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Death of the IPO

By JULIE SEGAL

Initial public offerings, those sweet harbingers of economic growth, are on the rise. General Motors Co., once the world's most influential carmaker, is returning to the market next month in what may be the largest IPO ever. Hulu, the popular video web site, is planning an IPO that has investors daydreaming of dot-com riches. Then there's Skype, the company that allows free calls over the Internet, looking to raise \$100 million. Rumors abound that social media juggernaut Facebook may soon decide to go public, in a deal that could rival Netscape Communications Corp.'s 1995 offering, which boldly ushered in the Internet era.

Indeed, this is shaping up to be the best year for capital raising since 2007. As of September 24, some 90 companies had gone public, raising \$13.6 billion, compared with just 64 companies for all of 2009. All told, 192 companies have filed to go public



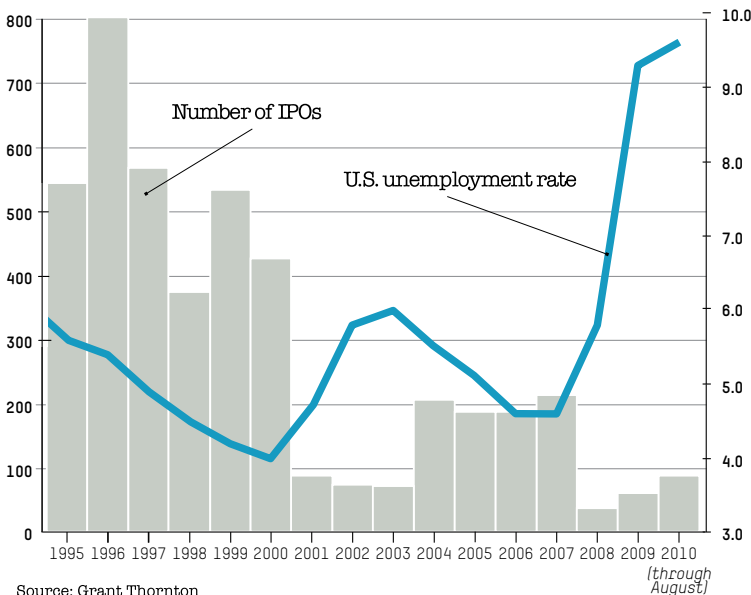
Elliot Spitzer's 2003 research settlement with Wall Street sealed the IPO's fate

CAPITAL MARKETS

this year, compared with 119 in 2009. Market experts are declaring that the IPO is back.

But they're wrong. As the media, investors and investment banks swarm around companies selling shares to the public, what's lost is that this year's 90 completed IPOs is a paltry figure when viewed in historical terms. From 1991 to 2000 an average of 530 public companies were born each year in the U.S., according to accounting and consulting firm Grant Thornton. This past decade, however, an average of 126 companies went public every year — a 76 percent decline, despite two bull markets and strong GDP growth (see chart, below). Couple the lack of IPOs with the natural attrition in stock listings, and the number of publicly traded companies in the U.S. has shrunk by more than 40 percent since it peaked in the mid-1990s.

UNDERWRITING THE ECONOMY: WITHOUT A HEALTHY IPO MARKET, THE U.S. WILL STRUGGLE TO REDUCE UNEMPLOYMENT



Source: Grant Thornton

“Today capital formation in the U.S. is on life support,” warns David Weild IV, who heads up the capital markets group at Grant Thornton and is the founder and CEO of boutique investment bank Capital Markets Advisory Partners in New York.

IPOs have been a critical part of a capital markets ecosystem that includes entrepreneurs, equity analysts, investment bankers and venture capitalists. A healthy economy, low interest rates and product innovations combine to provide the rich soil needed for a fertile IPO market. And with the maturation of the Internet, growth in online commerce, widespread adoption of computers and the resulting productivity gains, the 2000s should have been an ideal time for companies to form and go public. Yet IPO activity was threadbare.

