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Investment Dealers' Digest

# IDD

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# The Floatation Equation

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Credit market  
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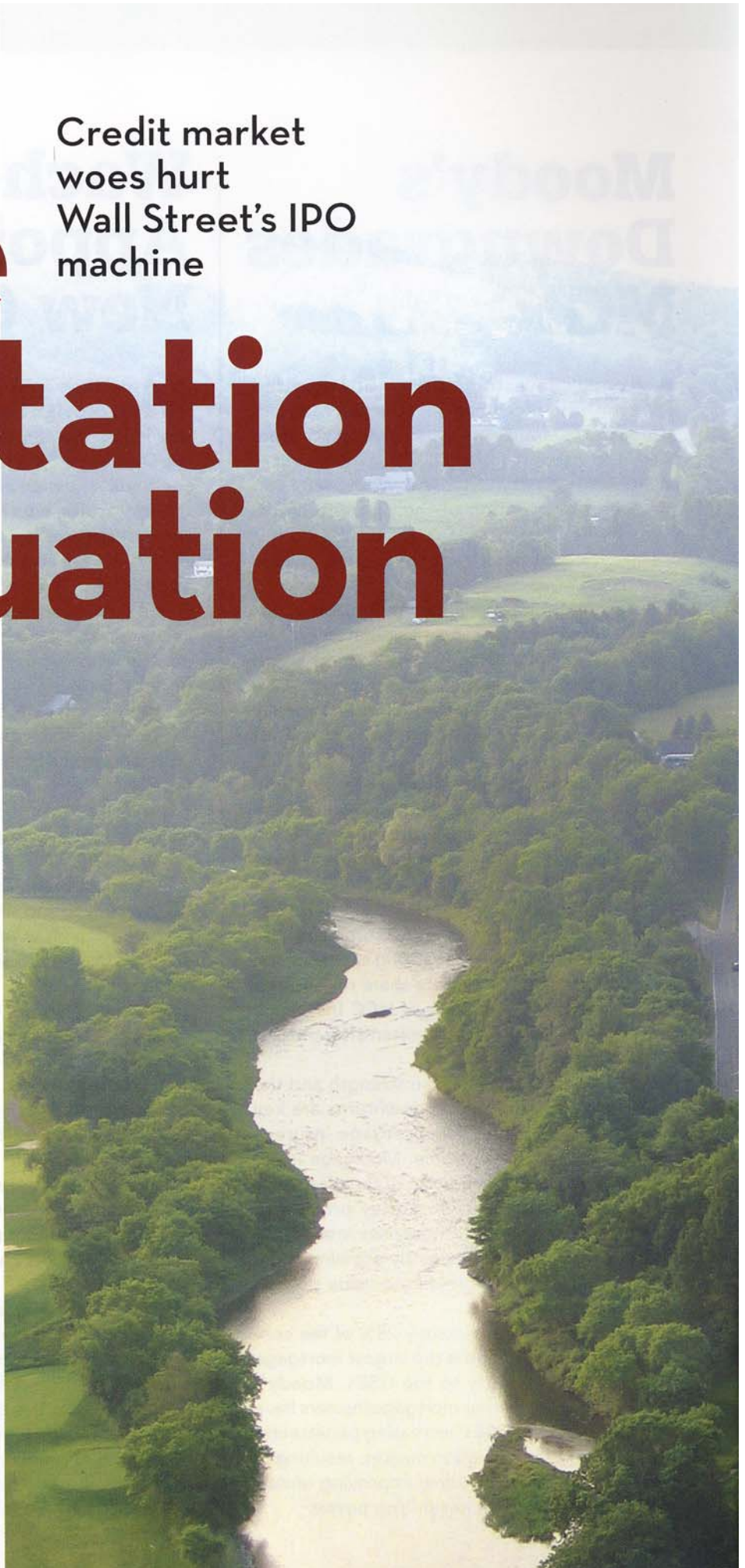
# The Floatation Equation

If the process of seeking out and seeding a young business is akin to a farmer raising crops and caring for them, then the trip to the public markets is a venture capitalist's own autumn harvest.

Some of the biggest names in US industry — many of them technology companies — have gotten their start with the help of venture capitalists who bank on taking a company public. The trip to the public markets is not only a way to get the investing public's imprimatur on a new business idea or technology. It allows a venture capital company to realize a profit that is passed on to its investors — public and private pension funds — and proceeds from the public offering are used to seed other young businesses.

These days, though, harvesting a young business has gotten tougher because of the credit market problems that started last summer within a subset of the US mortgage finance market. The number of companies taken to the public markets has dropped significantly. In the second quarter not one company was brought to the public markets by Wall

**By Aleksandrs Rozens**





Photography By Aleksandrs Rozens

## INITIAL PUBLIC OFFERINGS

Street brokerages that had been seeded by venture capitalists.

