Equity and Alternative Capital Mobilisation by SMEs in 21st century

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Abstract

This paper discusses the capital mobilisation of Small and Medium-sized Enterprises (SMEs). SMEs contribute approximately 50 per cent of the Gross Value Added globally. However, capital mobilisation for these companies has always been a hindrance. The paper attempts to define the various ways of capital mobilisation by dividing it into two main sections namely equity and alternative listings. During the years 2016–2018, the stock markets globally witnessed colossal Initial Public Offerings (IPOs) and these companies were unicorn companies. The paper discusses the background of unicorn companies and how IPOs play a major role as capital mobilisation source. The concluding part of the paper analyses the hindrances in policies and suggests ways for new policies.

Introduction

The structure and the concept of issuing public offerings and raising capital have significantly undergone many changes with the arrival of new type of companies in the market. The transformation of the structure of the stock market and the composition of companies coupled with the performance of the market have led to the emergence of many private companies going public. The Small and Medium-sized Enterprises (SMEs) contribute 50 per cent of Gross Value Added. SMEs require adequate financing throughout their business cycle. There are private and public ways of capital mobilisation. The private capital mobilisation includes seed investment, angel investment and venture capital investment firms. The public capital mobilisation can be done in many ways. The capital mobilisation by SMEs can be divided into SMEs equity investments, SMEs debt investments and SMEs alternative investments (Peterhoff, Romeo, and Calvey 2014). The paper discusses the equity and alternative ways of investments. The stock market has experienced a colossal IPO rush in two years (2016–2018). On inquiry, these companies were found to be unicorn companies.

Initial Public Offering

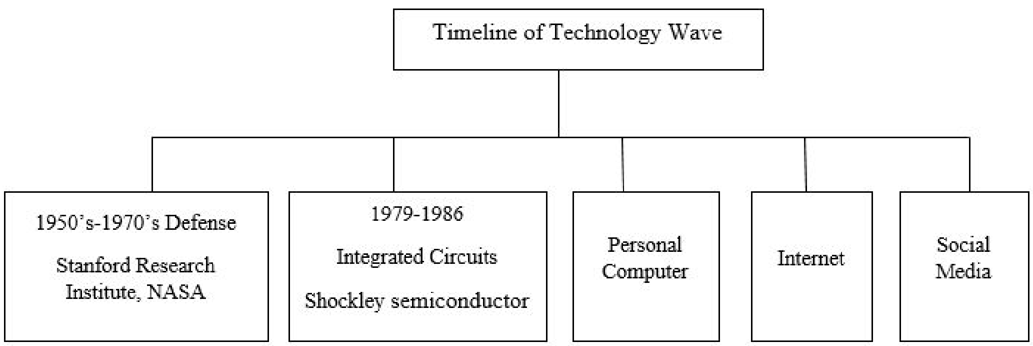
Unicorn Companies

The term 'Unicorn Companies' is very new in the dictionary of companies. It was introduced in the year 2013 by venture capitalist Aileen Lee. She observed that companies that were established after 2003 were valued at a very high threshold of market capitalisation (Simon

2016). The relevant definition for unicorn companies is the private heterogeneous companies[1] with their value more than $1 billion. Unicorn companies initially rely on venture capitalists for their funding and developments.

Unicorn Bubble or a New Phase?

There are several perspectives regarding the establishment and the functioning of the unicorn companies. The birth of the unicorn companies is the result of the "third phase of convergence". According to Williamson, this phase of convergence is the movement towards the transformation of everything through the digital transformation. There was a 115 per cent increase in the number of start-ups between 2013 and 2015 (Simon 2016). This technological wave has reduced the cost of entering into the market and has boosted the number of companies achieving a lucrative position in less than a decade.



Source: Global start-up ecosystem ranking

The fifth wave, namely social media, has contributed significantly to the growth of unicorn companies.

Unicorn Companies and IPOs

Unicorn companies are funded by venture capitalists and recently these companies have been issuing IPOs in the stock market at a greater level. Two questions arise in this context.

