were in place, that the investor education could be successful despite the legal restrictions and ensuring that there would be enough liquidity following the listing. Spotify's advisors were of great importance in the process, as they helped Spotify identify and mitigate the risks, and together with Spotify created an important foundation for subsequent direct listing candidates.

Although our results in the case study are solely based on one company, we are convinced that Spotify's rationale, motivations, process and potential challenges in the direct listing process are to a great extent applicable to a broad set of companies that are considering a direct listing. We believe this case study has contributed to the literature on direct listings in two ways. Firstly, we have provided deep insights into Spotify's consideration in conjunction with, and following Spotify opting for a direct listing, which were previously not, to this extent, publicly available. Secondly, our results provide a useful toolbox that can serve as a source of inspiration for practitioners interested in the increasingly more common subject of direct listings.

7.1 Suggestions for future research

Due to the low sample size of direct listings that can be compared to Spotify's, our assessment is that it would be difficult to make a meaningful quantitative analysis at this point in time. Once the sample size of direct listing executions becomes larger, we believe that there will be interesting quantitative studies to be performed on the subject.

Our first suggestion is to compare the post-listing performance of companies going public through direct listing with companies going public through a traditional IPO. Our second suggestion is to evaluate institutional investors' ability to accumulate significant positions in companies opting for a direct listing because of a potential, greater liquidity, or if they are diverging from direct listing investments since they are not targeted to the same extent as in a traditional IPO. We also believe that, once the sample size has become sufficiently large, great insights could be found in estimating the so-called "liquidity premium", by comparing a large set of candidates' last trade in the private environment, to the first day trading range.

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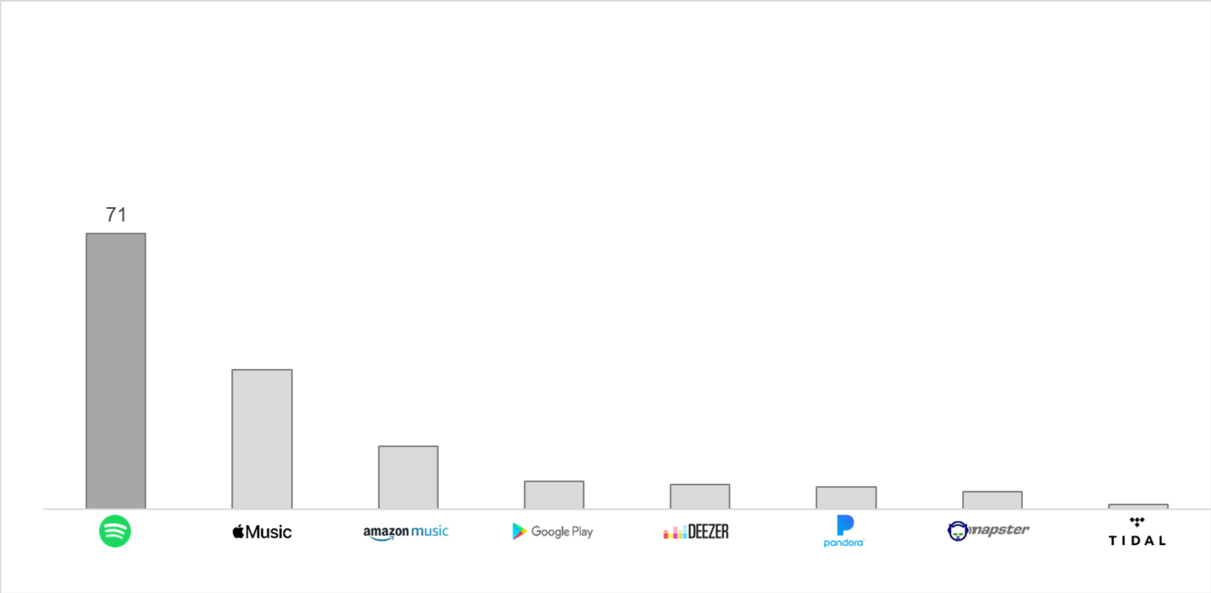
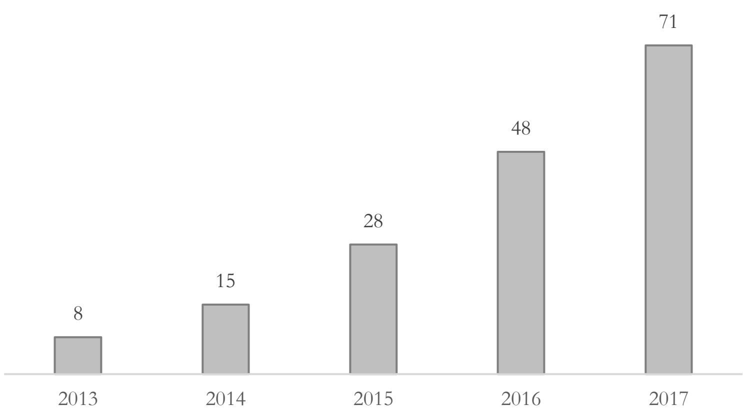
9 Appendix