“The credit markets have wreaked havoc in the equity markets,” says **David Hermer**, head of the syndicate desk at **Credit Suisse**. As **Mark Hantho**, head of equity and equity-linked capital markets for **Deutsche Bank** in New York, sees it, “with the uncertain economic climate and volatility, many people that built great companies are saying ‘why don’t we delay to a time when markets are better?’”

**Tom Crotty**, whose Boston-based **Battery Ventures** has been backing startups since 1984, says “the environment could not be more hostile to IPOs right now. The reason is simple. The buying public — institutions and consumers — has no interest to take risk right now. There is not an appetite [for IPOs] and that is what led to a goose egg for Q2.”

### On Hold

**Dixon Doll**, co-founder of **DCM**, a Menlo Park, Calif., venture capital firm, has been busy seeding companies that eventually end up making their way to the public markets since the 1980s. His firm has built a portfolio of more than 80 companies. Many make it on to the Nasdaq or the NYSE — like **Clearwire** or **Neutral Tandem** — or they get snapped up by so-called strategic buyers, companies hungry for a new technology or business idea.

Doll and his partners back a business with as little as \$500,000 and make additional investments over several years in hopes of taking the company public through an initial public offering. It is a time intensive process because professionals like Doll and his partners work with each company to shape its business plan and oversee its day-to-day management.

But, problems that started within the US mortgage finance market last summer have spread like a prairie fire to various Wall Street business lines including those that sell stocks of new companies. Credit market woes have made it tougher for professionals like Doll and Crotty to take their companies public. Tumult in financial markets has eaten away at broadly watched equity indices. The result is that investors are re-

luctant about putting money to work in an uncertain economic environment.

Venture capitalists and Wall Street bankers who usher private companies to public markets have watched the Nasdaq composite index, which tracks 3,000 companies, slip to 2,294.44 last week from a 52-week high of 2,859.12.

The Russell 1000, meanwhile, was at 696.61 last week — off from a year's high of 858.63 and the Russell 3000 was at 741.03, down from a high of 914.03.

"We have a very skittish market. It is not conducive to getting new issues out," says Doll.

The low stock prices mean comps — comparable companies already public — have a low share price and this then means that young companies with an eye for the public markets have to set their sights lower. "You have to understand appetites of buyers and their willingness to participate in transactions," says Credit Suisse's Hermer. "You also need to enter the market with an appropriate valuation."

"I am not surprised there is a lot of gloom and doom out there when you see stock market indices move south sharply over a protracted period of time," says Hal Ritch, co-founder of banking boutique **Sagent Advisors**. "If you have a great company, why take it public right now?"

Within the pool of companies in his firm's portfolio Doll has two businesses — both profitable — that are ideal candidates for an IPO. He would not identify them by name but describes one as a network security business that competes globally and the other as a telecom equipment business with "well over a hundred million (dollars) in revenues."

Speaking of the network security business, Doll says that in the 1990s — a decade that saw companies like **Netscape** and **Amazon.com** go public — it would have easily gone public.

"We hope that when the market settles we will go public" with these companies, says Doll.

Like Doll, Crotty has companies that would be ideal for public markets, but

he and his colleagues at Battery Ventures are holding back. "What we have to do is be patient, build our businesses to a greater size and wait it out."

## US Economy Feels The Blowback

The drop in IPO issuance has ramifications for the broader US economy because some portion of the money to be raised in the going public process usually funds a business' expansion plans which could include hiring professionals. It also results in spending money on goods and services.

Companies that were once venture-backed but are now public accounted for 10.3 million jobs and 18% of US gross domestic product, according to a study last year by **Global Insight**, a forecasting company that examined 23,500 venture capital-backed companies. The study found that employment in venture-backed companies rose by 3.6% while national employment grew by 1.4% between 2003 and 2006. California, Texas, Pennsylvania, Massachusetts and Georgia were states where most of the job growth was seen.

"Getting these companies public and getting the capital raised is one of the ways to grow these companies faster. There is a broader impact to the economy," says Battery Ventures' Crotty.

"It [the drop in IPOs] limits expansion. There is no question about that," says **Chris Low**, chief economist at **FTN Financial**. "It amplifies the existing weakness in the economy. The crisis in the financial markets, including the lack of IPO activity, is one of many indicators consistent with a recession."

## Sugar Plum Dreams

The drop in new initial public offerings is just another source of fees for Wall Street that has been diminished dra-

matically by problems in financial markets that cropped up last summer. The storm seemed to abate late last year, only to bubble up in March when the Fed orchestrated a bailout of Bear Stearns. Wall Street has seen a sharp decline in its debt financings — particularly the mortgage backed securities market — and activity on the mergers and acquisitions arena has quieted. US equity market indices have been chipped away at by concerns about Wall Street banks and brokerages as well as worries about the broader US economy and inflation.

