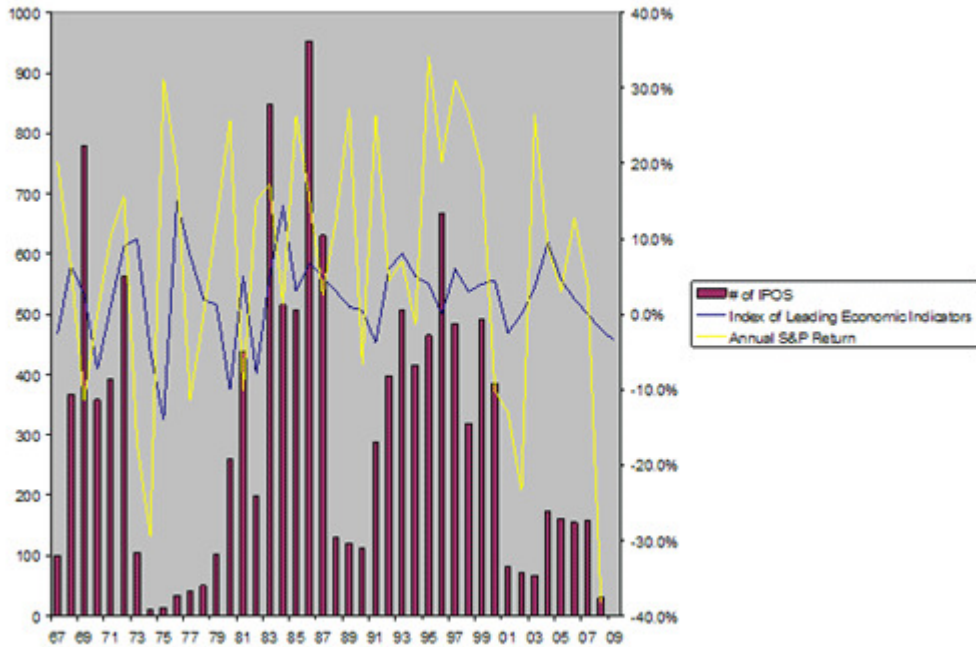


The Return of the IPO Market: What History Tells Us

The bleak 2008 IPO market included a number of historical low points for new equity issuance. According to Professor Jay Ritter of the University of Florida, only 17 operating companies in the US went public last year, and the nearly three month hiatus for IPOs in the second half of the year was the longest drought since the early 1970s. The equity capital markets are clearly not receptive to new issues at this point, but that has not stopped the pipeline of IPO companies from growing. According to Renaissance Capital, over 200 companies have current IPO filings with the SEC, and presumably, when the market for new issues returns, the supply of deals will be available and ready to go. Whether that date is around the corner or down the road a piece has more to do with the immediate financial crises than the quality or quantity of the backlog, as the appetite of risk capital is the critical element of the IPO market that is lacking at this point. We must assume that when the broader markets stabilize and the historic amount of stimulus being injected into our financial system begins to take effect, the logjam will be cracked. What may be interesting to note is what history may tell us about the market for new issues as we emerge from a significant dislocation like the one in which we find ourselves.

Until the institutional trading desks on Wall Street crawl out of their bomb shelters and begin to entertain the idea of moving their field of vision beyond the latest financial disaster that has shaken their traditional foundations, the IPO market will limp along slowly. At some point, however, the process of putting capital to work will begin, and money will begin to flow to the new issue market. We can look at the recession of 1982-83 for an interesting historical parallel, a recession in which initial jobless claims rose to a level (650K) that had not been seen in the post war period and has only recently been revisited. IPO issuance dropped dramatically. Although equity prices began to rise as we exited the deep recession, the IPO market lagged the market recovery. The key year for IPO issuance for bellwether technology companies did not occur until 1986, a year in which a number of pioneering Silicon Valley companies debuted to what we can only describe as a muted response, although the valuations and aftermarket performance of the "Class of 1986" provides an interesting blueprint for what we should expect of the next group of companies that will emerge from the current miasma in the markets.

A graph comparing the number of IPOs, the annual return of the S&P 500 and the value of the Index of Leading Economic Indicators illustrate that the IPO market tends to ebb and flow with the economy, and serves to validate strong movements in equity prices. What the chart does not show is that the relative valuations of the deals that are completed also reflect the broader realities of the equity markets, and that the valuations that can be expected as we emerge from broad recessions like the 1982-83 period will comply with overall lowered expectations from equity investors. Professor Alan Sinai has concluded that our current economic crisis represents the most severe recessionary period since the 1930s, with a longer, deeper and more severe impact than any crisis we've faced since that time. The transition from recession to recovery is underway, though, according to Dr. Sinai, and he identifies the recent rally as the beginning of the next bull rally. While he points out that this bull market will not be a strong one, he does not see us testing the recent lows and has tactically raised his target equity exposure from a low of 35% to 60%. Companies that hope to go public and the investors who participate in those deals should recognize that the profile of the IPOs that do get done as we exit this crisis will reflect that reality. The 1986 IPO class neatly illustrates this fact.



