Re-energizing the IPO Market

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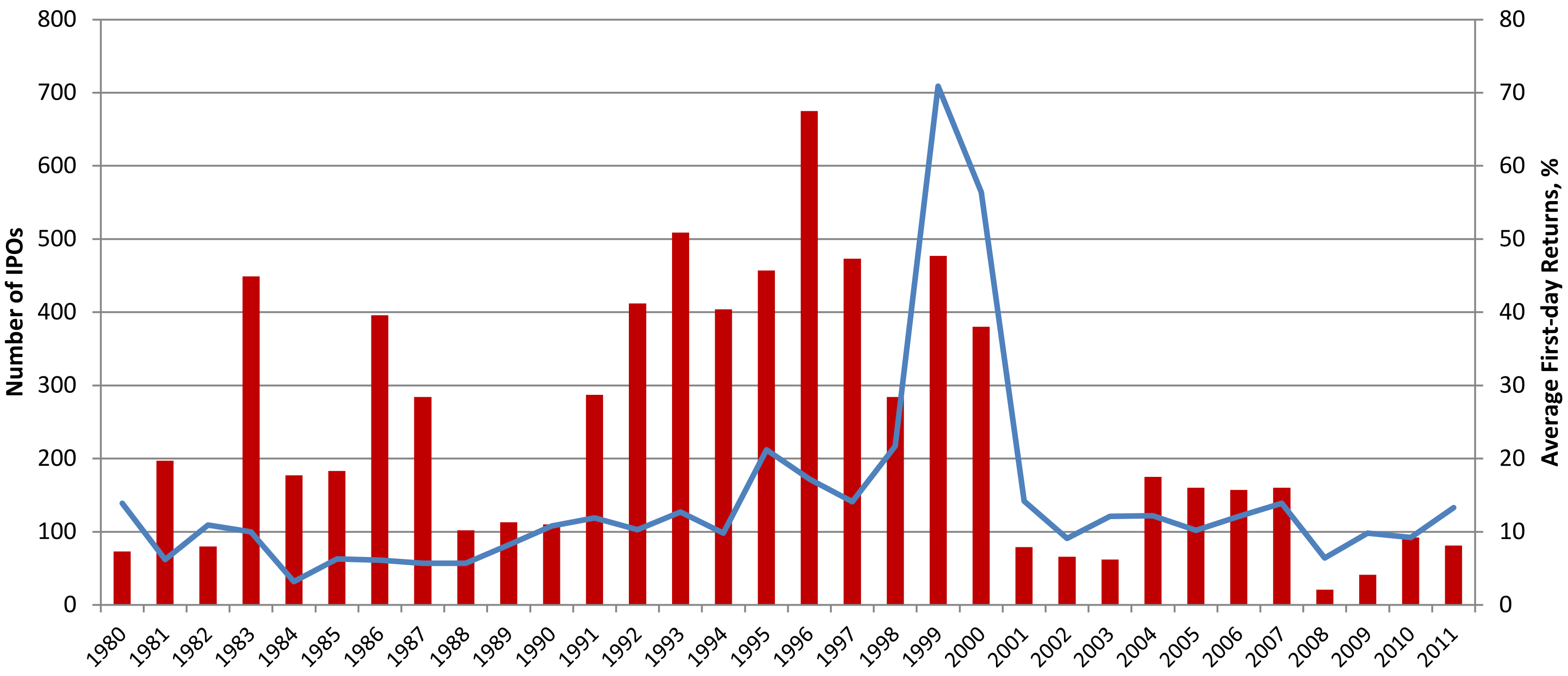
Partly based on joint work with Xiaohui Gao and Zhongyan Zhu “Where Have All the IPOs Gone?”

IPO volume has been very low in the U.S. since 2000

In 1980-2000, an average of 310 firms went public every year
In 2001-2011, an average of 99 firms went public every year



Number of Offerings (bars) and Average First-day Returns (blue) on US IPOs, 1980-2011

