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TECHNOLOGY ANALYSIS FOR BUSINESS & INVESTMENT

Thought Leader Interview

**David Marcus and James Donohue,
Managing Directors, WR Hambrecht & Co**

with Stephen Waite, June 9, 2010

In this Thought Leader Interview, we sit down with David Marcus and James Donohue of WR Hambrecht to talk about Initial Public Offerings (IPOs) and their OpenIPO process which incorporates a Dutch-auction pricing and allocation model. In the interview, David and Jim share their thoughts about the current state of the IPO market and future prospects for IPOs using the OpenIPO process. Some of the key points to emerge from the interview include:

- The IPO market has rebounded this year, but it will take a more stable global economy and a couple of large, high-profile deals to bring the market back to its glory days.
- The WRH+Co OpenIPO process is the “Linux” or “Open Source” of the IPO market. It aligns the interests of all parties involved with an IPO and creates a win-win deal.
- The Google IPO was a big success and put WRH+Co on the map with its auction-based IPO process. The OpenIPO process seems ideally suited to social networking companies such as Facebook, LinkedIn and Twitter who are seeking to go public.
- Traditional IPOs typically have higher returns over a 3-to-6 month period, but auction-based IPOs perform as well or better from 6 months and beyond.
- WRH+Co is exploring ways of making the IPO process more efficient than it is today. They are also looking at using the auction model to facilitate private capital raises.

We hope you enjoy this interview with David and Jim and their perspective on the IPO market and their auction-based OpenIPO process.

SW: Thanks for taking time to speak with us today, David and Jim. We're seeing a pick-up in IPOs. What's your perspective on activity in the IPO market so far this year, particularly with respect to the technology sector?

WRH+Co: Hi Steve, it's great to be with you. This has certainly been an interesting year so far. IPO activity, including tech, has been way up over the previous year, which, of course, is great news. The backlog of deals coming to market has been growing as companies have been unable to raise capital in the public markets over the past 2 years due to the financial crisis. However, the improved IPO market of the past 5 months has come in fits and starts due to investor jitters caused in part by continued uncertainty over the state of the global economy.

SW: How have the dislocations on Wall Street and new regulations affected the IPO business?

WRH+Co: The IPO market is driven by investor demand and there has been very little appetite for new issues during the credit crisis. What the market needs now is a sustained period of positive economic news and one or two high profile deals that will, in essence, unlock the market. And there are certainly some very good candidates out there!

We also think that the dislocation you refer to has shaken issuers' confidence in Wall Street. We have seen in stark fashion that situations can arise where the interests of investors, issuers and bankers don't align in the ways that one might think they should. From our perspective, issuers are growing increasingly concerned that underwriters serve their interest when taking them public. This is not always so easy to ensure when many underwriters' most important clients are its large trading partners, the hedge funds and mutual funds. For WRH+Co, the issuer is the sole client and the auction's market-based pricing model removes any and all opportunity for prejudicial results.

SW: Yes, let's talk about your innovative IPO process. It is based on a Dutch-auction model. Tell us about the WRH+Co Open IPO model and how it differs from a conventional IPO.

WRH+Co: The primary differences between an auction IPO and a traditional IPO revolve around pricing and allocation of shares. In many respects the two methods are more similar than most people realize. For example, auction issuers file a prospectus (S-1) with the SEC and deals are marketed via a roadshow to institutional and retail investors. However, the elements that are different in an auction deal—pricing and allocation of shares—are very different. In an auction the market—and by market we mean all those who place a bid—determines the price. Further, all those who place successful bids receive shares at a uniform, market-based price. Basically, our process aggregates demand from the broadest possible market in order to identify the highest, uniform price at which all the shares can be sold.

In a traditional IPO the investment bankers who are acting in the capacity of lead manager and bookrunner determine the IPOs offer price and the allocation of the shares. Another difference is that bidders must give a price and number of shares and, of course, they may tier their bids, thereby expressing specific levels of appetite at varying price points. Traditional IPOs work off of IOIs, or indications of interest, whereby an investor tells the banker the percentage of the deal he would like to own. As the name suggests, IOIs are not firm commitments and, in 'hot' deals, investors usually ask for large multiples of what they really want, knowing they will be lucky to get a fraction of that.

SW: Take us through the dynamics of an OpenIPO process and give us some insight on the merits of doing an IPO using a Dutch-auction model.

WRH+Co: The auction itself is usually open—meaning that people can place bids—for two to two and a half weeks. It opens on the first day of the marketing period (roadshow) and closes within a couple of days of the end of the marketing period. Bids can be submitted either to us or syndicate members, over the phone, or via the Internet. All bids are placed in a virtual stack from highest to lowest price. At the conclusion of the marketing period, we count down from the highest price bid, calculating cumulative demand at each price point, until we reach the highest price at which all the shares are can be sold. This price is called the “clearing price.” However, it is generally the case that once we reach a clearing price, there is demand for more shares than can actually be sold. In that case, in order to ensure every investor is treated equally, all successful bidders, i.e., investors who submitted bids at or above the clearing price, are allocated shares in the same pro-rata percentage and at the same price.

