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Optimal IPO Lockup Structure

CaaS Capital Management

ABSTRACT

We propose a staggered Initial Public Offering (IPO) lockup expiry provision that distributes the unlock date and quantity of shares offered throughout time. The traditional 180-day single lockup expiry is well known and tracked by short sellers in the market, which is evident by the increase in short interest approaching lockup expiry. Volume and volatility are also high during a single unlock date structure. To avoid these shortcomings, we encourage future IPOs to adopt a more staggered unlock schedule which would gradually add supply as newly listed stocks are introduced to the public market.

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STATUS QUO

An IPO lockup provision is a period of time when major shareholders are prohibited from selling stock. Major shareholders include insiders and early private investors. Common lockup periods in the US are typically between 90 to 180 days.

While a lockup provision is not a regulatory requirement, it is nearly always self-imposed by the company going public. The goal is to ensure that the newly issued stock can stabilize and arrive at an equilibrium level based on natural supply demand dynamics without the additional pressure from existing shareholders. This helps maintain the stock's upward momentum post IPO[1].

We investigated the common practice of releasing all locked-up shares in a single day and discovered a few shortcomings, including the aforementioned accumulation of short interest and excessive volatility. Thereby, we propose staggering unlock conditions as much as possible over various price levels and timeframes to minimize the impact of additional supply being released into the stock market.

SHORTCOMINGS OF THE CURRENT PRACTICE

The majority of current IPOs come with a 180-day lockup period for all pre-IPO investors. The advantages of single lockup expiry dates are simplicity, and that it is a customary practice. The most obvious shortcoming of the traditional 180-day lockup period is that the market anticipates the additional supply when the lockup expires. Data from Bloomberg demonstrates that for IPO lockups since 2010, average short interest gradually increases towards the lockup expiry date, and drops on the day after lockup expiry[2] (see Exhibit 1 below). Average short interest continues to decrease after the initial drop and stabilizes around 40 days after lockup expiry.

Exhibit 1: Average Short Interest Ratio Around Lockup Expiry Date

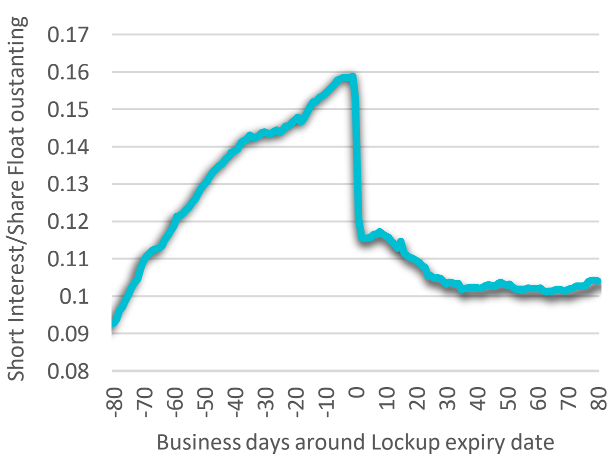
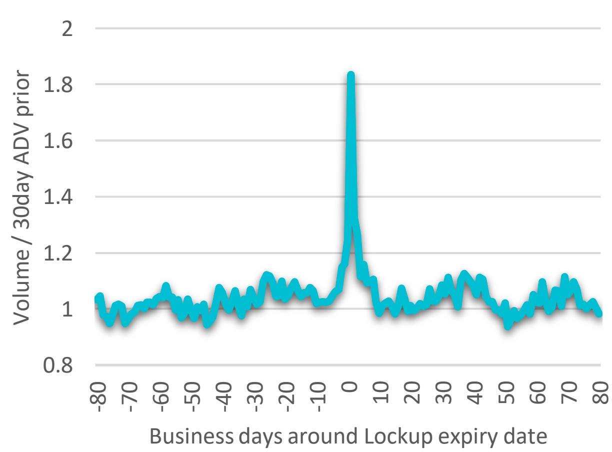