The reason lies within the ecosystem itself. Public offerings have long been dependent on quality equity research. Investment banks have traditionally paid for that research, and the analysts who produce it, through trading (charging investors

commissions and earning the difference between a stock's bid and offer prices, or spread). But beginning in the mid-1990s, regulatory and other changes, ranging from the rise of online brokerage to order-handling rules and decimalization, reduced the profitability of trading — and undermined the economic incentives for firms to create in-depth investment research. When banks could no longer support research with commissions and trading revenue, they turned to investment banking, but the inherent conflicts of interest eventually attracted the attention of regulators and politicians.

In 2003 then-New York State attorney general Eliot Spitzer unwittingly destroyed the last pillar of economic support for investment research by prohibiting firms from using investment banking revenue to underwrite the work of their armies of analysts covering thousands of public companies.

Although Spitzer's motives were seemingly pure — to protect mom-and-pop investors from Wall Street analysts promoting stocks that they secretly thought were dogs — his actions have had unintended consequences. In the wake of the landmark Global Research Analyst Settlement, as Wall Street has decoupled research from its primary funding source, brokerage firms have dropped coverage of all but the largest U.S. companies. As a result, many small- and midcap companies are in the penalty box, unable to attract attention from Wall Street even as demand from investors has grown, and many entrepreneurs have been discouraged from pursuing IPOs.

“Spitzer's name should live in infamy,” says Charles Newhall III, co-founder of venture capital firm New Enterprise Associates, which has funded more than 650 companies, including 165 that have gone public. “There was good research in small companies, even if some got tainted in the speculative fervor of the bubble.”

Equity research surely had its low point in the 1990s, as analysts appeared on CNBC and other news networks touting sky-high price targets for companies that they'd had a hand in bringing public. But the best analysts allowed good ideas to turn into good companies — and good companies to turn into good investments.

“In the old days, the market makers would commit capital, research analysts had an opinion, and then the salespeople would get on the phone and they would find a buyer,” says Weild, who spent 14 years at Prudential Securities in senior investment banking and equity capital market positions, including co-chairman of the firm's strategic planning committee for equity research, investment banking, institutional sales and trading. “What kept people honest was the great competition for ideas. At any point in time, an analyst would cover 15 stocks, and he didn't have to tout one over another.”

Since the settlement, research staffs have been slashed, pay has been cut, analysts have scattered to hedge funds and other investment firms, and capital and sales support is largely

gone for all but the biggest stocks. To be sure, large-cap stocks still garner the attention of research analysts. That's where the trading volume is. Nearly 50 percent of publicly listed companies, however, have market caps of less than \$350 million, well below the radar of most sell-side firms.

Size matters for entrepreneurs and venture capitalists who want to take their companies public. Twenty years ago the median IPO was \$10 million. In 2009 it was \$140 million. Similarly, from 1991 through 1997, 80 percent of IPOs were smaller than \$50 million. Since 2000 just 20 percent of IPOs have fallen in that range.

"I think our capital markets for financing innovation in the U.S. are virtually destroyed, and no one knows it has happened," says Newhall, one of the deans of the venture capital industry. "Nasdaq [with its population of technology-heavy, smaller listings] was the goose that laid the golden eggs for the American economy."

From a peak of 8,823 in 1997, the number of publicly traded companies had fallen to 5,107 as of the end of August. Weild calculates that 360 new listings are needed every year just to replace exiting companies. If the U.S. wanted to expand the number of its listed companies at 3 percent annually — about equal to GDP growth — it would have to add 520 new public companies every year, a far cry from where the markets are today.

This is a decidedly American problem. IPOs outside the U.S. are humming. Corporate listings in Tokyo rose 28 percent from 1997 through 2008; listings increased 92 percent in Hong Kong, 65 percent in Sydney and 11 percent in Toronto, according to Grant Thornton. Listings in Germany and Italy for the same period rose 36 percent and 26 percent, respectively.