- Why have the unicorn companies taken so long to issue IPOs?
- Why there is a sudden rush? In addition, are companies like Uber too optimistic about issuing IPOs?

The first perspective is that the venture capital had a short maturity period, i.e., five to six years. However, since there is an increase in the number of companies introduced each year, the maturity period has also increased to a decade and more. The unicorn companies stay private;

[1]By heterogeneous, the definition means that the companies are diverse in terms of business models, organisational and growth models.

raise a considerable amount of money to cover their fixed and variable costs, and issue IPOs. This has led to the emergence of a new ecosystem of financing companies before an IPO (Cave 2016).

Snapchat Inc.	Jeremy Liew, Light speed venture partner, Benchmark
Dropbox Inc.	CEO Drew Huston, Sequoia capital (major Stakeholders)
DocuSign Inc.	Sigma Partners, Ignition Partners, Fraxier Technology Ventures, Keith Krach
Moderna Inc.	Sequoia Capital China, Fidelity Management & Research Company, Pictect, Viking Global Investors, Arrow Mark Partners and Alexandra Venture Investments.
Allogene Therapeutics Inc.	Vida Ventures.
Pluralsight Inc.	Insight Venture Partners, Iconiq Capital, Arne Duncan.
Bloom energy Inc.	New Zealand Superannuation Fund, Excelon, Constellation energy, Power Secure.
Pinterest	Valiant capital partners, First Mark capital, Fidelity Investments, Bessemer venture Partners, Andreessen Horowitz.
Airbnb	Sequoia Capital, TCV, Capital G, Andreessen Horowitz, Fidelity, Jeff Bezos.
We work	Softbank, Hony capital, Legend Holdings, Glade Brook capital Partners, Goldman Sachs, T.Rowe Price, Wellington management.
Uber	Softbank, Lower capital, Kapor capital, Saudi Arabia Public Investment Fund.

Source: Crunch Base, CNBC.

The answer to the second question is probably unsettled.

A recent report by Intelligize states that there are 300 unicorn companies in the world as of 2019 and the phenomenon behind the flush of IPOs is the herd mentality. The extent to which this factor can be explained is ambiguous. The first quarter of 2017 and 2018 saw two big unicorn companies, Snapchat (Q1 2017) and Dropbox (Q1 2018) issuing IPOs. Both Snapchat and Dropbox received different responses from the public. Snapchat received a huge backlash after its price fell down tremendously. From the first quarter of the year 2016, the market was in a bubble and the investors anticipated large inflow of IPO in the market. The largest inflow came through Snapchat's IPO in the year 2017. However, its price fell 48 per cent in six months. This led some unicorn companies such as eviCore Healthcare and Blue Apron to temporarily back off their IPO plans. After the Dropbox's successful IPO plan, there were 18 public offerings in the next three quarters. Most of the unicorn companies were concerned about the capital structure and the company's control on shareholders. Snapchat gave zero voting rights to its investors. The multi stock approach is disappointing the investors as it restricts their rights in the company. Unicorn companies are identified as "Emerging Growth Companies". The provisions for filing IPO are different for these companies. They have concessions in provisions like disclosure of executive compensation and audited accounts that give them advantage over other public companies (Peters and Alyson 2019).

Uber-IPO Failure Story

Uber is a ride sharing company founded in the year 2009. The company issued IPO on May 2019. However, the over-optimism turned out to be dismay. Uber's initial price was $45 and it opened at $42, which was 6.7 per cent low. After that, it slid to $41.06 proving that it did not live up to its expectations. The main reasons attributed to the failure of Uber IPO starts from its prospectus[2]. The company's earnings have been remarkably low over the past years, registering 2.5 billion in 2016, 2.6 billion in 2017 and 1.8 billion in 2018. Thus, the company even after nearly 10 years has not managed to bring out a positive figure (United States Securities and Exchange Commision 2019).