Just how many companies were brought to public markets this year? Twenty-four businesses with proceeds of \$25 billion. Take out the behemoth **Visa** IPO and that is just under \$6 billion worth of proceeds. In the first half of 2007 Wall Street dealer firms completed 103 initial public offerings worth in aggregate \$24 billion, according to **Thomson Reuters**.

Businesses that came to market in the first half of this year include Oklahoma's **Williams Pipeline Partners** — a \$325 million dollar deal — Florida's **Mako Surgical Corp.** which brought in \$51 million and **Verso Paper Corp.**'s \$168 million IPO. The industry segments with the most IPO activity were oil and gas as well as natural resources. Credit Suisse's Hermer believes renewable energy companies — wind and solar power — will be embraced by IPO investors in coming quarters.

The slowdown in IPOs of venture capital-backed companies was also evident in the first three months of the year. A mere five companies seeded by venture capitalists were harvested in the IPO market. The absence of any venture capital backed deals in the second quarter was something not seen by the industry since 1978.

Things may not get any better in the second half of 2008.



Fried Frank's  
Valerie Jacob:  
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A survey of venture capital professionals surveyed by the industry's trade group, the **National Venture Capital Association**, found that some 80% of venture capitalists do not expect the IPO market to improve this year.

"There aren't as many people prepared to use the public markets as an exit strategy," says **Valerie Jacob**, founder of the capital markets group at **Fried, Frank, Harris, Shriver & Jacobson** and co-managing partner of the firm where she advises companies and firms underwriting the public offerings. Jacob adds that managers of private companies and venture capitalists are increasingly employing a strategy that considers selling a business via an IPO while at the same time gauging interest from other companies through a merger or acquisition. "They are going on a dual track," she says.

This year, there have been 120 mergers and acquisitions worth nearly \$6 billion orchestrated by venture capitalists, according to the NVCA. Last year, the first two quarters saw 169 mergers and acquisitions worth just over \$8 billion.

Battery Ventures' Crotty says managers of one of his portfolio companies — he declined to name the firm or describe its business — have decided to forgo the public market. This business, which posted \$100 million in annual revenues, has three bidders. "Management wanted to take it public, but given the depressed state of the stock market they concluded they would rather sell the company," says Crotty.

Looking ahead, Crotty believes that "M&A will be a bigger piece of the exit pie for us than IPOs."

For some the harvest of an investment in a company through M&A is nothing new.

Consider the case of **Alan Patricof**, a well-known figure in the venture capital world who has backed companies such as **America Online**, **Apple Computer**, and **Office Depot**. Patricof founded **Patricof & Co Ventures Inc.**, predecessor to **Apax Partners**. These days he is founder and managing director of **Greycroft Partners**. As he sees it, "IPOs are not a factor

today. When we make an investment we are totally focused on who would be a buyer. Our computations consider who would be the other buyer."

Many of the buyers are large corporations looking to augment their business with a new technology or business idea. DCM, for example, backed **About.com**, which was sold to **The New York Times Co.**

Patricof says gone are the days when "we could go public without a long history of sales and earnings. We had expectations — dreams of sugar plums — of taking a company public with no revenues or modest revenues. I saw it after the dotcom bubble and now it's very apparent."

### Change in Revenues

Venture capital in some form or another has been around since the birth of the United States, but the more formalized seeding of companies as we know it today began in the wake of the Second World War with the encouragement of the Boston Federal Reserve president and a Harvard professor, **Georges Doriot**. Their objective, according to a Fed study, was to "devise a private sector solution to the lack of financing for new enterprises and small businesses." The industry blossomed after changes in legislation allowed pension funds to invest in the venture capital funds in the early 1980s.

Initially, smaller companies — in terms of revenues they generate and profits they earn — could be taken to the public markets. Some companies embraced in the public markets were an earnings quarter away from profit. These days, the business being taken public had better have \$100 million to \$200 million in revenues. To get to this point it takes longer to grow a business. Battery Ventures' Crotty says these days it takes eight to nine years to get a com-

pany ready for the public markets, up from five or six years in the late 1990s. "This has implications for returns and investors, private and public pension funds," says Crotty, adding "they need a certain level of returns to fully fund their pensions. If they don't get the returns, the system gets gummed up."

Expectations of selling a business to a strategic buyer are driven, in part, by the change in how the public market views young companies. Most of the companies in Battery Ventures' portfolio today would not readily be accepted by public markets because they are too small.

"We used to take companies public at a \$75 million revenue level," says Crotty. But, "now it has to be at least \$125 million to \$150 million in revenues."