Research analysts, who closely follow public companies and know the ins and outs of their financials and strategies, play an important role in the capital-raising process. They call the companies to the attention of investors, drum up excitement and create liquidity. With-

out them, companies can have difficulty finding takers. "CEOs of small publicly traded companies feel abandoned," says Robert Mancuso, founder and managing partner of private equity firm Dellacorte Group. "You might get one research report a year, but that's not coverage." Mancuso has directly witnessed the decline of the IPO over a 34-year career that began with a stint at investment bank Lazard Frères & Co. and included three years as CEO of Merrill Lynch Capital Partners, overseeing Merrill's first private equity fund.

To be sure, investment banks provide research on what their clients want — and are willing to pay for. The heads of research at several major banks say their firms cover more than 80 percent of the dollar value of their clients' holdings. Those same firms, however, publish research on only a tiny fraction of the total number of U.S. companies. J.P. Morgan, which has the largest coverage universe, puts out research on 1,135 U.S. companies; Barclays Capital, which acquired the North American research group of Lehman Brothers Holdings in September 2008, covers 965 companies; and BofA Merrill Lynch Global Research follows 950.

"The buy side has become less excited about sell-side research as senior people have left."

— George Shapiro, Access 342

The troubles in the U.S. IPO market have had a dramatic impact on the venture capital industry. Venture capitalists, which Weild calls the "Johnny Appleseeds" for the IPO market, have little choice but to pursue alternatives to going public. Close to 90 percent of venture capital exits now are done through mergers and acquisitions — typically, large companies buying small players. "Venture capitalists today are looking at their portfolios and saying, 'It's been so long since one of my companies went public that I may want to see these firms get acquired,'" says Mark Heesen, president of the National Venture Capital Association. In 1993 just 25 percent of venture transactions were M&A deals,

he adds. Back then, it typically took 4.3 years for a venture-backed company to go public. By 2009 the time had more than doubled, to 10.3 years.

IPOs aren't just a way for investors to potentially get rich or for entrepreneurs to cash in. They are engines of job creation, as newly public companies often enjoy periods of high growth and robust hiring. In fact, according to Grant Thornton, because of the dearth of IPOs, 22 million potential jobs were not created during the past decade. That's roughly 3 times the 7.3 million jobs that were lost during the Great Recession of 2007-'09 — unpleasant statistics for a country that is hoping to avoid a double-dip recession.

WALL STREET INVESTMENT RESEARCH traces its roots back to the 1960s, when growing pension funds, mutual fund complexes and other big institutional investors started looking to their brokerage firms to help them in the labor-intensive task of assessing stocks. Donaldson, Lufkin & Jenrette was one of the pioneers in the field, exchanging good ideas in return for executing trades, and underwriting its growing ranks of analysts with the riches from

commissions and trading spreads. Soon every brokerage firm followed suit and *Institutional Investor* got into the game, launching its first All-America Research Team ranking of top equity analysts in 1972.

Three years later, Congress deregulated brokerage commissions, a move that unleashed a wave of discounting among firms. In the wake of deregulation and increased competition, smaller players were acquired by big shops that had enough volume to offset lower commissions. Paine Webber snapped up Mitchell, Hutchins & Co., and Drexel Burnham Lambert bought William D. Witter, to name two such deals. Research survived, though the changes started

chipping away at firms' lush profit margins. Around that time, investment banking boutiques Hambrecht & Quist, Montgomery Securities and Robertson Stephens sprang up in San Francisco to focus on venture-backed companies in nearby Silicon Valley, while Alex. Brown & Sons — the first U.S. investment bank — started doing the same for small startups in the mini-venture capital alley between Baltimore, Washington and northern Virginia. These firms, dubbed "the Four Horsemen," were all later gobbled up by big commercial banks.

