Are your portfolio companies ready for an IPO?

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The Jumpstart Our Business Startups (JOBS) Act, which was enacted on April 5, 2012, makes pursuing an IPO more attractive for many smaller companies by relaxing certain accounting and other regulatory burdens. Under the JOBS Act, Emerging Growth Companies (EGCs), which are defined as companies with total annual revenues of less than $1 billion in their most recently completed fiscal year (and other criteria), are entitled to pre- and post-issuance relief. Since the vast majority of companies in private equity firms' portfolios fall under the $1 billion limit, the JOBS Act is especially helpful to them.

Pre-issuance relief under the act, which can significantly reduce the effort to complete an IPO, includes:

- Reduced financial statement and management discussion and analysis disclosure
- Delayed application of new accounting standards
- Exemption from new PCAOB audit requirements
- Reduced executive compensation disclosures
- Expanded communications with permitted investors
- Confidential submission of registration statements with the SEC
- Relaxed research analyst restrictions

Post-issuance relief includes exemption for certain aspects of the Sarbanes-Oxley Act, saving newly public companies hundreds of thousands of dollars.

Preparing for an IPO

The current combination of favorable equity market conditions and the relaxed IPO process for qualifying EGCs available due to the JOBS Act has heightened interest in IPOs among the private equity community. Yet, even with the lowered bar of the JOBS Act, an IPO will require considerable time, effort and expense. An examination of S-1s versus successfully completed IPOs over the past several years shows that about a quarter of the companies that start the IPO process fail to complete it. The question then becomes how can private equity firms best prepare a portfolio company for an IPO?

Since the equity markets have been slow over the past few years, private equity firms may have more than one company ready to be sold. If that is the case, they should consider running the IPO readiness process concurrently for them. By preparing more than one portfolio company for IPO simultaneously, the firm may realize savings and efficiencies through economies of scale. Efficiencies may be gained related to program management, technical accounting, valuations, audit services, technology upgrades and temporary staff augmentation, to name a few. Further, the private equity firm may choose to bring portfolio management teams together for training on various aspects of being a public company.

Where private equity can boost value

In addition to the traditional ways that private equity firms add value—capital for expansion, bolt-on companies, intense focus on EBITDA, among others—they should consider the many qualitative factors that can negatively impact an IPO. RSM's point of view is that most companies unnecessarily lose value as they near the IPO transaction because of a lack of appreciation for the significance of the following items. Fortunately, loss of value related to these can be proactively addressed throughout the IPO process:

- Quality of management
- Corporate strategy
- Regulatory compliance and corporate governance
- Operational effectiveness
- Technology

Regarding management, running a public company is not the same as running a private one. Is the management team at the company you are considering for an IPO ready for that challenge? For example, suppose you have a CFO with extensive private company experience, but that has never worked at a public company. Given the significant differences in reporting requirements and the risks associated with improper handling, the CFO's lack of public company experience could raise real concern among potential investors.

Portfolio companies have different strategies, some strong and others not as strong, but what is important is articulating the strategy in a way that will resonate with investors. Look at your company's story from Wall Street's perspective and recast it in those terms.

Regulatory compliance and corporate governance are significant items to consider and growing concerns. However, some private companies look at these factors as peripheral in importance, addressing them on an ad hoc basis as the need arises. Private organizations often need to be revamped and redesigned from a compliance and governance standpoint to support the pressures of being under the microscope as a publicly owned corporation. Do you have a board in place with the right mix of experience to meet public company governance expectations? Is senior management ready to set the tone at the top necessary to establish an environment where compliance and governance matter? But remember, there is a balance here. It is often the entrepreneurial drive and spirit of leadership that has driven a company's success. To the extent necessary to meet compliance concerns, that spirit may need to be reined in, but you do not want to squash it. Investors are looking for that, too.

At a more specific level, are the company's internal control environment and internal audit functions sufficiently robust? What about Sarbanes-Oxley compliance? Is the company in an industry like banking where there is an industry-specific set of regulatory concerns, and is the company's compliance history in that area clean? To the extent that there are past issues or current weaknesses, address them prior to the IPO and be ready to convince investors why they are no longer a concern.

Technology, too, needs to be viewed through a public company lens. Not only does the company need to have the systems in place to effectively manage operations, those systems also must be ready to meet the different reporting demands the company will face once it goes public. If an upgrade is needed, make it now so that it is in place and operating effectively before investors start looking. The technology a firm employs needs to be supported by the right processes and people to ensure it is effective.

Timing is everything

Any time a company makes significant changes, it can take some time to work out the bugs. That's why we advise our clients to begin IPO preparation 18 to 24 months before the target IPO date.

Evaluate all the issues outlined above. Note and address any gaps. Make the changes necessary to fix them. Then, have the company operate as if it were a public company for one year before starting the registration process. This will give you a chance to identify and address concerns before investors do.

Don't underestimate the work involved first in preparing a company for an IPO and then in completing the registration process. It will be a team effort. The private equity firm and the target company's management will need to work closely with your external auditors, IPO consultants, tax advisors and others.

The equity markets are heating up. The JOBS Act will make IPOs easier for many private equity-owned companies. Now is the time to start preparing your companies if an IPO makes sense as an exit strategy.

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