3 LESSONS FROM SPOTIFY FOR COST-EFFECTIVE PRIVATE SECURITIES SALES

We draw on Spotify's recent IPO, tokenised securities, and the new economy ethos to unlock better possibilities for making private offerings.

JEFFREY SWEENEY

CHAIRMAN & CEO,

US CAPITAL GLOBAL

Lesson One:
Start with a Sound Business Model

Building a business on a sound, ethical footing creates better outcomes for all involved. Companies can get the best of both worlds by combining the use of innovative technologies with measures that protect stakeholders, and so create and protect their legacy for the long-term. In Spotify's recent launch into the public (retail) securities markets, we see a landmark case that features modern and best practice private capitalisation, a solid company ethos, and investor protections.

The direct listing for Spotify, a music-streaming company, on the New York Stock Exchange on April 3 is unusual for an IPO in that the primary goal was not to acquire further capitalisation. Instead, it has been an opportunity for existing shareholders to cash out, while making those same shares accessible to a wider pool of mom and pop investors. This seems to reflect the company's commitment to growing at a pace and through a process that serves its shareholders as well as its customer base.

Compared to predecessors such as Napster, whose initial premise was to rip off music artists by sharing their songs online for free without permission, Spotify provides a consensual meeting point between music labels, their artists, and their fans. The company's business model is not without its challenges, as the lack of direct ownership of content means it has to rely on third parties to make its music-streaming platform a one-stop shop for music lovers. But with over 70 million paying subscribers and 10 million new subscribers joining every 6 months, the company leads on digital music consumption, and all while maintaining strong values and an ethical approach to its business.

Lesson Two:
Secondary Markets Can Provide Attractive Liquidity for Investors but Comes with Limits

Turning our attention to capitalisation for private companies, we can observe that Spotify executed best practice in the private securities markets. From its inception, the company has taken the usual path from attracting investments from family and friends for their angel round, to growth phase sponsor-backed rounds, to raising capital via sophisticated, very high net worth investors who were Qualified Purchasers (QP, $5M min investable assets). This was followed by a long growth phase with further investments from additional Qualified Purchasers (QPs). But in its scale-up phase, we see there was a divergence from the traditional route of early round funders buying, holding, and growing Spotify's private securities to then sell it on in an emerging private secondary market to new investors. Unfortunately, this opportunity was unavailable to high net worth, accredited investors.

The reality of long gestation periods to an IPO for tech companies like Spotify means that we are seeing the emergence of a robust secondary market for private securities for these large-cap companies (those valued at over $1 billion). Through this secondary market, certain investors are able to purchase private securities from early investors or employees, and so provide them with liquidity while participating in further raising the value of the company. Spotify has been an excellent example of a company having a very active secondary market for many years while the company pursued growth, away from the limelight of an IPO.

Companies allowing the sale of their private stock to provide liquidity for investors can indicate a positive ethos of doing right by their shareholders. However, this secondary market is not always an option for young companies and their early supporters, as the expensive and inefficient transaction process tends to limit the pool of participants only to institutional investors. With block purchase minimums of $5 million and the associated high transactions costs, the vast majority of high net worth and qualified investors are effectively shut out of this market. That Spotify was able to successfully participate in this narrow market is a testament to the company's appeal among investors.

Spotify has continued to honor its commitment to its investors by finally 'going public' and directly listing its stock on the public markets, and in so doing, bypassing the expensive process of having investment bankers formally underwrite the process. This move has provided liquidity to the company's early investors much more easily than a secondary sale could ever do, while finally allowing retail (individual) investors to buy stock and participate in the company's growth and prosperity.

Lesson Three:
Security Tokenisation of Private Offerings Could Expand Participation Pool Ahead of IPO

For pre-IPO companies wanting to encourage investments from a greater pool of participants, tokenised private securities could offer a suitable alternative to traditional secondary market sales.

It is important to note here that a tokenised security is starkly different from an Initial Coin Offering (ICO), which solicits investments without issuing any security or equity in return – to the detriment of investors. ICO issuers will often declare that their offering is not a security and is therefore exempt from the securities laws that are in place to protect investors from inappropriately risky investments.

Tokenised securities, on the other hand, are very much regulated and come with the same value and legitimacy as traditional securities. By using the underlying blockchain architecture that ICOs are based on, smart issuers can take an innovative technology and use it to improve the security and efficiency of their regulated offering. 'Tokenising' a security would mean tying an offering to its own secure blockchain ledger and recording all transactions related to that particular security on that digital ledger, so that the chain of ownership is transparent and uncontested.

While this is still an emerging practice among issuers, the tokenisation of securities could potentially allow companies and investors to solve many of the historical problems and inefficiencies that have been faced by companies like Spotify who want to provide secondary liquidity to their shareholders. Using blockchain technology for the compliant sale of securities can help reduce transactions costs while improving security and transparency. This in turn can help expand opportunities for liquidity and participation to a wider circle of investors, which can only mean better possibilities for all involved.

Spotify may have missed out on adopting this emerging model for increasing its investment participation pool prior to its IPO, but it doesn't seem far-fetched to conclude the innovative young company would have considered it, had it been an option at the time. But the good news is that, for the new Spotifys of the startup world, tokenised securities could very well be the answer to better liquidity and participation that helps to draw greater investments and rapidly increase shareholder value.