Deregulation of commissions was only the beginning of the changes. In an effort to protect investors and level the playing field, the Securities and Exchange Commission implemented the Manning and Order Handling Rules in 1996 and 1997, respectively. Under the Manning Rule, brokers couldn't trade before the interests of their clients. The Order Handling rules required brokers to display all client limit orders publicly when they were at or better than the national best bid or offer. In 2001, fol-

lowing yet another SEC rule change, the Nasdaq Stock Market and the New York Stock Exchange began trading in decimals rather than fractions.

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The new trading rules and decimalization put downward pressure on bid-offer spreads, further eroding the once-thriving economics that underpinned IPOs and a healthy aftermarket for stocks. With skinnier spreads, there was no choice but to automate trade execution. This set the stage for high frequency traders and hedge funds to develop computer algorithms and programs to try to detect anomalies and arbitrage opportunities in the markets. These players send thousands of trades into the market every minute, primarily on the largest, most liquid stocks. The challenge to the brokerage firms was to produce more insight into the biggest

companies, while catering to the short-term traders that generate the most commissions.

Beginning in the 1980s, as commission rates shrank dramatically, and gaining steam in the 1990s with the other market structure changes that eroded profits, investment banking became the new patron of research. Analysts frequently brought in new business, joined bankers on IPO road shows and were paid directly out of banking profits. "The joke was that the analysts were bankers in research clothing," says Weild.

Then, on December 20, 2002, just as another bull market was about to unfold and a thriving IPO market might have taken root, Spitzer dealt his crushing blow against capital raising, announcing that ten big firms had agreed to settle charges that they had been publishing tainted investment research in hopes of winning banking business.

The Global Research Analyst Settlement, which was finalized in April 2003, incorporated different agreements with Bear, Stearns & Co.; Citigroup; Credit

Suisse First Boston; Goldman, Sachs & Co.; J.P. Morgan Securities; Lehman Brothers; Merrill Lynch; Morgan Stanley; U.S. Bancorp Piper Jaffray; and UBS Warburg. The firms were to pay \$1.4 billion in fines to fund restitution, education and independent research. In addition, for five years the firms had to provide clients with independent research alongside their own assessments. Spitzer believed that investors would be able to assess the quality of their brokerage firms' research by comparing it against research provided by third parties. The settlement also prohibited the practice of paying analysts from banking revenues, and analysts and bankers could no longer talk without a compliance person in the room.

Wall Street responded swiftly and decisively. Firms cut the ranks of their

analysts, dramatically reduced their pay, fired their support staff and made each researcher follow far more companies, shrinking the depth of their coverage. Investment research became a cost center — and a potential legal liability. The Street even began outsourcing some number-crunching tasks to low-cost countries like India. Many of Wall Street's most respected analysts balked under the new restrictions that traced their every move. Firms began monitoring e-mail and sent out lengthy legal disclosures every time an analyst spoke to the press. Hedge funds and other money management firms were only too happy to snap up analysts at relative bargain-basement salaries. In the early years after the settlement, several All-America top-ranked analysts left the Street, including Morgan Stanley insurance researcher Alice Schroeder and Judah Kraushaar, who covered brokerages and asset managers at Merrill Lynch.

The analyst exodus continues today, as do the layoffs. "The buy side has become less excited about sell-side research as senior people have left," says former Citi analyst George Shapiro, whom *II* ranked No. 1 in Aerospace & Defense for seven years. Citi laid off Shapiro at the end of 2008, when the bank said it was cutting the number of companies it covered by 7 percent; in June 2009 he joined Access 342, a Stamford, Connecticut-based independent research firm.

U.S. sell-side equity research expenditures are expected to decline from \$4.9 billion in 2006 to \$4.0 billion by 2011 — an 18 percent decrease, according to Integrity Research Associates, a New York-based firm that matches investment managers with research products.