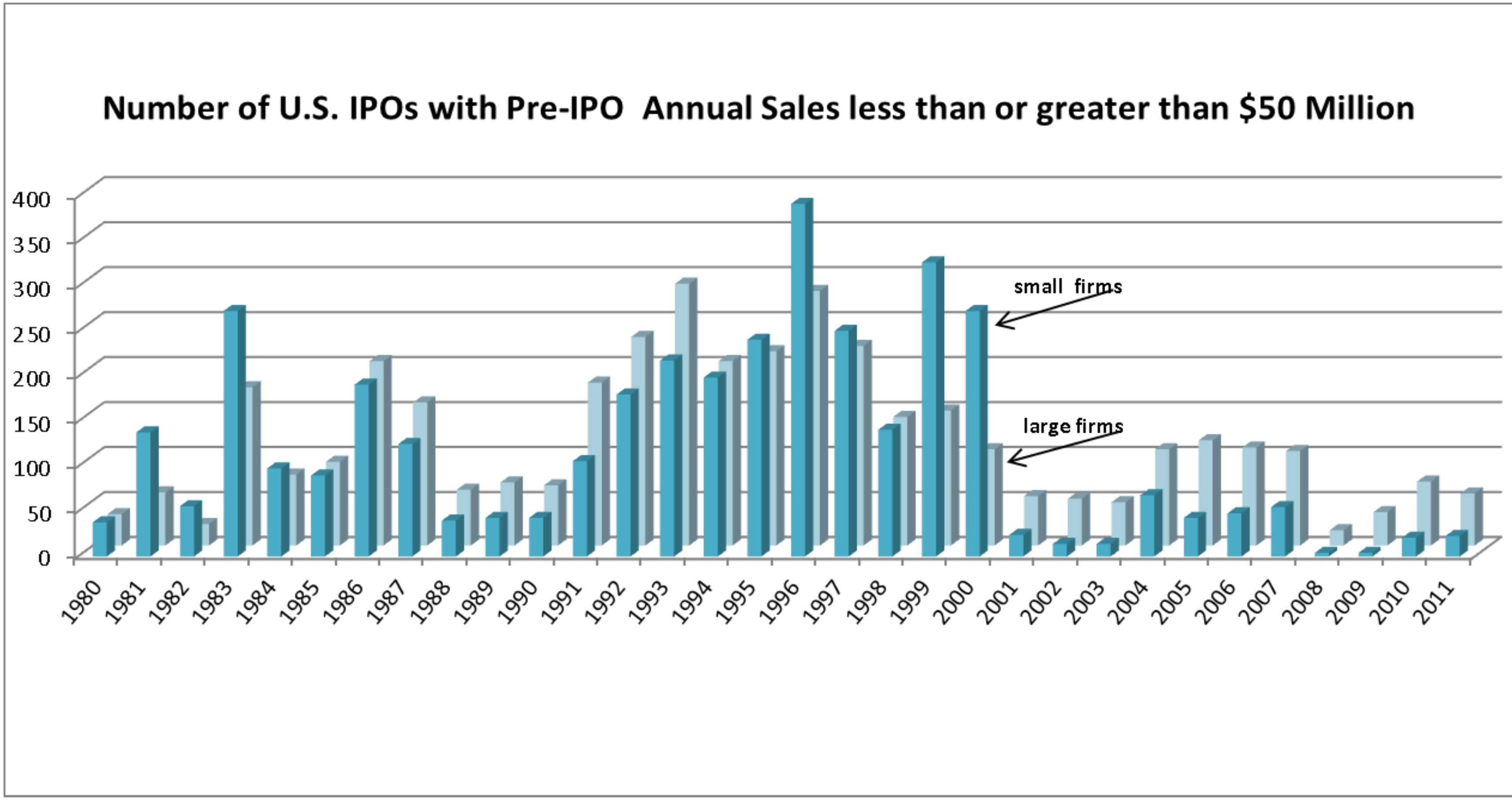
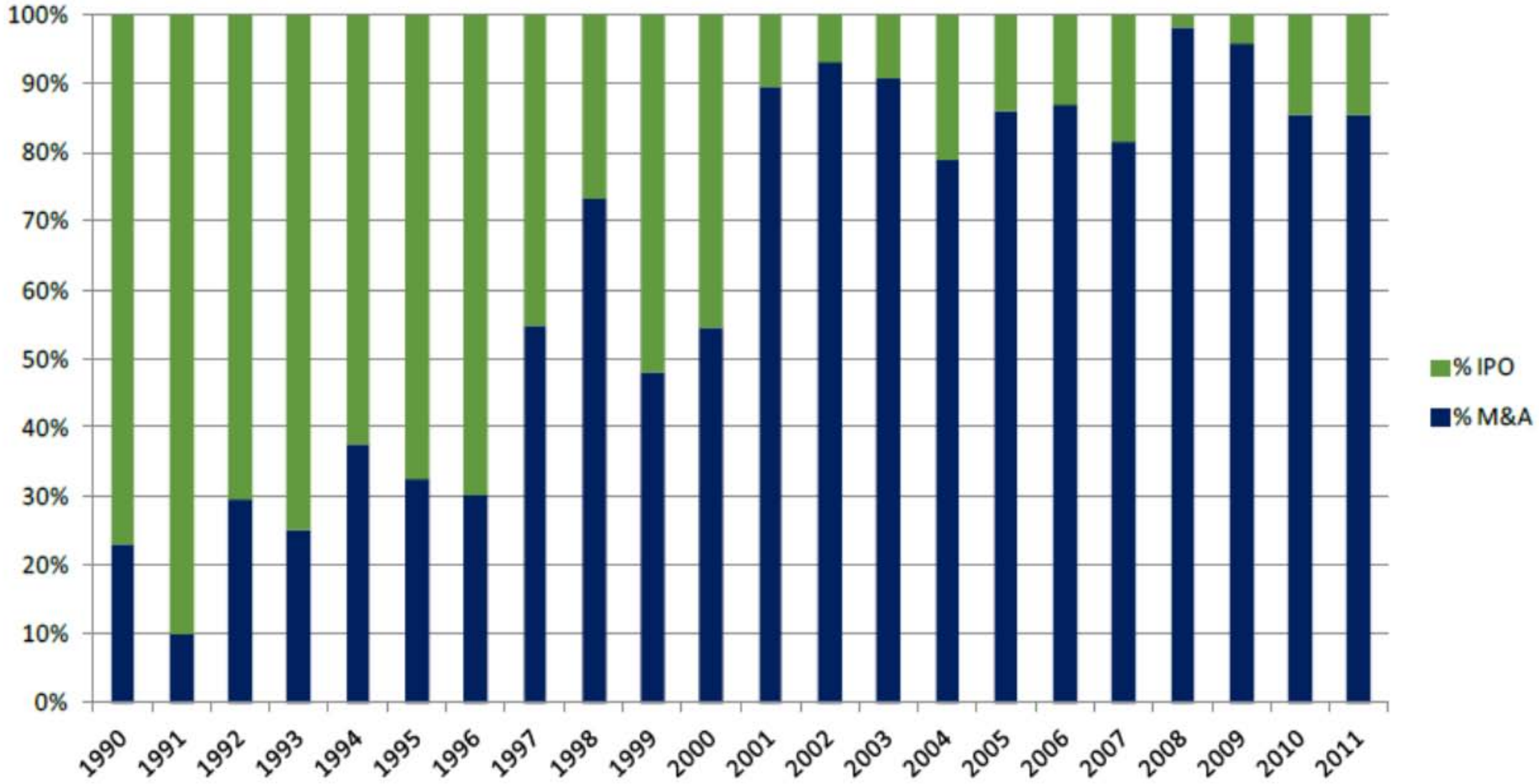