The issuer also has the option to sell the shares either at the clearing price or at a discount to the clearing price. A typical reason for taking a discount to the clearing price is to bring in an investor who bid at a lower price. Once the offering price is set, anyone and everyone who bid at or above that price receives shares at that price on a uniform pro-rata basis.

As I hope you can see, everything about the auction is structured to promote openness and efficiency and geared to get the highest price for the issuer while simultaneously granting the fairest access to all interested investors. Because there is no deep discounting of the offer price, there is no “pop” in the immediate aftermarket. This discourages “flippers” and encourages longer-term investors, those who really want to own the stock.

SW: We read a Harvard Business Review article recently written by Eric Schmidt that discussed the Google IPO, which you guys helped bring to market. Eric said if he could do it all over again, he would employ the Dutch-auction process again. It sounds like he is a satisfied customer. Looking back, what's your impression of the Google IPO experience?

WRH+Co: The Google IPO was amazing for us because it put the auction and WRH+Co on the map. We believe the IPO was also a success for Google because it launched them on their public path with a mechanism that gave their entire affinity base (customer, users, fans, etc.) access to the transaction. In some ways, that was the most defining “moment” of the IPO. We would argue that never before in the history of Wall Street was such an offering truly made available to the users that had helped make the company a success in the first place. The Google IPO proved two of our most important beliefs: 1) that the market can price a deal better than any capital markets officer ever could and 2) that enabling retail participation in an IPO can deliver some great financial and marketing results.

SW: What other companies have used a Dutch auction and what does their experience teach us about the benefits of using the Dutch-auction model for an IPO?

WRH+Co: Over the last 10 years we have led or co-led auctions for companies of all sizes and types: retailers: Ravenswood Winery (\$12mm), Peet's Coffee (\$30mm), biotech: New River Pharmaceuticals (\$33mm), financial services: Morningstar (\$162mm) and Interactive Brokers Group (\$1.2bn), technology / internet: Rackspace (\$187mm), NetSuite (\$185mm), cleantech: Clean Energy Fuels (\$138mm).

What we have learned is that the auction almost always finds a price and, as a result, we have had to ‘pull’ very few deals. That is a very powerful message to potential issuers, particularly in difficult markets.

SW: When you do a post mortem on deals that have come to market using OpenIPO, what do you find in terms of share price performance and turnover 6-to-12 months out versus a conventional IPO?

WRH+Co: There is no question that traditional IPOs fair better on the first trading day up to 3 to 6 months. This is due entirely to the discount / pop. However, from 6 months and beyond auctions perform as well or better than traditional deals. We say this is part of a self fulfilling prophecy as the best companies chose the auction!

SW: Are there any other interesting differences that would suggest the OpenIPO model is more efficient than a conventional IPO?

WRH+Co: We believe that the auction does a much better job of getting IPO stock into the right hands. We do this by marketing to a much broader audience and by letting the market price the deal. To put some numbers around this concept, in a ‘hot’ deal typical first-day turnover is 2 to 4 times the number of shares issued. So if a deal has one million shares placed, 2 to 4 million shares will trade / change hands that first day. In other words, the people who were rewarded with shares by the investment bank have sold it, and the people they sold it to have sold it as well. In a “hot” OpenIPO auction the typical first-day turnover is less than 1.

SW: It would seem to me that the OpenIPO is ideally suited to social networking companies like Facebook, LinkedIn and Twitter. Users and fans could participate in the Dutch-auction and become owners. Does that jibe with your thinking?

WRH+Co: We are in complete agreement on this point. Nothing is more important to most companies than their customers, users and fans. This is absolutely true for social networking companies; the customers “are” the company. The auction is the only IPO method that ensures equal access for all investors. An individual Facebook user would have almost zero chance of participating in a traditional IPO led by a bulge-bracket bank. The auction, however, allows anybody to bid. This puts Joe and Mary Public on a level playing field with Fidelity and T Rowe Price.

One of the main reasons that Google chose the auction was so that it could offer the deal to its customers. Or, to put it another way, they didn’t want to offer stock in a way that *excluded* their customers from participating. We think the social media companies should and will have the same sentiments.

SW: What are your thoughts about employing the Dutch-auction model to raise private equity?

WRH+Co: We’ve had a large number of requests over the past several years to use the auction for private raises. Up until now we have resisted on the basis that our focus is the public equity market. Further, what makes an auction successful is having many parties bidding. Typically, private raises have only a few investors. However, with the proliferation—or maybe I should say the promise—of electronic distribution, via social media companies in particular, we believe the auction could be used to great effect for private capital raises. And, to that end, we are currently working on that product offering.

SW: Are there any future innovations you see for the WR Hambrecht OpenIPO model?

