WeWin: A failure of dual class shares in private markets

Due to his disproportionate supervoting shares, WeWork founder and ex-CEO Adam Neumann held de facto total control of the firm and so a significant payout was required to push him out.

For those incredulous over WeWork founder and ex-CEO Adam Neumann exiting with US$1.7 billion for his not-profitable office sub-letting company, I recommend the memoir Disrupted by Dan Lyons. Mr Lyons, who is a former Newsweek journalist, provides a first-hand account of working under start-up founders less concerned with their products, customers, vision and, God forbid, profitability, and much more concerned with how to market their firms to the highest bidder. The real currency in Silicon Valley is an ever-increasing company valuation and the game is to maximise this figure from private and eventually public investors. With the valuation of his firm dropping from US$47 billion to US$8 billion in a mere nine months while walking away a very wealthy man, Mr Neumann is possibly both the greatest and worst player of all time. However, from the position of corporate governance and investor protection, the WeWork initial public offering (IPO) debacle will live on as a cautionary tale.

Red flags from the start

WeWork is a provider of well appointed office spaces on a flexible basis with over 500 locations globally. Since the beginning of its IPO process there were clear red flags on corporate governance. These included unusual related party transactions from the US$6 million purchase of the trademark for the word “We” from a company controlled by Mr Neumann, to several leases signed at buildings owned by Mr Neumann.

The company also provided loans to the founder in order to buy these properties at favourable interest rates. Another concern was the archaic succession plan where in the event that Mr Neumann was unable to act as CEO, a two- or three-member committee headed by his wife would handpick the new CEO. While much was subsequently remedied, arguably the greatest concern was the outsized control that Mr Neumann was afforded.

The double-edged sword of dual class shares

The headline figure to pay off Mr Neumann – US$1.7 billion – seems extraordinarily high, yet this was the premium required from new owner SoftBank to seize control of WeWork. PHOTO: AFP

While dual class shares (DCS) structures are not uncommon among US tech IPOs, WeWork’s structure was extreme even compared to other famous listings that left founders with “only” 10 votes per share such as Facebook and Snap Inc. While there was a unique sunset mechanism linking WeWork’s supervoting shares to charitable giving, this is now defunct.

The typical argument for DCS is the benefit of a founder guiding a firm without external pressures especially during the early stage of public existence. WeWork proved to be an example of the exact opposite.

Public investors judged Mr Neumann to be detrimental to the future of WeWork, hence the DCS structure, rather than a mechanism to further corporate growth, became a major obstacle.

As disclosed in the S-1, major external investors in the firm held 165 million shares, compared to Mr Neumann’s 115 million shares with economic rights, a ratio that had been reduced from 115/15 to 7/93. While illiquidity will always remain a risk when earning equity at any privately held firm, the massive decline in valuation at WeWork is by no means normal. If the cadence of capital raises were better managed, this risk to employees’ shares could possibly have been mitigated. Whether SoftBank will be able to turn around WeWork and recapture value for employees remains to be seen, though given the massive amount of capital invested they should be well incentivised to do so.

Protecting investors at all stages of growth

The real currency in Silicon Valley is an ever-increasing company valuation and the game is to maximise this figure from private and eventually public investors, potentially providing better due diligence.

Similarly, once a firm has reached a stage where an IPO is viable, CFA Institute has argued that dual class shares are not preferred and should not exist indefinitely as detailed in the report “Dual Class Shares: The Good, the Bad, and the Ugly.” In this sense, WeWork perhaps represents the ugliest of the bunch.

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