Figure 1. The number of U.S. IPOs by year, 1980-2011, with pre-IPO last twelve months sales less than (small firms) or greater than (large firms) $50 million (2009 purchasing power). Reproduced from Gao, Ritter, and Zhu (2012).

IPO Exits for VC-backed firms have been limited

from IPO Task Force slides, October 2011



Source: Thomson Reuters/National Venture Capital Association (Based on number of exits per year; M&A exits are for private company sales only.)

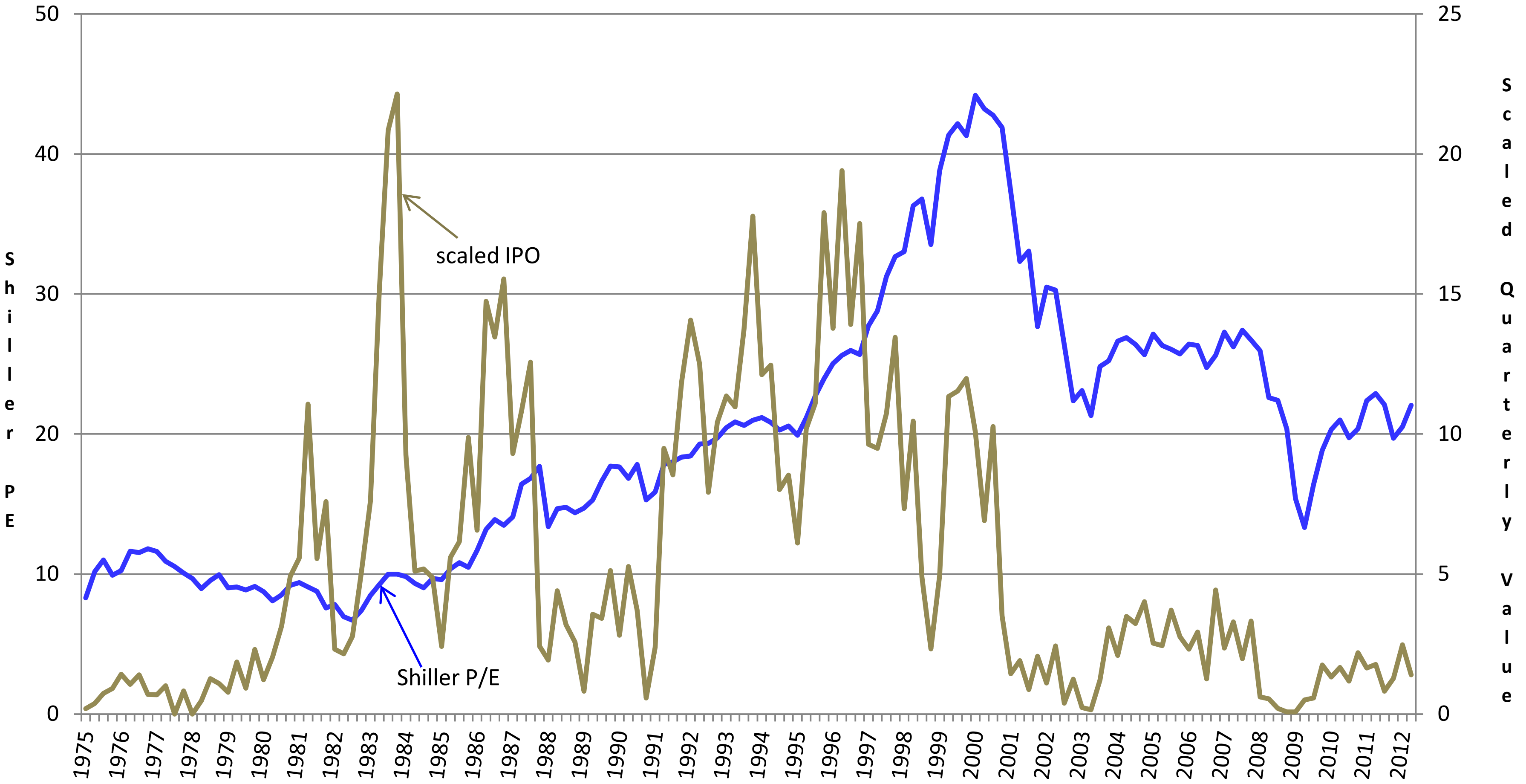


Figure 2: The Shiller P/E ratio is taken from Robert Shiller's website and is computed as the ratio of the S&P 500 index divided by the inflation-adjusted ten-year moving average of S&P 500 earnings. Scaled IPO volume is quarterly IPO volume divided by annual real GDP, in trillions of 2009 dollars.

Conventional Wisdom: The IPO Market Is Broken

Sarbanes-Oxley Act of 2002 (SOX) has imposed costs on publicly traded firms, especially small firms

Decimalization, Reg FD in 2000, and the Global Settlement in 2003 have led to a drop in analyst coverage for small firms, lowering their P/E ratios, and the collapse of the IPO ecosystem

