Increased Costs Discourage Many Companies from Going Public

by David J. Berger*

Ah, the 1990's. Life used to be so simple then, at least for companies considering whether or not to go public. The path to success was clear: you receive initial funding, do a couple of rounds of venture capital financing, and eventually participate in an IPO to provide liquidity to your early investors and gain all the advantages of being a public company.

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The numerous advantages of being public were easy to understand: your stock was a "currency" to use for acquisitions, employees could be retained and motivated through stock option plans, strategic partners and customers could also become investors, and public companies—even the new ones—were perceived to have stability and a future. In contrast, the costs of being public were minimal. While there were some additional legal and regulatory filings, these were largely handled by lawyers and accountants whose fees were more than compensated for by the profits from the initial sale of stock.

How times have changed. Today, companies shun going public, unwilling to bear the substantial additional costs involved. Further, many companies that went public several years ago are now trying to figure out if it makes sense to remain public. According to a recent Thompson Financial study, 66 companies were de-listed as a result of going private in 2002, up from just 35 in 1999, the peak year for IPOs. Yet recent indications are that this number is likely to increase over the next several months as the market continues to stall and the costs of being a public company (regardless of size) continue to grow.

The Public/Private Decision

There are several issues that a company must consider when thinking about whether it makes sense to go private. By far the most important task is to identify the business needs that will be solved by being a private company rather than a public company. For example, does the company need to make some short-term significant investments that will affect earnings (and thus its stock price) but that are necessary for long-term competitive reasons? Are there some strategic decisions that have to be made that will be difficult to get the public markets to understand or accept? But in addition to deciding whether it makes business sense to go private (or remain public), management must examine the costs of being a public company in today's environment.

The Costs of Being a Public Company

Historically, a significant reason for being public was the lower cost of capital. It was simply cheaper to sell stock in a public company than a private one, and it was also easier to raise other types of capital. Recent market conditions have changed that calculus. In today's market, many public companies, especially small- and mid-cap companies, have tremendous difficulty raising capital; it is certainly not clear that their status as public companies makes the situation significantly easier. Further, with the decline in analyst coverage and the drop-off in the number of investors and trading volume, the reality is that many shares are not significantly more liquid than they would be if they were the shares of a private company. (This is particularly true of large blocs of stock, which often can be sold only at a substantial discount to the market price.)

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Thus the major historical reason for seeking access to public markets—to raise significant amounts of capital—is not the benefit it used to be.

Putting aside market conditions, however, there can be no doubt that the cost of being a public company has increased dramatically over the last year. Perhaps the most obvious burgeoning cost is for recruiting and retaining directors. As the demands and risks of being a director have increased, companies have had to raise their pay to attract the best candidates. Moreover, this higher compensation is coming largely in the form of cash; stock options are no longer viewed as providing an appropriate incentive to a director whose primary function is to monitor the corporation rather than take steps that result in an increased stock price.

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Recruiting new directors has become more difficult, in part because of new definitions of independence. For example, in the past, venture capitalists who served on a company's board could be (and were) considered independent if they did not participate in the management of the company, even if their funds owned company stock. With new rules and listing requirements prescribing more narrow definitions of independence, this is no longer the case. Further, it is becoming increasingly common for venture capital directors to step off a board prior to or just after the company goes public, but it has become progressively more difficult to find their replacements. Indeed, in contrast to prior years when many companies were able to line up new independent directors immediately before their IPOs, today's start-up and small-cap companies are finding that the lag period between the time a board seat opens up and the time it is filled can be months, if not longer.

Another cost for public companies is the additional pay provided to chairs of various committees and directors engaging in special tasks. These directors are increasingly receiving additional "combat" pay due to the risks and time requirements of their jobs. For example, former SEC Commissioner and Stanford Law Professor Joseph Grundfest received a fee of $100,000 for serving as vice chairman of Oracle's audit and finance committee. This may seem like a large fee until one realizes that this committee met 10 times during the year, presumably in meetings lasting an hour or more (it was reported by the Wall Street Journal that at least one meeting lasted for six hours). At this rate, Professor Grundfest is undoubtedly getting paid less than he could command for other endeavors, while Oracle's shareholders are facing the difficult reality that their cost of governance has increased and is likely to continue to rise if Oracle wishes to attract and retain directors of his stature and quality.

Director recruitment costs and compensation are not the only increased costs of being public. The auditing function, for example, has increased dramatically in price and scope. Many companies are reporting audit fee increases of 50% or more—again not a surprise given the new requirements on auditors by Sarbanes-Oxley, as well as the risks they bear for any mistakes. Indeed, auditors' insurance premiums have skyrocketed in recent years; it not unusual today for the per partner cost of insurance in a Final Four firm to exceed $100,000. Given the costs being borne by auditors, as well as their expanded roles and risks of liability, it should be no surprise that auditing fees have also increased.

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The costs, and use, of other advisers have also gone up. In this post-Sarbanes-Oxley world, it is not unusual for the audit committee to have its own lawyer(s), and it is increasingly common for other committees to seek to have their own counsel—all paid for by the company. Directors also are seeking the input of independent advisers like compensation consultants—again at the company's expense.

Another significant increased cost in being a public company is the rising cost of director and officer ("D&O") insurance. A number of insurance companies have left this business entirely in recent years, as the demands on policies have been enormous. Their departure has left the few remaining companies in a stronger competitive position, but also determined to price policies to reflect the risk and cost of securities class actions. The result is that D&O premiums have increased substantially, while the scope and amount of coverage being offered has declined.

In addition to the increased costs for all aspects of board oversight, companies are spending significant amounts to design and implement internal control, internal audit, and internal disclosure systems and policies. This was clearly necessary as part of a broader scheme to ensure accurate financial reporting and thereby restore investor confidence, but the increased costs are particularly troubling for many smaller corporations. Indeed, what is perhaps most important to note about all these increased costs—and what is driving small- and mid-cap companies to consider the possibility of going private—is that the costs apply regardless of size. Thus, directors of small- and mid-cap companies often (correctly) perceive themselves to be facing the same (if not more) risks as the directors of larger companies; neither insurance companies nor auditors base their fees on a company's revenues; and the internal controls necessary to comply with the new regulatory regime are not determined by a company's market capitalization. For these and other reasons, small- and mid-cap companies bear a proportionately greater compliance burden than their larger counterparts.

The end result is that many of today's public companies will be looking for alternatives to reduce their exposure and the costs of complying with the new legislation and regulatory risks, while private companies reconsider whether it makes sense to go the IPO route.