Table A1: Largest music subscription audience (As of December 31, 2017) (millions)



Source: Investor Day – Spotify

Table A2: Premium subscribers of Spotify – Development 2013–2017 (million)



Source: Spotify F-1 Statement

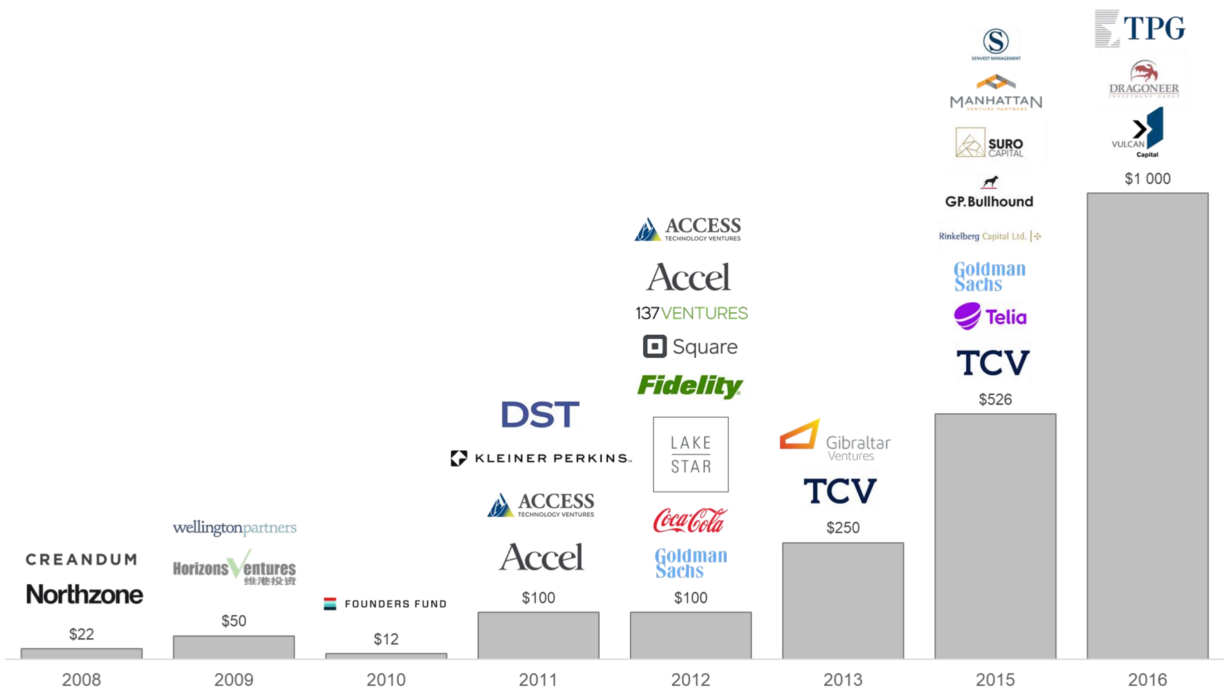
Table A3: Spotify's acquisitions October 2008 – December 2020