We call these explanations

The regulatory overreach hypothesis

Our Explanation: A Long-term Change

Increased economies of scope

Increased importance of speed to market

Getting big fast is more important than in the past

The Consequence

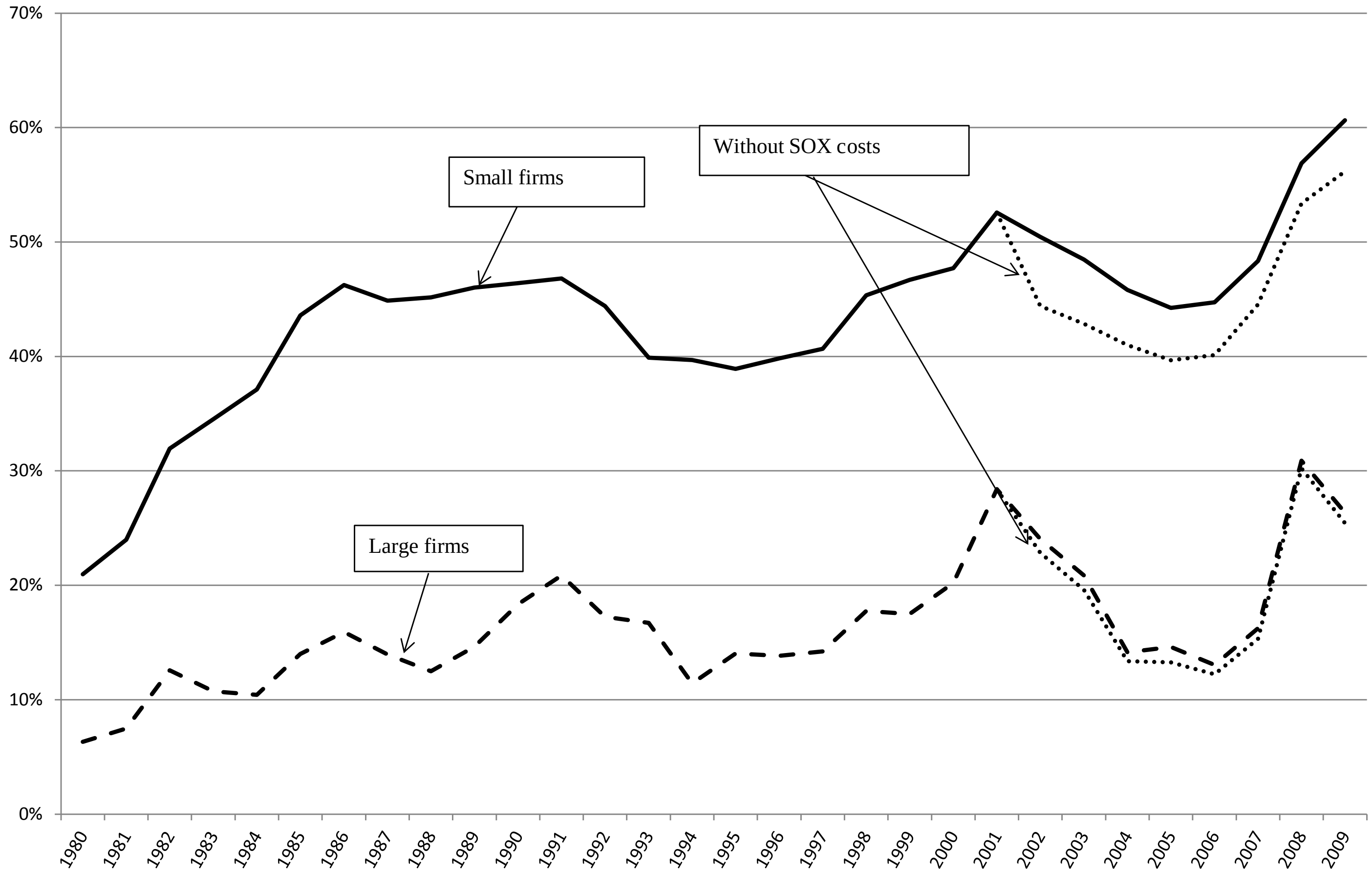
The profitability of small independent firms has declined relative to the value created as part of a larger organization that can quickly implement new technology and benefit from economies of scope. As a result, small firms are selling out rather than staying independent.

