The Only Time Slacking Off Could Pay Off

An analysis of Slack's direct listing

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Introduction

Based on our analysis of Spotify's direct listing last year, we expected at least a few other unicorns that exhibit all the key characteristics (strong brand recognition, self-sufficient on a cash basis, plentiful capital on balance sheet, transparent culture, etc.) would proceed along the same path. Slack is the first technology unicorn since Spotify to list directly, and while the company doesn't perfectly fit the mold for this exit strategy, its deviation from the prototypical direct-listing candidate could open this opportunity up to a much broader group of companies.

What makes Slack different?

Firstly, the company's product is enterprise-focused. This is unique because direct listings rely on investor familiarity with the brand and its story, lending itself to consumer-facing companies. Slack is not a traditional enterprise company, however; it employs a freemium model and is known for a stickiness from users, which has driven Slack's brand recognition to levels on par with many consumer-facing entities. As is now typical with a direct listing, Slack will forgo the traditional roadshow and instead opt for an investor day accessible to any interested parties. Furthermore, Slack has a much faster growth profile than Spotify did at the time of its listing, with 81.6% YoY revenue growth recorded last year. This growth and the company's prospects for scalability make the story revolving around Slack truly distinct from Spotify and meshes with a whole host of other VC-backed enterprise software companies.

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A more important difference is that Slack has not reported positive free cash flow, which we expected companies pursuing a direct listing would. With the direct listing raising no additional cash for the company, Slack's short-term growth will rely instead on the $841 million in cash on its balance sheet built up through its prolific fundraising from VCs. To be sure, Slack's negative $97 million in free cash flow last year is significant; however, the company's strong balance sheet still provides years of runway if the rate of cash burn remains flat or decreases compared to last year. This leeway highlights the company's ability to determine the optimal time for it to raise money through a secondary sale, which we see as one of the major benefits of listing directly.

Predictably, the lion's share of Slack's expenses comes from sales and marketing as the company focuses on expanding, but the company is showing progress toward profitability, with sales and marketing coming in at 58.2% of revenue in the year ending January 2019, down from nearly 100% of revenue two years prior. Revenue growth is the main underlying cause of this improvement, as the near quadrupling of revenue over the same two years has outstripped almost all expense categories. Slack's continued ability to drive sales more efficiently will be key to achieving cash flow positivity.

While Slack is using the same group of advising banks (Morgan Stanley, Allen & Company and Goldman Sachs) as Spotify to consult and assist with the direct listing, the company also engaged a whole host of associate financial advisors (Credit Suisse, Barclays, Citigroup, RBC, KeyBanc, Canaccord Genuity and William Blair & Company), nearly filling out an entire IPO syndicate. Slack will benefit from the experience of the three main advisors that have already completed a multi-billion-dollar direct listing, but the company also decided to widen the network of participating institutions able to pass information along to the direct market maker on pre-listing selling and buying interest. The lower cost of completing a direct listing relative to a traditional IPO has been one of the most widely reported selling points, but it is unclear how much Slack will actually save with the addition of so many advisors.

Secondary market trading

Similar to Spotify, secondary trading of Slack's shares has accelerated in both price and value as the public listing approaches. In March, 2.4 million shares changed hands at prices ranging from $21-$26, the second highest volume for any single month and implying a fully diluted value of over $15 billion at the top of the range. This registers far above the $7.1 billion at which the company was valued in its August 2018 Series H fundraise. As a reminder, Spotify's first trade priced well above the final direct secondary sales but closed down following first-day trading. Slack's prospectus provides only one year of historical direct secondary transactions, which offers less data than we had with Spotify, but we continue to see robust activity in this market as a critical prerequisite to a successful direct listing since this is the only reference point for the opening stock price.

Other key considerations

A few of the parties most interested in Slack's filing may be some large public technology companies. Workplace collaboration and productivity software has been heating up as a strategy, and mounting momentum in the space in general (look no further than Zoom's aftermarket performance) suggests some potential interest in a takeout before Slack has a chance to go public. We've seen a few pre-IPO takeouts of enterprise software businesses over the past few years, most notably AppDynamics and Qualtrics, in which acquirers paid significant premiums to supersede the planned IPO.

One wrinkle to consider with Slack is the company's own investing efforts. Slack Fund, the private company investment fund run by Slack, is small relative to the overall business but part of a unique trend in the ecosystem wherein VC-backed companies engage in VC investing. Adding to the intrigue is Slack Fund's similar structuring to a traditional VC fund, with a 10-year life span and capital from outside the company's balance sheet (only existing company investors in this case). Slack has already contributed $8.8 million of a total $13.0 million committed to the strategy (out of a total $80.0 million fund size), which focuses investments on enterprise software companies that have potential for substantial contribution to the Slack ecosystem—especially those companies making Slack integration part of the application's core functions. The vehicle's investments have tended toward the early stage given the smaller fund size, highlighted by 2019 investments in Polly, Astound, GRID and Hone, all of which are Series B or earlier.

Conclusion

Since Spotify's debut, there are fewer questions about the direct listing process for large technology companies, and while Slack's profile may not be fully prototypical, the growth story and aftermarket performance of recent workplace collaboration businesses should encourage investors. Pending the outcome of Slack's direct listing, the company's differences from the ideal direct listing candidate have the potential to open this exit route to a much larger sample of companies. Essentially, Slack looks much more like the current cohort of large VC-backed software companies than Spotify. This could give executive teams of fellow well-capitalized startups such as Stripe, Snowflake, UiPath, Zenefits, Dataminr and Rubrik further confidence in taking this less common path to liquidity.