Target	Date of Announcement	Description of the target
Tunigo	May 3, 2013	Tunigo helps users find music by providing playlists via an app in Spotify's platform.
The Echo Nest	Mar 6, 2014	The Echo Nest is a self-described "music intelligence company" that does things like determine what recommendations to make to listeners for automatic streaming radio services.
Seed Scientific	Jun 24, 2015	Seed Scientific specializes in devising algorithms to understand information for commercial, public, and social sector clients. It offers data discovery, collection, science, and visualization services, identifying what data is relevant to a company, capturing it, analyzing it for actionable insights, and then making those concepts comprehensible to its clients.
Soundwave	Jan 20, 2016	Soundwave tracks the music you are listening to and shares this on your Soundwave profile – allowing you to see what your friends are listening to and start conversations about music.
Cord Project	Jan 20, 2016	Soundwave, based in Dublin, enables users of its app to discover new music together, by letting them create private groups to share songs from any music player and start chat sessions with other users to discuss the music.
CrowdAlbum	Apr 27, 2016	Launched in 2013, the platform brings together fan content that has been captured during live events and posted online via social media. The photo/video albums give artists a visual history of their tours and help them identify and connect with their most passionate fans.
Preact	Nov 2, 2016	Preact offers a cloud-based platform and service developed for companies that operate on subscription models reduce churn and build up their subscriber numbers.
Sonalytiv	Mar 7, 2017	Sonalytics has developed a next-gen approach to audio identification that is "robust to changes in pitch and tempo, the addition of background noise, distortion, filtering, compression, looping, EQing and much more."
MightyTV	Mar 27, 2017	MightyTV's Tinder-style mobile app for iOS and Android let you quickly indicate whether you liked or disliked a given title, which helped customize MightyTV's suggestions to your own personal tastes. As with Tinder, the idea is that the app's recommendations would then improve over time, the more you used the product.
Mediachain	Apr 26, 2017	Mediachain is a peer-to-peer, decentralized database for sharing information across applications and organizations.
niland	May 17, 2017	Paris-based machine learning startup specialising in music search and recommendations.
Soundtrap	Nov 17, 2017	Soundtrap is an online cross-platform music studio where the user can record audio creations and explore extensive collections of beats, loops and instruments.
Loudr	Apr 12, 2018	Loudr offers products and services that allow content creators, aggregators, and digital music services to identify, track and pay royalties to music publishers.
Gimlet Media	Feb 6, 2019	Gimlet Media is the premier digital media company focused on producing high quality narrative podcasts.

Anchor	Feb 6, 2019	Anchor is an all-in-one platform where the user can create, distribute, and monetize podcasst from any device, for free.
Parcast	Mar 26, 2019	Parcast is a digital media firm and podcast network, which specializes in producing scripted podcasts and audio dramas.
SoundBetter	Sep 12, 2019	Leading global music and audio production and collaboration marketplace. SoundBetter offers creators a place to connect with each other and hire services from fellow artists to create and perfect their tracks.
The Ringer	Feb 5, 2020	The Ringer is a sports and pop culture website and podcast network, founded by sportswriter Bill Simmons in 2016.
Megaphone	Nov, 10, 2020	Megaphone is one of the world's leading podcast advertising and publishing platforms.

Source: Crunchbase, and public information. References can be given upon request.

Table A4: Funding and investors, Spotify – Series A to convertible bond offering



Source: Crunchbase (2020)

9.1 Initial internal reactions of the idea of opting for a direct listing

Barry McCarthy communicated his idea of opting for a direct listing and was initially met with skepticism, as people were at first not used to the idea. As a concept, direct listings were nothing new, but it was new in the context of Spotify. "The idea of Spotify doing a direct listing at first appeared very exotic. It simply hadn't been done before. In fact, I think most people still learned as it happened" (Cassel, 2020-10-12).