We call our explanation

The economies of scope hypothesis

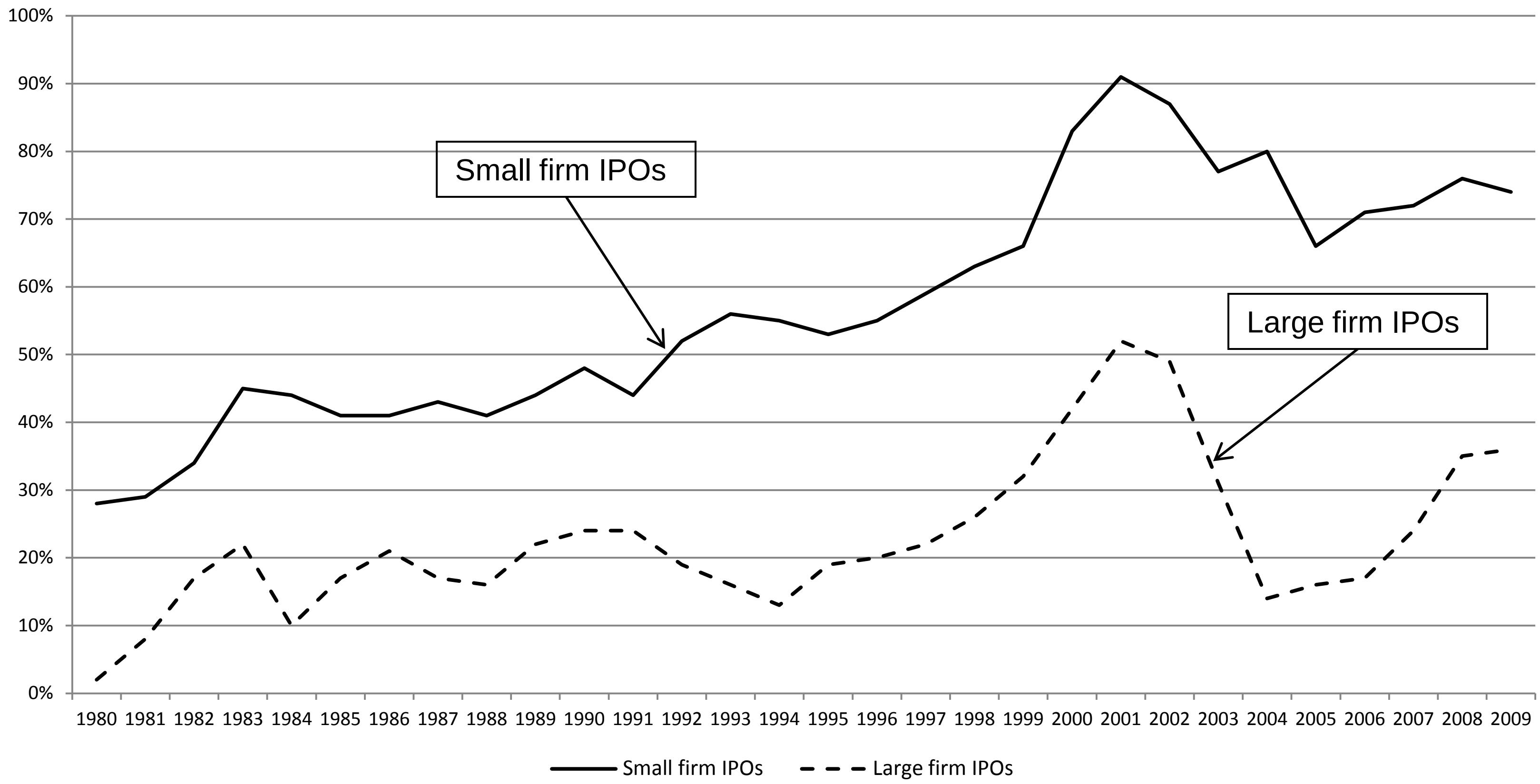
Our Evidence

The percentage of small firms that are unprofitable has increased