	Year Ended December 31, 2016	2017	2018
	(in millions, except %)		
Other Financial and Operating Data:			
Monthly Active Platform Consumers(1)	45	68	91
Trips(2)	1,818	3,736	5,220
Gross Bookings(3)	$ 19,236	$ 34,409	$ 49,799
Core Platform Adjusted Net Revenue(4)	$ 3,170	$ 7,136	$ 9,924
Core Platform Contribution Margin(5)	(23)%	0%	9%
Adjusted EBITDA(6)	$ (2,517)	$ (2,642)	$ (1,847)

Source: (United States Securities and Exchange Commision 2019).

The stockholders deficit[3] of Uber has steadily increased in the past five years from 1 billion in 2014 to 7.38 billion in 2018.

[2]Prospectus is a legal document, more like a disclosure document, that describes the financial security of a potential buyer.
[3]Stockholders' deficit shows the net value of the company. It is called "negative book value" or "negative equity", a term denoting that the company has incurred liabilities than assets.

	As of December 31,				
	2014 (unaudited)	2015 (unaudited)	2016	2017	2018
			(in millions)		
Consolidated Balance Sheet Data:					
Cash and cash equivalents	$ 1,961	$ 4,188	$ 6,241	$ 4,393	$ 6,406
Working capital[(1)]	1,748	4,644	4,589	2,990	4,399
Total assets	2,241	6,740	15,713	15,426	23,988
Long-term debt, net of current portion	—	1,423	3,087	3,048	6,869
Redeemable convertible preferred stock warrant liability	—	3	211	125	52
Total liabilities	330	4,078	9,198	11,773	17,196
Redeemable convertible preferred stock	2,881	6,256	11,111	12,210	14,177
Additional paid-in capital	101	120	209	320	668
Accumulated deficit	(1,109)	(4,265)	(4,806)	(8,874)	(7,865)
Total stockholders' deficit	(1,009)	(4,146)	(4,596)	(8,557)	(7,385)

Source: (United States Securities and Exchange Commision 2019).

Name	Number of Shares
Morgan Stanley & Co. LLC	
Goldman Sachs & Co. LLC	
Merrill Lynch, Pierce, Fenner & Smith Incorporated	
Barclays Capital Inc.	
Citigroup Global Markets Inc.	
Allen & Company LLC	
RBC Capital Markets, LLC	
SunTrust Robinson Humphrey, Inc.	
Deutsche Bank Securities Inc.	
HSBC Securities (USA) Inc.	
SMBC Nikko Securities America, Inc.	
Mizuho Securities USA LLC	
Needham & Company, LLC	
Loop Capital Markets LLC	
Siebert Cisneros Shank & Co., L.L.C.	
Academy Securities, Inc.	
BTIG, LLC	
Canaccord Genuity LLC	
CastleOak Securities, L.P.	
Cowen and Company, LLC	
Evercore Group L.L.C.	
JMP Securities LLC	
Macquarie Capital (USA) Inc.	
Mischler Financial Group, Inc.	
Oppenheimer & Co. Inc.	
Raymond James & Associates, Inc.	
William Blair & Company, L.L.C.	
The Williams Capital Group, L.P.	
TPG Capital BD, LLC	
Total	180,000,000

Source: (United States Securities and Exchange Commision 2019).

Morgan Stanley, Goldman Sachs, Merill Lynch and Barclays Capital were the major underwriters of the company. Though the market experience was negative, all these underwriters were able to pull $106.2 million.

Underwriters	**Amount in million US $**
Morgan Stanley	40.6
Goldman Sachs	21.2
Merill Lynch	10.5

Source: (Shen 2019).

What are the Lessons We Learn from Uber's IPO?