Although Spitzer's settlement with Wall Street was aimed to ensure that individual investors could compete more evenly with institutions, the markets, ironically, have become less efficient because of the falloff in research. As a result, the cost of capital for smaller, emerging companies has risen. "Historically, there is a pretty clear tie between getting research coverage and getting

sufficient liquidity and trading in your name,” says Michael Mayhew, founder and chairman of Integrity Research. “If you’re a large-cap company and you have 18 analysts covering you, you’ll have a lower cost of capital than a small-cap company in the same industry that has two or three analysts.”

Boutique firms like JMP Securities in San Francisco were founded specifically to fill the gap. “The bulge-bracket firms are saying a company isn’t a good IPO prospect until it has \$100 million in revenue or \$400 million to \$500 million in potential market cap,” says Carter Mack, president and director of investment banking at JMP. “We believe that there are viable companies at \$50 million in revenue and \$150 million to \$300 million market cap, if they have good growth characteristics and large addressable markets.”

Both independent research and buy-side research have grown as investment banks have retrenched, but this is hardly replacing what’s been lost on the sell side. Furthermore, money management firms greatly depend on sell-side research to augment their own resources. “The buy side wholeheartedly uses research from the sell side,” says Craig Huber, who at Barclays was the All-America team’s top-ranked Advertising & Publishing analyst for four years before joining Access 342 in November 2009. “Buy-side analysts are covering so many subsectors and stocks that the smart ones figure out who the best sell-side analysts are and get them on the phone.”

The changing face of independent research includes the emergence of expert networks that allow investors to talk to suppliers and other experienced professionals in the field of the target company. “The overall research budgets are declining, but the dollars are being spent on alternative sources of data,” says Unni Narayanan, CEO of Mountain View, California-based Primary Global Research, an expert network. “People are now looking at satellite images of clouds in their research. But what you lose is focused coverage on these smaller companies.”

WHAT WILL IT TAKE TO REVIVE THE IPO market? Obviously, there must be companies, but the U.S. has them. Since 2005 some 6,100 privately held companies have received venture capital funding, according to the NVCA and Pricewaterhouse Coopers, and this has created a rich pool of IPO candidates. In addition, the rebound in Wall Street’s fortunes since spring 2009 has boosted investment banking, which is expected to become a bigger part of bank profits given the new restrictions on proprietary trading. At the same time, smaller companies should benefit from U.S. monetary policy, as the Federal Reserve Board has said that it expects to keep interest rates near zero for the foreseeable future.

What’s missing for most of these companies, even if they eventually manage to go public, is high-quality equity research — the capital markets glue, so to speak. Putting in place economic incentives for investment banks to produce that research will require re-creating a U.S. regulatory environment that is friendlier to IPOs. Going back to the future is no small feat, and perhaps impossible: It demands that commissions be raised and trading spreads widened.

Grant Thornton’s Weild proposes that an alternative stock market be established by Nasdaq OMX, NYSE Euronext or even a venture-backed company. Issuers would voluntarily list on the market and be actively supported by market makers and specialists, in an arrangement not unlike the old floor-based exchanges. Electronic communication networks would be prohibited from trading in the stocks listed on this new market, which would have minimum spread and commission levels and require market makers to provide research that would also be held to a minimum standard.

Weild, a former Nasdaq vice chairman, testified in June before the SEC and the U.S. Commodity Futures Trading Commission on the reasons for the May 6 “flash crash.” He told the regulators, “We have called for an alternative market system to reinvigorate primary capi-

tal formation and the fundamentally oriented ecosystem of research, sales and liquidity provision that is essential to support companies that need capital to build plants, buy equipment and put people to work.” Sources say SEC chairman Mary Schapiro is incorporating some of Weild’s thinking on job creation and capital formation into the agency’s stances on market structure and other regulatory issues.

Brokers that participate in Weild’s alternative market would have decent revenue from trading and commissions and could once again afford to produce equity research. But such a market would need the blessings of regulators and would require officials to admit that all their well-intentioned reforms had perhaps taken a wrong turn. “We’re recommending higher costs on a per-trade basis, and that is anathema to the ideology that has gripped the SEC for the last decade,” Weild says.