Percentage of seasoned public companies with negative EPS, 1980-2009

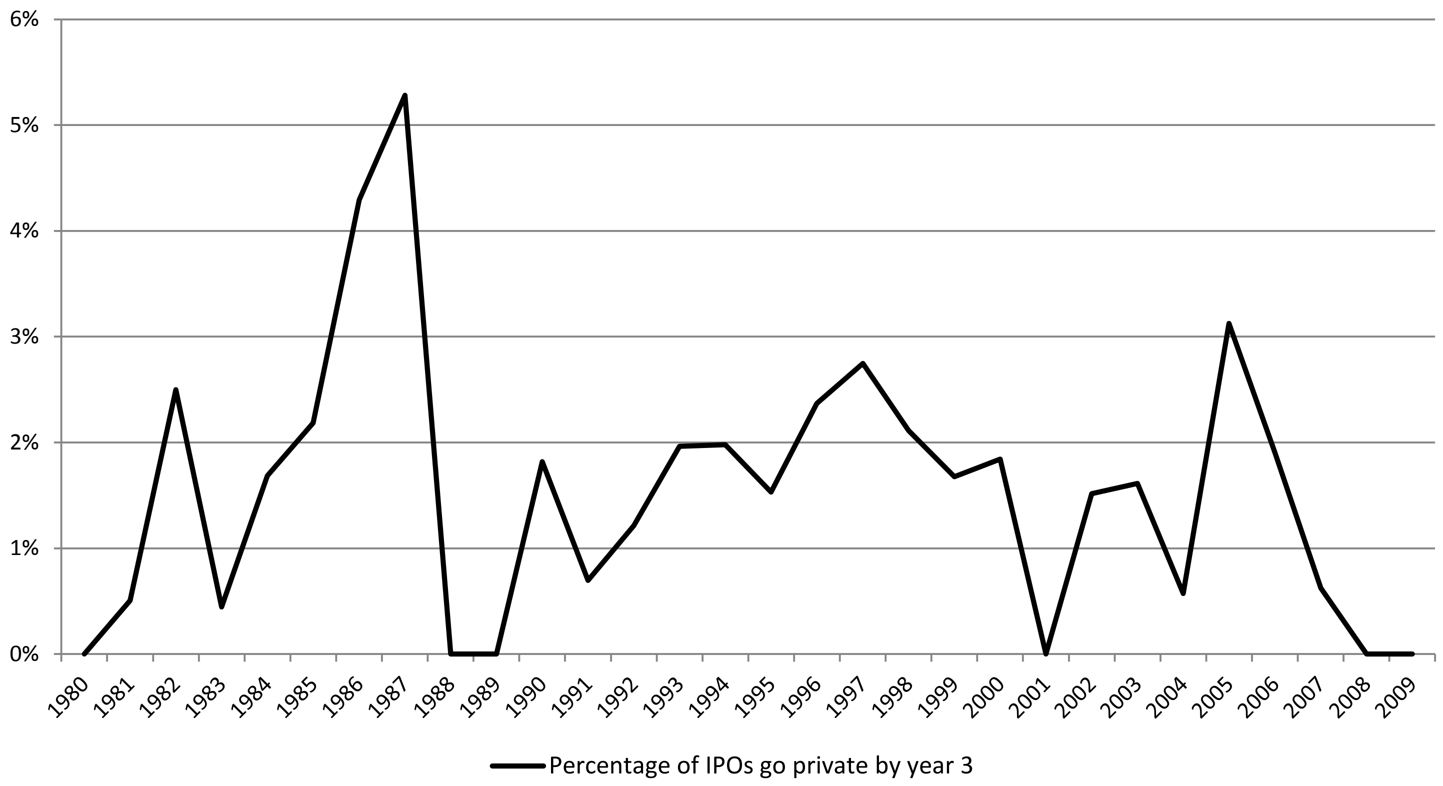
Small firm IPOs have become less profitable