One important phenomenon in the stock market is the timely capitalisation of the stock market. Uber, a 10-year-old established company was completely reliant on venture capital firms and angel investors (Series G). The transition period for the company took a decade. The reputation of a firm among the investors could get tarnished when it takes a very lengthy transition period. Along with this, the overpricing of share is also said to be one of the prominent reasons for the failure. The underwriters failed to act as proper intermediaries between the issuing company and the public. Uber should have considered the outcome of Lyft before issuing the shares.

Direct Public Offering

Direct Public Offering (DPO) is selling securities to the public without underwriters or brokers. Unlike an initial public offer, no new shares are issued. The existing share of the shareholders is sold. The advantage of DPO is that it reduces many compliance costs like underwriting fees, legal fees, audit fees, printing fees and complex regulatory framework of furnishing financial statements and financial data. There are four different types of DPOs each serving different purposes. The Small Corporate Offering Registration allows the selling of securities within a specific state. The Rule 147 offering is an intrastate offering exemption where the company can sell shares only in the state where it has registered. The Reg A offering (Regulation A Registration statement) is where the securities can be sold nationally with registration in each specific state under Reg A. The S-1 Offering is the more commonly used form of DPO. The shares can be issued nationally once the company has registered with the exchange. The regulatory framework required here is furnishing past two years' financial statements. Snapchat in the year 2018 went public through DPOs. Following Snapchat, companies like Slack and Airbnb are planning to issue DPOs (Bisonnette Funding Solutions 2019).

Dutch Auction

Google in the year 2004 followed the system of Dutch auction. It is a system of price discovery where the auctioning starts from the highest price and continues until the lowest price where the bids received cover the entire offer quantity. The disadvantage of Dutch auction is the drastic price fluctuations and it is an informal way of capital mobilisation. The market after a certain point reaches saturation and faces a situation called “winners curse”, which is the depressed price after the initial offering.

Policy Hindrances

Comparison of rules and regulations of US Securities and Exchange Commission, and Securities and Exchange Board of India

US Securities and Exchange Commission	Securities and Exchange Board of India
Jumpstart Our Business Startups Act, 2012	Innovators Growth Platform
Sarbanes Oxley Act, 2002	Startup India

There are exemptions for SMEs in the rules and regulations. The Jumpstart Our Business Startups (JOBS) Act was enacted in the year 2012 exclusively for startup companies. The SMEs come under the provision of “Emerging growth Companies”. The emerging growth companies have certain exemptions compared to other public companies. Title 1 of the JOBS Act has scaled disclosure of two years of audited financial statements and two years of selected financial data against five years and three years for public companies. Section 404(b) of the Sarbanes Oxley Act states that the public companies must submit the auditor attestation of internal control of the company. Under the JOBS Act, 2012 this particular provision was overruled.

The Innovators Growth Platform was an initiative by the Securities and Exchange Board of India in the year 2016. Under this initiative, the SMEs are encouraged to go public with certain relaxations in the rules and regulations. The SMEs are exempted from publishing financials for three years and to show a positive net worth. The condition for the SMEs is to complete at least Series B round.

SME Alternative Listings

The arrival of a large number of startups has made the initial phase of private capital mobilisation difficult. As an alternative, peer-to-peer lending has become more significant. In the rapidly growing markets, there are several other opportunities for capital mobilisation like crowdfunding, invoice auctioning and venture capital banks. Crowdfunding as a platform has no regulations and disclosure requirements. There are several formal organisations like Crowd cubeplc. that connects investors and companies. Market Invoice is another platform for capital mobilisation through invoice auctioning. (Anthony 2018)

Conclusion

Capital mobilisation in the 21st century has become complicated with the arrival of new companies. The experiences of companies like Uber and Lyft show that the present rules and regulations are insufficient for the SMEs. They focus only on relaxing the rules and regulations rather than creating new rules and regulations considering their functional structure. The exemption from furnishing financial statements and data is regrettable because it causes information asymmetry. Further, dual regulatory frameworks (in the case of India, special state startups and a central startup scheme) intensify the vagueness of the regulatory framework and hamper performance. A robust action will need in depth research and separate policy measures for these companies.

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