Weild isn’t the only capital markets veteran who believes such a radical step is necessary. “We need to consciously take a risk for capital formation,” says Michael Halloran, a partner at Haynes and Boone who splits his time between the law firm’s Washington and Silicon Valley offices. From 2006 to 2008, Halloran was deputy chief of staff and counselor to then-SEC chairman Christopher Cox — experience that gives him insight into how markets really work. “You could fix spreads or commissions; when you go public, your underwriter and you would make that decision,” he explains. “By doing that, you would bring back sales support and the economics for equity research. You’re turning back the clock voluntarily.”

The solution could come from the banks themselves, but that’s unlikely because most big investment banking firms don’t believe there is a problem. The biggest banks say they already cover almost as many companies as they did before the global settlement, even if it’s now with a smaller staff. “Because of the data-gathering power of the Internet, the time spent searching for data has been reduced, which enables more time for

in-depth analysis,” says David Bleustein, head of U.S. equity research at UBS.

Thomas Schmidt, head of Americas equity research at J.P. Morgan, says his firm was one of the first to ramp up its research coverage of small- and midcap stocks over the past few years. “It was clear to us that the segment lacking was small- to midcap names,” he says, adding that about 35 percent of J.P. Morgan’s coverage now focuses on large-cap companies. The bank does provide some coverage of companies with market caps of \$200 million to \$400 million, but, Schmidt says, “we may be more nimble there, including a willingness to drop coverage if clients no longer show interest in a company.”

Schmidt believes the economics of the equity business have changed in the past decade, independent of the research settlement. “We just faced the cold, hard facts that the top line for the entire equity business had slowed,” he explains. J.P. Morgan, like most of the big banks, is doing more with less. “We used to have an eight- or nine-person team covering each sector,” Schmidt says. “They would write 50 pages ten years ago, but the market didn’t want that. Clients want analysts’ thoughts, assumptions and information on what their contacts are

telling them in real time, with only the occasional 50-page report that goes in-depth on the entire sector.”

In addition, American investment banks are increasingly focusing on burgeoning non-U.S. markets for new business. Most derive almost half of their profits from overseas. Therefore, the U.S. economy can hardly depend on American investment banks for a solution to the IPO problem in the U.S.

Meantime, the IPO problem and its effect on markets and job creation rears its head every day. Larry Tabb, founder and CEO of research firm TABB Group and a longtime market observer, says IBM Corp.’s acquisition last month of privately held Blade Network Technologies, a Santa Clara, California-based company that makes networking switches for data centers, is just one example in a long line of many. Ten years ago a company like Blade would have gone public and aggressively competed against IBM, he says. Now it’s cheaper for IBM to raise capital for an acquisition of Blade than it is for the smaller company to go public. “Instead of creating more jobs, you create the synergy effect: IBM fires anybody who is redundant,” says Tabb.

The growing populism in the U.S. that

is foiling politicians and regulators in their efforts to get the economy jump-started again — think of the debate on taxation and the federal stimulus plans — clearly has its roots in the mortgage crisis. But it also has sprung up because Wall Street is no longer intricately connected to Main Street via the IPO market and jobs. Wall Street has stopped raising money for all those Main Streeters.

“The dream was for many years to found a business and take it public,” says Dellacorte’s Mancuso. “Now, unless you’re a very big company, the costs of being public and the liabilities outweigh the rewards of seeing your stock go higher.”

What does Eliot Spitzer think of all this? The former New York governor, who on October 4 began his new career as co-host of a nightly news program on CNN, tells *Institutional Investor* that Wall Street can hardly blame him for the problems in the IPO market. “If people say that a prohibition on lying in the market is hurting the market for IPOs, there is a deeper problem than I thought,” he says. ●●

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