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A SPOT of secondary activity

Analysis of Spotify's direct listing

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Updated Analyst Note: 4/3/2018

Direct listing success: As expected, shares experienced low volatility while closing share price comes in 13% above last private trade

Spotify's public debut wasn't without its hiccups, however from the early indications we would count the company's direct listing experiment as a success. The initial premium of $10 billion over Spotify's most recent private valuation was much greater than we expected, and while shares traded down steadily from the highs of the day, existing shareholders who didn't sell are still sitting on significant gains from where shares were trading in the private markets just a few weeks ago.

One of the most common worries with the Spotify direct listing revolved around the volatility of initial trading without formal underwriting support. Interestingly, the ~$20 intraday share price fluctuation – which calculates to 12% variation from the initial pricing at $165.90 – is fairly low volatility for the first day of trading for a technology IPO.

Spotify made a concerted effort to smooth the transition to public markets by promoting increased volume in the private secondary markets over the last few quarters. The ability for existing shareholders to achieve liquidity before the direct listing may have caused more subdued volume than a traditional IPO, and a less volatile public debut was a welcome side effect. After the delayed start due to the novel price discovery process, it took over two hours to trade 10% of the total shares outstanding with less than 17% changing hands as of market close (compared to long-term average first day turnover of 42%). With no lock-up period, it seems many large existing shareholders may be biding their time before making any final decisions.

Original Analyst Note: 3/20/2018

A SPOT of secondary activity: An analysis of Spotify's direct listing

Key takeaways

- In preparation for its direct listing, Spotify has waived its right of first refusal on private secondary share sales to facilitate increased transaction volume. From these trades, Spotify and its advisors are receiving vital information about investor sentiment and a more up-to-date market valuation than the typical private company.

- If the price discovery in the private markets turns out to give an accurate prediction of the initial public pricing, we think that direct secondaries will become more common for companies preparing to go public. These transactions also provide existing shareholders the opportunity to sell before the listing, getting rid of "pent-up" demand and potentially reducing early volatility on the public markets

- With the decision to pursue a direct listing, Spotify has shirked the need for the full-service investment banking IPO package and opted for an à-la-carte approach to pay solely for what they need. We believe the outcome of this transaction could have long-term effects on the bargaining power between pre-IPO companies and banks.

- Based on the share prices of Spotify's private sales in 2018 and the probability-weighted expected return method, we've estimated Spotify's market capitalization will fall between $17 billion and $23 billion. As such, there is still uncertainty if the public market valuation will exceed the company's most recent private valuation of $19 billion.

Analysis

While the direct listing is a decision to list on a public exchange, Spotify's choice is really an early litmus test of the maturity of private secondary markets. So, while much of the focus will be on Spotify's post-listing price activity, we see an equally interesting and overlooked scene currently taking place in the private secondary markets.

Over the last few quarters, Spotify waived its right of first refusal on company share sales to promote increased secondary volume in the private markets. From the beginning of 4Q 2017 to March 9, 13,403,720[1] shares have changed hands, with prices varying 170%. While this price action in less than two quarters may be concerning to some investors, we think these trades serve as a form of price discovery and may help to contain some of the expected volatility of the direct listing.

Additionally, we believe the secondary sales are providing the company and its advisors vital information about investor sentiment, in addition to providing a more robust market valuation. In essence, the secondary transactions provide a sneak peek of the demand for Spotify shares from potential new investors and a more real-time gauge of the valuation investors are willing to accept. Because of the enlarged role the secondary market is playing in this scenario, the success of this direct listing could now provide a boon for the overall trading volume of venture shares in the direct secondary market. If the valuations implied by the private sales turn out to give an accurate prediction of the initial public pricing and more companies are persuaded to pursue a direct listing, direct secondaries pre-listing should become more common.

IPO advisory investment banks are one segment of the financial services industry that may be most impacted by direct listings. Spotify has shirked the need for the full-service IPO package and opted for an à-la-carte approach to pay solely for what they need. While the three advisors on the Spotify deal are still receiving a fee, it is almost assuredly less than a traditional IPO percentage fee—and a much smaller syndicate of banks are benefiting from the deal.

1. This figure excludes the share transfers in relation to the Tencent transaction.

	Per Share Sale Price (in U.S. dollars)		Number of Ordinary shares sold in the period
	High	*Low*	
Quarterly			
1Q 2017	$56.25	$37.50	1,265,360
2Q 2017	$85.00	$46.25	2,067,600
3Q 2017	$95.00	$65.50	2,482,040
4Q 2017	$125.00	$81.50	6,989,440
1Q 2018 (through March 9)	$132.50	$48.93	6,423,280

Source: Spotify F-1

This only really becomes a factor if Spotify is successful in proving that private market secondary activity, in addition to the public reputation and excitement large private firms can garner without a traditional roadshow, is enough to transition to the public market. Nonetheless, the potential of this transaction to cause substantial shifts in bargaining power between companies and banks is a highly intriguing side effect.

Lastly, it is important to consider valuations—an increasingly important topic in venture capital as they have extended to decade-high levels. Using information from the F-1, we've estimated Spotify's market capitalization will fall between $17 billion and $23 billion. We came to this conclusion based on the range of share prices of Spotify's private sales and calculating the company's fully diluted shares using the treasury stock method for the options and warrants (see summary table below for detail). The company also uses a probability-weighted expected return method (PWERM) to calculate a fair value for the business based on five scenarios. As of December 2017, this method valued the company at $120.50 per share, which falls near the top of our estimated valuation range. With our estimated range, some uncertainty lingers around whether Spotify's initial market capitalization will exceed its most recent private valuation of $19 billion. Pricing above the company's latest private valuation has become an even more important achievement as some sky-high VC valuations have been slashed by leery public market investors.

In theory, any investor in Spotify will be able to sell as many shares as they choose at the publicly determined valuation, another departure from the classic IPO structure where many large investors and employees agree to lock-up periods, or can't sell directly into the IPO. From this standpoint, the direct listing should prove a truer liquidity event than a traditional IPO for current Spotify shareholders, given enough outside demand.

	Low	Midpoint	High
March 2018 Share Prices	$48.93/share	$86.97/share	$125.00/share
Estimated Market Capitalization	$9.33B	$16.58B	$23.83B

Source: PitchBook

	Current	Strike Price	Proceeds	Pro-forma Shares
Shares Outstanding	183,567,880	-	-	183,567,880
Options	15,291,410	$59.76	$913,814,662	4,783,566
Warrants	6,720,000	$59.92	$402,662,400	2,089,834
RSUs	191,985	-	-	191,985
Fully Diluted Shares				190,633,265

Source: PitchBook