Exhibit 2: Average Volume Ratio Around Lockup Expiry Date



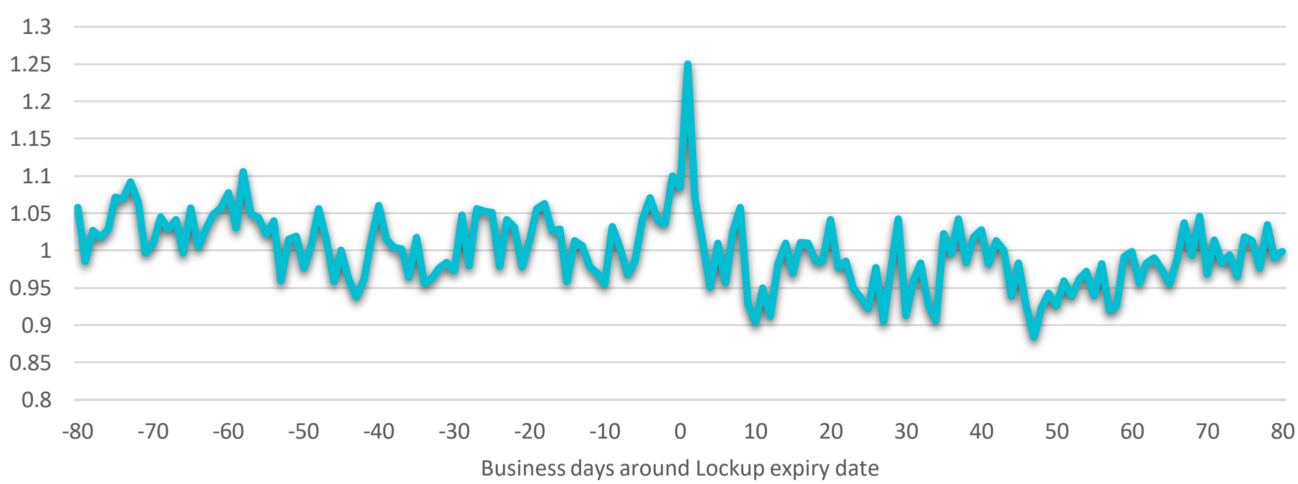
Source: CaaS Capital Management, Bloomberg, Capital Market Gateway.

[1] We have discussed the importance of positive returns for newly listed stocks in "First Day IPO Excess Return "Abnormality" in the US".
[2] The drastic drop of the average short interest over floating shares ratio is partly attributed to the increase in equity float, as blocks and follow-on offerings tend to happen after the lockup expires.

In addition, volatility and volume also increase substantially around lockup expiry. This signifies that the market has been paying significant attention to the lockup expiry date. The dates of lockup expiry are known and tracked by market professionals and are available through certain third-party vendors. Average volume spikes on the day after lockup expiry (see Exhibit 2), indicating that substantial volume traded on the day after lockup expiry. Blocks or follow-on offerings are also more likely to happen during lockup expiry. Substantial volumes are likely to come from inventories that were previously unavailable in the market.

This excess volume leads to meaningful increases in price swings, and average realized volatility is more than 20% higher around lockup expiry (see Exhibit 3[3]). The increase in volatility is an unnecessary distraction for the company, and especially for employees who witness their net wealth greatly fluctuate.

Exhibit 3: Average Return Ratio Around Lockup Expiry Date



Source: CaaS Capital Management, Bloomberg, Capital Market Gateway.

Furthermore, as the market anticipates the increase in volatility and volume driven by unlocked shares, buyers are likely to hold off until the lockup expires. This will result in a lower price when insiders and investors are eventually able to monetize their investments. If the stock price falls significantly, the negative press could impose even longer lasting effects for the newly listed stocks.

To mitigate some of the volatility, investment banks sometimes arrange block trades for large buyers and sellers on the day after lockup expiry. These arrangements provide positive value to the current shareholders and potential sellers because all sellers will receive the same price in the process[4], and investors do not need to rush to sell before others. However, it can be argued that block trades arranged by investment banks favor large holders as they are able to sell stock before smaller private investors get a chance. Block trades marketed by investment banks are not always possible, especially for stocks with a diverse shareholder base.

[3] The y axis represents the absolute return on a single day divided by the average absolute return during the period.

[4] When there are multiple blocks across different banks, their prices tend to be similar to each other, if not the same.

CURRENT DEVELOPMENTS

We have seen lockup provisions evolving over time. Some corporations have incorporated additional conditions to allow early unlock for certain shareholders if stock prices meet certain pre-set targets. Others have implemented simple staggered unlock schedules. A few examples follow:

- Confluent Inc (CFLT) – 5% of stock unlocked on the first day of IPO. 50% of stock unlocked on the second day after the first earnings release post IPO and all remaining stock unlocked on the second day after the second earnings release[5].
- Coursera (COUR) – 25% of stock unlocked on the second day after the first earnings release post IPO, with closing prices being 33% above IPO price for any 10 days out of a consecutive 15-day prior period[6].
- On Holding AG (ONON) – 10% of shares unlocked on the third trading day following the first earnings release post IPO, with closing prices being 30% above IPO price for any 10 days out of a consecutive 15-day trading prior period. All remaining shares were unlocked on the third trading date following the second earnings release. The final unlock date will be between 160 and 180 days after IPO[7].