Woody Marshall was one of the first people to hear about Barry McCarthy's idea of pursuing a direct listing, and had a similar reaction as most people at the time: "When he told me about it I literally had no idea what he was talking about, and I have been in the financial industry for close to 30 years". After further researching the topic he would quickly conclude that it was a rather "unsavory comparable set", as it mostly contained public companies that had to do a prepackaged bankruptcy. However, Barry's point was "that is just the mechanism" (Marshall, 2020-11-03). When people started to get a better understanding of how the concept of a direct listing could be applied to Spotify, it started to make sense, and again, to some extent relied on a belief in efficient market theory:

> There is no way to have a great outcome in the public market with a crappy business, so the point is if you believe in your business and you believe in the management team, which every investor and board member did, you will understand the logic of this. We did not need to raise money, it provided more clarity and access to all, which was an underlying philosophy that is core to the company. It made all the sense in the world. (Marshall, 2020-11-03)

Daniel Ek had confidence in McCarthy's ability and was not a stranger to the idea of doing something that had not been done before, as this was the essence of Spotify's ability to grow to such a successful company (Marshall, 2020-11-03).

> The opportunity to be different, to be innovative, captured his [Daniel Ek's] imagination, and all the benefits that came with it: the equal access, the fair treatment of employees; those things were all super compelling. I do not think he was ever intimidated by the risk; he was captivated by the opportunity. (McCarthy, 2020-08-13)

The investors in the convertible bond offering were expecting to convert their notes into shares in Spotify at a discount relative to the IPO price. However, would Spotify opt for a direct listing they would not be able to convert at a discount compared to an offering price, as it was not part of a direct listing process. The contracts therefore needed to be adjusted. "It is difficult as for lawyers to write contracts that predicts a process that has not been invented yet." (Rodgers, 2020-10-26). After discussions and negotiations between the parties, the convertible notes holders accepted the given terms. Both parties were satisfied with the outcome.

9.2 Direct listings with a primary offering of shares (cont.)

A company could under the proposed rule change (as of December 7, 2020), sell shares without an underwriter through a direct listing, given that it sells at least $100 million in market value of shares in the opening auction on the first day of trading. The NYSE may permit the company to sell shares for less than $100 million of market value if the aggregate market value of the company's outstanding shares is at least $250 million. Such market value will be calculated by using a price per share equal to the lowest price of the price range written in the registration statement.

Companies intending to raise capital in conjunction with a direct listing must also satisfy other applicable listing requirements as companies opting for a traditional IPO or a direct listing, including having at least 400 shareholders, having at least 1.1 million publicly held shares outstanding at the time of the listing, and that the share price is at least $4.00 at the time of the listing (Vinson & Elkins, 2020). This new proposal adds yet another pathway to the public markets outside of traditional IPOs.

> We are adding the option for newly issued shares, either alongside existing shares or standalone, to be priced in an opening auction [...] The value of these newly issued shares represents the capital raised by the company. All of the newly issued shares sold by the company itself must be sold in the opening auction, at one price and at one time. Selling shareholders may also sell in the opening auction if there is demand for additional shares at the opening auction price and may also sell at any time after the opening auction is completed. John Tuttle, Vice Chairman and CCO of the NYSE

In August 2020, Nasdaq proposed to the SEC a similar rule change, which would permit private companies to issue shares in the opening auction in conjunction with a direct listing at Nasdaq (Business Insider, 2020). Nasdaq had, according to familiar sources on the matter, been working on the filing for around a year.

Nasdaq's proposal would allow the company, with the assistance from a financial advisor, to set a non-binding price range before the first trade on the exchange. This would include a fixed number of shares that were to be issued. There would be no limit on how far above the price range a company's shares could open. However, the stock would not be able to open more than 20 percent below the indicated price range.