

## Going Public: The Pros and Cons

Imagine, if you will, the great American dream—a small town boy goes into the restaurant business by serving a unique hamburger at a price everyone can afford. Years later, this young man is the chairman of the board of a huge public company with restaurants throughout the world.

Despite the opportunities, many hurdles stand between dream and reality. While many experts feel that restaurant achievement is the result of the concept, the product or the service, the facts prove that inadequate financing of the venture severely prohibits the growth of the successful company.

**RIDING A SKATEBOARD.** Going public is the financing alternative that most restaurants CEOs want to consider, but few choose. The reason: Going public for the first time—commonly referred to as an initial public offering or IPO—is like riding a skateboard. If you have a certain level of skill, timing, preparation and luck, you'll go much further and faster than you could ever hope. But if your timing is wrong, you run out of luck or you ignore your coaching, you could wind up on the ground.

Managers of small companies look at IPOs as a way to get out of or capitalize on an investment made in prior years. No matter how one looks at an IPO the fact remains that it is primarily a vehicle to raise capital to operate the business. As most operators can attest, borrowed capital, including mortgages on new stores, falls short of the requirements for sustained growth.

Going public is also a vehicle for establishing a value for the company's equity. This puts the company in a better position to acquire another company, or for that matter, to be acquired. Many Wall Street investors use market capitalization (total number of shares times the existing stock price) as an indicator of comfort level for investors. The higher the market "cap," the easier it is to buy and sell large blocks of stock without disturbing the market. With a high market cap, other restaurants can be acquired by using the now-marketable acquirer's stock.

**POTENTIAL CUSTOMERS.** Going public is often an outward sign of credibility solid reputation and achievement. This tends to pay off not only with the investing public but also with bankers, industry participants and customers. Every stockholder, after all, is a potential customer.

Because a public offering increases the company's net worth, a company that has gone public should find it possible to borrow funds in the future on more favorable terms. Banks use a company's debt-to-equity ratio as an indicator of loan risk; most bankers prefer that total debt never exceed the net worth of the company.

From an owner/operator's standpoint, going public also establishes a fair market value for the company's securities which can be used to attract, retain and motivate key personnel.

Another reason for going public is to diversify the risk of a business among more shareholders. Many operators own a significant share of the common stock of their firm. When this stock ownership represents the vast majority of an individual's worth, betting the house each day prompts many owners to sell out. An IPO may provide an owner with significant liquidity.

With all of these advantages it seems clear why so many entrepreneurial restaurant operators have chosen to go public. Despite this, however, less than 40 percent of all registrations for initial public offering are completed. When one considers that most CEOs investigate the public market as a financing alternative, the start-to-finish rate falls dramatically.

What many corporate executives don't realize—what no accountant, underwriter or attorney could possibly describe—is that life in the public fish bowl is indeed a plunge. Going public clearly involves more than pushing a series of lengthy legal documents through the Securities and Exchange Commission (SEC). It's like consistently being held under a publicly held microscope. Besides costs, legal regulations, compliance procedures and constant pressure to perform and market its stock, a company must conduct itself very differently.

Another reason for this low completion rate is that going public requires an extraordinary amount of effort. For example, all financial statements must be prepared in accordance with generally accepted accounting principles. Many smaller operators receive unaudited statements from their accounting firms. To prepare the registration documents several prior years' financial statements must be reworked, which may show unexpected results.

Most initial public offerings do not include the sale of shareholders' stock. So, becoming rich may exist on paper, not in cash. The securities community looks upon shareholders' sales in an initial offering as a bailout. The only justification for such a sale is an outstanding performance record of a company prior to its IPO. When this is so, the owner can usually sell up to 25 percent of his holdings in a hot issue without lowering the initial stock price. In most cases, insiders have a restriction period when they are not allowed to sell their stock. In some cases, measurement milestones can also include negotiated performance objectives.

Another deterrent is the large expense involved. Rarely does the cost for an initial public offering fall below \$100,000. The cost can exceed \$400,000 – this depends upon the size of the offering and the underwriter, but some underwriters will only handle high-risk IPOs on a best efforts basis, where expenses could run above 20 percent.

What of the dilution of ownership that will necessarily occur through a public offering? Many owners forget that one of the conditions of allowing someone to invest in your company is their right to vote on certain decisions. The manager may maintain control of the day-to-day decisions, but according to statute, many organizational decisions require board approval. And the board is elected by the shareholders.

Some owners are dissuaded from going public because it carries responsibilities of disclosure. Regulations require that the owner disclose many aspects of the business including compensation of officers and directors, details regarding stock option plans, discussion of significant contracts such as lease and consulting agreements, as well as such information about the business operation as sales, cost of sales, gross profits, net income, borrowings and plans for the future. Such information will be of significant interest to competitors.

This disclosure and reporting responsibility does not end after the initial public offering period. The SEC requires periodic reporting of the financial information and business operation which would have a significant bearing on an investor's decision. Further, the operator must now manage shareholders' expectations, answer questions and publish annual reports in addition to managing the business.

**LOSS OF INDEPENDENCE.** Many have found that going public transforms the entire environment in which the business has operated. There's a loss of independence—external forces other than those from customers influence the method of operation—and the need to manage earnings per share rather than cash flow. Beyond the costs, the changed goals and the new administrative burdens, the overriding concern and trauma for CEOs after an IPO is how the public will judge the company's growth potential and how the market will value his company's stock.

Other factors affect the success of a public offering, including timing, profits, reputation, expectations and the underwriter.

Initially, the most important ingredient is timing. Looking within, you must assess the amount of management time that can be devoted to taking the company public. Also, an assessment needs to be made by an expert as to whether the concept has the ability to sustain an increasing rate of earnings that will satisfy investors.

One must also evaluate whether the company is in the most opportune stage of development to maximize the objectives of the public offering. If originally financed by a venture capitalist, the company may need to go public at a time which will benefit the venture capitalist but may hinder the vitality of the company. Further, waiting until the company has sustained stronger earnings may increase the per-share price, thereby maximizing the amount of the offering.

Because of the sheer volume of IPOs, and the highly technical nature of some of the often-unproven concepts, investors are depending heavily on an underwriter's reputation when making the decision to buy or not. Investors make their decisions based largely on the image conveyed by management and by the preliminary prospectus. Despite all the problems, almost 93 percent of those CEOs of recent IPO companies surveyed said that, if given the choice, they would go public all over again.

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