WRH+Co: We have always striven to make the IPO process more efficient. Our view is that the best way to do this is to put tools and processes in place and then step aside and let the market do its job. A very exciting evolution of our model is letting issuers, ones with a certain ‘star appeal’ and sufficient capital, lead their own auctions with WRH+Co as the Auction Manager / Auction Advisor. We believe that some of the social media / gaming companies are perfect candidates for this. As auction manager we will do 80% of what a lead manager typically does but for 20% of the price. In our business this is the Holy Grail of IPO disruption and innovation.

SW: What other services does WR Hambrecht provide for companies today?

WRH+Co: Besides initial public offerings we have two products for raising follow on capital. The two products are at opposite ends of the spectrum from a marketing perspective. OpenFollowOn is a “fully marketed” transaction. This product is designed for an issuer who wants to raise a specific, discrete amount in a single capital raise. The issuer files a prospectus under form S-3 with the SEC and uses a roadshow to market the deal to investors. After the market close on the final day of the roadshow, the auction opens for 30 minutes to an hour; the time is specified in the prospectus. All interested investors must place firm bids during that period. At the conclusion of the auction a clearing price is established and stock is allocated on a uniform pro rata basis.

At the other end of the spectrum is the E-ATM, or electronic at-the-market transaction. An E-ATM is used by an issuer who is trying to raise capital without signaling its intentions to the market. This is a great tool for an issuer who wants to raise a certain amount of capital over an extended period of time (as a general rule a company can sell up to 20% of the average daily trading volume of its stock) and, therefore, doesn’t want to do anything that will negatively affect its stock price. If an issuer already has a ‘shelf’ on file all they need to do is file a Prospectus Supplement (which is quite short and sweet) and execute a stock sale Agreement with us. The way I would think about an E-ATM is that you are looking to sell into naturally occurring liquidity in your shares: e.g. you are simply satisfying market demand for your own shares.

SW: One last question, David and Jim. In all the years you guys have been doing deals, what are the most important lessons you have learned that you would share with CEOs looking to go public through an IPO?

WRH+Co: Taking a company public is one of the most important undertakings of a CEO’s career. It is imperative that he surrounds himself/herself and his team with professionals—lawyers, accountants and bankers—who will always represent his interests. As we discussed earlier, there can be serious conflicts of interest for banks that maintain large trading and prime brokerage operations catering to mutual fund and hedge fund clients. These banks generate significant commissions from their top trading accounts throughout the year. It is very common for banks to heavily discount a company’s IPOs in order to reward their top trading accounts with underpriced stock. For this reason a CEO must ask the question: Who is really the bank’s key client, me or their trading clients?

SW: Thanks again for your time. I really enjoyed speaking with you and wish WR Hambrecht all the best in the future.

About David Marcus and James Donohue:

David Marcus

David is a Managing Director and Head of Distribution at WR Hambrecht + Co. Prior to Hambrecht, David was a Senior Vice President in the Asset Management group at Lehman Brothers, where he led alternative asset distribution. Prior to Lehman Brothers David was Founder and Head of Sales & Business Development for WorldStreet Corporation, a CRM and peer-communication platform for the financial services industry. Named by InfoWorld Magazine as one of the 25 most innovative companies of 2001, WorldStreet was acquired by Thomson Financial in 2002. Prior to WorldStreet David was a Vice President in the equity capital markets group at ING Barings and before that he was an Assistant Vice President in the equity capital markets group at Bankers Trust Company. David holds a B.A. in Political Science from Boston University.

James Donohue

Jim is a Managing Director and Head of the investment banking group at WR Hambrecht+Co. Prior to joining WRH+Co, Jim was a member of SoundView Technology Group's Investment Banking Group, where he focused primarily on the software and telecommunications industry sectors. Prior to joining SoundView, Jim worked in a variety of operations and technology related positions at Chase Manhattan Bank. Jim holds a B.A. in International Affairs from Georgetown University and an M.B.A. from the Stern School of Business, New York University.

For more information about WR Hambrecht, go to: <http://www.wrhambrecht.com/>. We also encourage interested readers to check out Vinnie Mirchandani's book, [The New Polymath](#). There's a chapter on Hambrecht as well as chapters on Zach Nelson and his company Netsuite, which WRH+Co took public in 2007, Cognizant, GE and Plantronics.

Previous Thought Leaders:

Think Twice: An Interview with Michael Mauboussin, Chief Investment Officer, Legg Mason Capital Management (November 2009).

Into the Multiverse: An Interview with Corey Bridges, Co-founder, The Multiverse Network (December 2009).

2D-3D: An Interview with Craig Summers, Founder and CEO, 2D-3D Video Inc. (January 2010).

Global Solar Technology: An Interview with Dr. Alan Rae, Technical Director (February 2010).

China: An Interview with Arthur Kroeber, Founder, Dragonomics Research and Advisory (March 2010).

Web 3D: An Interview with Anita Havele, Executive Director, Web 3D Consortium (April 2010).

3D Technology: An Interview with Ami Dror, Co-founder and Chief Strategy Officer, XpanD (May 2010).