The majority of the early unlock provisions are centered around first earnings release dates post IPO and sometimes with closing prices above a certain percent of IPO level for a period. Staged unlock provisions allow a stock to build liquidity and coverage in the market without pressure from supply during the early days post IPO. At the same time, supply is gradually added to the market to match demand only if prices are at reasonable levels.

Admittedly, most modified IPO provisions were created in 2021 during a time of record issuance. During which time, sellers had more leverage in deal structuring when the demand was strong. The simplicity of a simple 180-day lock-up could be more important during times when capital is less readily available. Before a staggered unlock process can become the norm, active dialogue between issuers and investors, facilitated by the bookrunners, will be necessary. The importance of a banker with a good sense of market sentiment is self-evident, as they can add value in this process and design customized lock-up structures adapting to the company fundamentals and current environment.

NEXT GENERATION OF LOCKUP PROVISIONS

A lockup period of 180 days is a reasonable cooling-off period for the stock to find its natural supply and demand level. However this does not take into account the price levels. Stocks at 150% of IPO levels are more likely to absorb the additional supply than stocks at 50% of IPO levels. Also, 50-90% of a company potentially being for sale on a single day is an obvious target for short sellers given the publicly known lockup expiry dates and percentages. Modern lockup provisions should target multiple and independent unlock dates and price triggers to maintain the advantages of the cooling-off period, and at the same time avoid exposing the stock as a target for short sellers.

The ideal lockup provision is to release stock continuously. However, other regulatory requirements, such as earnings blackout periods, still prevent insiders and certain large holders from transacting. Hence, newer provisions often focus unlocks around post earnings releases. We believe in decoupling the requirement of price triggers from time-lapsed post IPO, i.e., unlocks automatically trigger for a certain percent of stock after the price

[5] Confluent Inc S-1/A dated June 16, 2021
[6] Coursera S-1/A dated March 22, 2021
[7] On Holding AG F-1/A Dated September 13, 2021

reaches certain levels regardless of time listed. If a stock can stabilize above a certain price level, there is no reason to restrict supply artificially when the market wants more shares at significantly higher prices. Exhibit 4 is an example lockup provision, combining price and time, that can gradually unlock the shares with minimal impact in the market.

Exhibit 4: Proposed Lockup Provision

Conditions	Percent of Total Pre-IPO Stock Unlocked
First closing price greater than 110% of IPO level	5%
Closing prices greater than 115% IPO price for 10 days or greater than 30 days after IPO	15%
Closing prices greater than 125% IPO price for 5 days or after first earning releases	35%
Closing prices greater than 150% IPO price for 5 days or after second earning releases	60%
Closing prices greater than 175% IPO price for 5 days or after third earning releases	85%
Closing prices greater than 200% IPO price for 5 days or after fourth earning releases	100%

The goal for a staggered unlock schedule based on price or time independently is to reduce the impact of a single unlock date that attracts too much attention from the market. Price triggers irrespective of time allow large shareholders to liquidate their holdings early if the stock performs well prior to an unlock date, provided that the company is not in an earnings blackout period. The proposed structure allows additional supplies of stock to enter the market gradually in a less predictable fashion while balancing the need for investors to liquidate holdings. The new structure potentially lengthen the lockup period beyond the standard 180 days if a stock does not perform as initially expected. This entices the investors to accept the new structure as the benefit is mutual

During the IPO lockup structure designing process, a knowledgeable investment banker can add significant value in determining the unlock conditions based on early investor feedback, e.g., dispersed price targets warrant wider price triggers. Stabilizing agents, often the lead bookrunners, can also manage the early liquidity with the unlock conditions in mind. Experienced bookrunners usually have expertise in estimating the optimal allocations to investors with various price targets and time horizons to allow for gradual increase in share supply according to lockup conditions. With the optimal combination of initial investors, issuing companies can maximize long-term shareholder value and liquidity post IPO.

CONCLUSION

We found that traditional lockup provisions with a single unlock date is suboptimal for companies due to increased short interest into the lockup expiry and excess volatility shortly after lockup expiry. We encourage executives to consider staggered IPO unlock schedules based on time and price levels independently. This will balance the need for insiders and early investors to reduce their holdings, while the gradual increase of liquidity in the market can maximize the market value of the stock post IPO.

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