### Sarbanes Oxley

When lawmakers unveiled the Sarbanes-Oxley Act of 2002 the legislation was hailed as a way to protect investors by improving the accuracy and reliability of corporate disclosures and the legislation aimed to "deter and punish corporate and accounting fraud and corruption, ensure justice for wrongdoers, and protect the interests of workers and shareholders."

However, many venture capitalists today bristle at how much their expenses have jumped when it comes to adhering to regulations brought about by Sarbanes-Oxley. While no one really wants to do away with the regulations they point out that upstart businesses face high costs of adhering to regulations. For example, a component of Sarbanes

Oxley, known as 404 compliance, has become time consuming and costly for young companies that go public on US exchanges.

"For small companies there is no allowance for a difference in the size of a business. GE has to do what the little company has to do. The problem is that



the costs from this has a bigger impact on a smaller company," says Crotty. "There is value in the concept of 404 and the discipline it enforces on companies. The problem is it is applied in the same way no matter what scale of business is. It needs to be right-sized. We need some kind of relief or changes in compliance so it is not as costly."

Crotty estimates that meeting the requirements of rules such as 404 compliance can take away three to four cents a share in quarterly earnings. That, he says, translates into millions of dollars.

"We have portfolio companies that, in any other environment, would be public now. They are saddled with a bewildering array of accounting requirements," says DCM's Doll.

In their survey of the venture capital world, the industry's trade group found that over half of 660 venture capital professionals quizzed on market conditions believe Sarbanes Oxley regulations are behind the drought in new issuance.

Not only do the regulations slow down the process of bringing a company public, they prompt some venture capitalists to float their companies overseas. Battery Ventures has in its folio of young companies a communications equipment company that boasts \$150 million in revenues. The company has hopes of going public on Bombay's bourse.

"That is a business we would have taken public on the Nasdaq four or five years ago," says Crotty.

According to Doll, "there is a general negative psychology about young companies going public. If you are a new company about to go public, you have a massive amount of bureaucracy and red tape and compliance costs that come about as a result of Sarbanes Oxley."

Market conditions and that red tape associated with the regulatory

steeple chase may be why in June 42 venture backed businesses had filed for IPOs with the Securities and Exchange Commission - down 40% from a three-year high of 72 companies in the third quarter of last year.

## Changes in Market Topography

Looking back at their decades of work building young companies, venture capitalists like Doll and Patricof lament the loss of small investment banks that not only embraced the idea of taking small companies public, they supported the secondary market of shares in these young businesses.

These companies included in their ranks firms such as **Alex Brown, Hambrecht & Quist, Montgomery Securities** as well as **Robertson Stephens**. Many of these

firms merged or were acquired by larger companies. Doll

recalls these firms fondly, referring to them as "the four horsemen" that could deliver young businesses to the public markets. He describes them as an important component of the venture capital industry's ecosystem.

"They had dedicated research [professionals] whose job was to focus entirely on emerging market companies,"

says Doll. "They would court them and be ready to write coverage on them, if and when they went public."

For many firms today the fees generated from a small IPO are not enough to cover the cost of time and effort put into the process of taking a business public.

In the second quarter, for example, there were only two companies with a \$5 million to \$6 million IPO - an offering for **Healthy Fast Foods Inc** and an issue for **Bioheart Inc.** - while most deals were over \$20 million.

Look back to late 1996, the eve of the dotcom era, and you will find plenty of IPOs under \$20 million.

## This is Not 2002

While the pace of new issues has dropped off substantially this year, market participants say the current environment feels better than what it was in 2002 after the dotcom bubble burst.

"The big difference between now and 2002 is that in 2002 the industry shut down," says Doll. "There was very little new money [being invested] and very little new company formation."

The poor market conditions and changes in the venture capital world mean that venture funds will put in more time and money into their portfolio companies. In some cases hedge fund managers such as **The DE Shaw Group** have set up special groups of professionals to finance young companies. "Some hedge funds have set up operations focused on providing venture debt. Hedge funds are one of the new buckets," says Doll, adding that "sovereign wealth funds are putting their toe in via PE funds."

Also, Doll says he takes heart in the fact that owners of start up companies can cash in on their investment by selling their business to another fund manager or a strategic buyer. "We have a better M&A environment than back then. M&A's are reasonably frequent."

Looking ahead, syndicate desk officials like Deutsche's Hantho and Credit Suisse's Hermer believe IPO activity for Wall Street firms will pick up in coming quarters.

"We're going through a natural outcome of a very uncertain time. These times will pass," says Hantho. "Our hope is that we'll see more issuance take place in the IPO market in the fourth quarter. It won't kick off a huge torrent of IPOs. It'll be more established companies rather than young growth businesses."

DCM's co-founder warns though that Wall Street's IPO machine has to get back on track soon. "In order for the venture capital industry to return to its vibrant state we need a healthy IPO market." **IDD**

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