Percentage of IPOs from the prior 3 years with negative EPS in fiscal year t

Source: Table 2, columns 2 and 4 of Gao, Ritter, and Zhu “Where have All the IPOs Gone?”

Are recent IPOs going private more frequently?



Source: Table 7 (both LBOs and acquisitions by private firms) of Gao, Ritter, and Zhu (2012)

Young growth firms are more likely to be involved in an M&A transaction

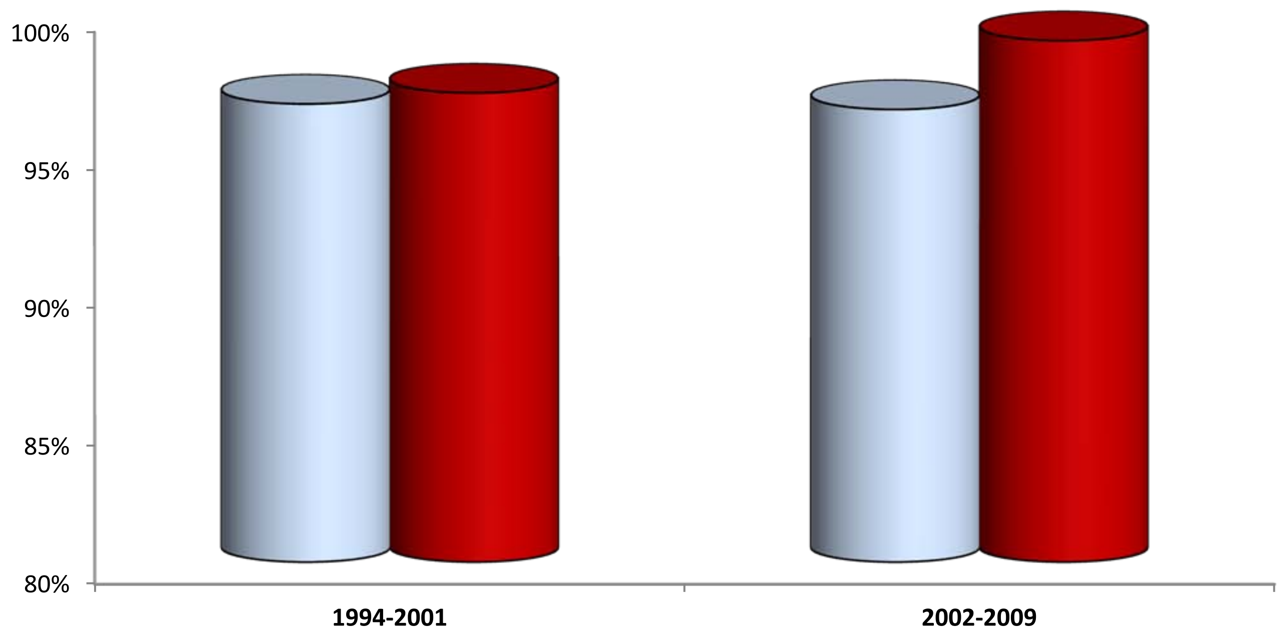
Either as an acquirer or being acquired

Uptrend started in early 1990s

Evidence on post-IPO analyst coverage

There is near universal analyst coverage on IPOs in 1994 to 2009

The percentage of small (grey) and large (red) firm IPOs with analyst coverage from at least one lead underwriter within one year of the IPO