Professor Ritter has compiled metrics on the relative valuations of the ten companies that make up the “Class of 1986”, and they are included here. (For similar information on all 384 companies that debuted in that year, visit Professor Ritter’s website, <http://bear.cba.ufl.edu/ritter/>). We begin with the valuation of the companies at the time of their IPOs:

Name	P/E	EPS12	SALES	ASSETS	MV/Assets	MV/Sales
Harman International	9.4	1.59	253.3	165.8	0.76	0.5
EMC	28.9	0.57	33.4	22.7	10.48	7.12
SunGard Data Systems	21.6	0.51	58.6	33.8	2.40	1.37
Linear Technology	200	0.04	20.2	21.5	5.97	6.35
Oracle Systems	65.2	0.23	32.5	23.8	8.31	6.09
Silicon Graphics	125	0.09	41.5	29.1	4.62	3.24
FiServ	---	-0.25	69.8	52.4	1.64	1.23
Sun Microsystems	48.5	0.33	147.1	93.7	4.63	2.95
Microsoft	15.8	1.33	162.6	94.4	5.68	3.3
Adobe Systems	21.6	0.51	9.5	9.3	6.00	5.88

While the valuation multiples show some variation, overall they were priced modestly compared to the bubble valuations of fast growing (and unprofitable) tech companies that followed in the 1999-2000 era. These companies were operating profitably, and in the chart below, if we look at the amount of money raised in their offerings and the modest first day returns, we get a sense of how different the muted IPO market of the mid eighties was versus the bubble market that followed a decade later. What really stand out are the incredible five year returns of this particular group of companies, which are listed in the last column below. Even today, after the meltdown in the markets, the combined market capitalization of the publicly traded companies in this group is north of \$300 billion. Professor Ritter concludes: “Almost all of these companies were pretty successful companies at the time that they went public. The valuations, given the more conservative multiples that existed in 1986 (and exist again today), reflected some expected growth, but were not pie-in-the-sky numbers as in 1999-2000.”

Name	First Day Return	PROCEEDS	Market Value	Buy and Hold Five Year Return
Harman International	-1.6667	34.6	125.58	-46.61
EMC	-7.5758	41.3	237.848	13.115
SunGard Data Systems	9.0909	25.5	80.212	14.583
Linear Technology	9.375	21.2	128.33	153.521
Oracle Systems	36.6667	31.5	197.84	234.545
Silicon Graphics	11.1111	20.3	134.56	234.653
FiServ	0	16.3	85.86362	283.168
Sun Microsystems	-1.5625	64	433.73	304.743
Microsoft	33.3333	58.7	535.899	1335.71
Adobe Systems	22.7273	5.5	55.847	1648.47

What conclusions can we draw from the 1986 bumper crop? For companies and the venture firms that back them, the lessons are sobering but clear. Valuations of new issue companies will need to be discounted in order to get deals done in the public markets, and the multiples that were justifiable in 2004-2006 are for now a thing of the past. The lag between the recovery in the broader markets and the return of a vibrant IPO market as illustrated by the class of 1986 may have more to do with the venture community's reluctance to accept the lower valuations that a discerning market will place upon their companies, but eventually even the reluctant VC community will come to realize that the path to liquidity is through the public markets, and that expectations must be adjusted to reflect that reality. The recent recommendations of the National Venture Capital Association to "restore liquidity in the U.S venture capital community" (visit nvca.org) strike us as an understandable attempt to recreate the bubble valuations of the past decade through legislation and tax incentives rather than a genuine assessment of the existing market environment and an adjustment of expectations and tactical strategy to reflect the altered market as it exists today.

More importantly, some venture capitalists have concluded that the practice of selling their holdings in the IPO should be reconsidered in light of the readjusted valuations and the successful long-term track records of the companies that are strong enough to get to market. Not only will the market refuse to accept deals that represent insiders cashing out of a long standing investment, VCs and their limited partners should look at history and hopefully conclude that if the market is willing to price their deals, they are better served holding on to their investments for the long run as some of the most successful venture capitalists have done. We of course feel strongly that the use of an impartial and unbiased auction in the pricing of these deals is a significant improvement on the arbitrary pricing that the traditional Wall Street investment banks use, and would fully expect that the price discovery that emerges from the OpenIPO process will reflect the adjusted valuation expectations that exist in the investing community.

It is undeniable that the IPOs that will be priced over the next cycle will have to have extremely compelling stories, strong operating results, or both. This should be a positive development for early stage investors going forward, as the market will prove to be a discerning quality filter and a stern regulator of valuations as the IPO calendar recovers. For investors, history surely shows that after a prolonged drought in the new issue market, the opportunity is to buy and hold the quality companies that are able to go public at what assuredly will be attractive valuations overall.

*http://www.wrhambrecht.com/pdf/what_history_tells_us.pdf

Best regards,



Matthew Regan

Director of Brokerage Services

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