Source: Table 5, column 3

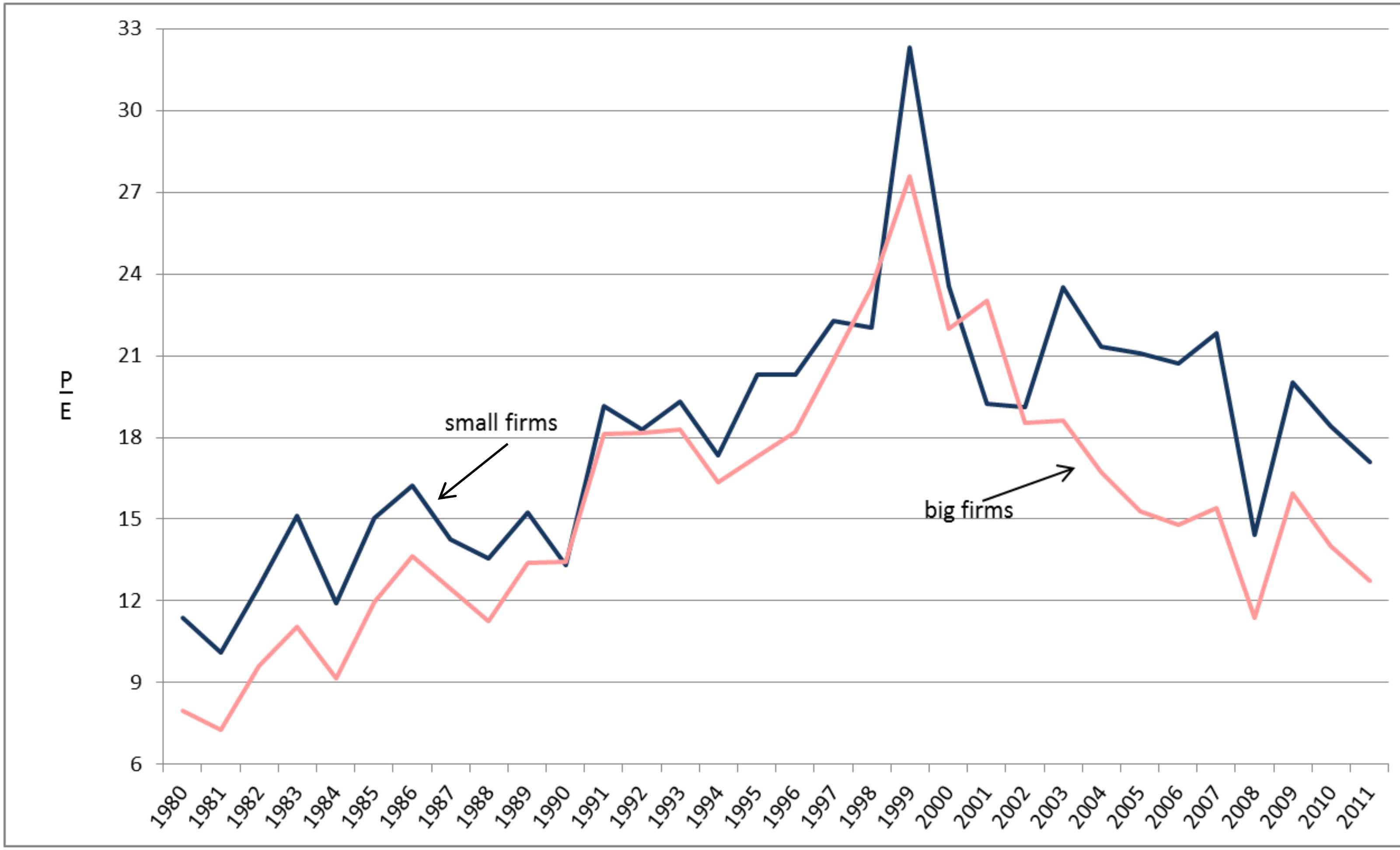


Figure 2. Price-earnings ratio of small company (annual sales less than $1 billion, 2011 purchasing power) and big company stocks with positive EPS (Before extraordinary items) traded on the Amex, Nasdaq, or NYSE with Compustat EPS data available. The price-earnings ratios are computed as the sum of the market values divided by the sum of the earnings for, respectively, small and big companies with positive EPS.

Policy Implications

The stock exchanges and VC industry have argued that structural changes (e.g., subsidizing analyst coverage, lowering regulatory burdens) are needed to boost IPO activity

Our analysis indicates that these will not be very effective at generating IPO activity

Policy Implications

Our analysis suggests that companies are not going public because they have less value as a small independent company than as part of a larger organization

Conclusions

No one explanation explains all of the prolonged drought in small firm IPOs in the U.S.

SOX and Analyst Coverage explanations are of the category “The IPO market is broken”

Our economies of scope explanation focuses on increased economies of scope and the importance of speed to market

We focus not on public vs. private, but small vs. large firms as the profit-maximizing organizational form