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Will the U.S. Swoon Go Global?

By Paul Sweeney

While 2007 was a record-setting year for public stock offerings worldwide, the economic morass in the U.S. has created a far bleaker outlook for 2008. That s spurred some investors to consider alternative ways to go public.

First the good news on initial public offerings: the world s financial markets are coming off a record-setting year. Through November 2007 and with December still not accounted for more money was raised worldwide and more IPO deals were consummated than in any previous year. The record $255 billion raised in 1,739 IPOs in only 11 months of 2007 outstripped the $246 billion in financing generated by 1,729 IPO deals for all of 2006, reports international accounting firm Ernst & Young LLP.
In the U.S., moreover, last year was the most robust in a half-decade. We re coming off a bumper crop of IPOs, says Maria Pinelli, Americas director of strategic growth markets at E&Y. We ve seen very strong performance in both numbers and proceeds. We should all be standing up and celebrating. But, unfortunately, the markets are tentative now.
Indeed, the other shoe has dropped with a thud, especially in the U.S. market. It s a whole new ball game, says Chris Kelly, a partner at Jones Day and head of the New York law firm s capital markets practice. The salad days of 2007 the $54 billion raised in domestic IPOs, according to Tampa, Fla.-based researcher IPOBoutique.com, easily surpassed the $43 billion for 2006 have come and gone. Right now, it s slow here, Kelly says, and people are down-in-the-mouth over what s happening.
Last year, as many as 15 newly public companies were being listed weekly on the domestic stock exchanges, notes Scott Sweet, managing director of IPOBoutique.com. The 234 listings in 2007, he says, constituted the most since 2004. But, as few as one or two companies per week have been going public in 2008. In 35 years, he says, and even in the worst of times, I have not seen numbers this small.
Right now, Sweet adds, companies are canceling, postponing or just not filing because of market conditions. IPOs are in a very difficult environment now. Institutional buyers need to monitor and maintain their core positions so they re protecting capital rather than investing in IPOs, which are far more speculative.
The downturn reflects a refrain echoing throughout the world of finance. Market players who were on the verge of euphoria last year have come back to earth. Doug Fawell, co-head of equity capital markets for the Americas at global universal bank UBS AG, asserts that the quality of companies going public isn t the issue. The fate of the IPO market, he says, is determined by the state of the macro environment.

Sour Outlook in U.S.
By all accounts, that environment looks dismal, particularly in the U.S. In the wake of the subprime mortgage crisis, as defaults and home foreclosures were mounting late last year, some lenders went belly-up and mortgage-lending giant Countrywide was teetering on bankruptcy. Banks and brokerage houses such as Citigroup, Merrill Lynch & Co. and Bear Stearns were piling up red ink and firing their chief executives. Since October 2007, Bank of America said it would dismiss 3,650 employees, including a quarter of its investment banking arm s equity analysts.
We are experiencing what some are calling a credit crunch, Kenneth D. Lewis, chairman and CEO at Bank of America, declared in a January speech to the Delaware Chamber of Commerce. Actually, [it s] a seizure in the capital markets that is unprecedented in my career in its depth and duration.
Predictably, all of this is wreaking havoc in the IPO markets as well. Says Fawell of UBS a bank that, according to Thomson Financial, currently reigns as the world s No. 1 IPO midwife, having hatched 96 public offerings worth $34.2 billion in 2007: The IPO market is currently being demand-driven by the buy side.
Mark Jennings, a managing partner at private equity firm Generation Partners in Greenwich, Conn., notes: When there are daily

swings in the stock market of plus-or-minus 300 points, money managers don t have time to look at something new.
Now, the $64,000 question is whether the current travails of the U.S. economy will cascade onto world markets and, in particular, the so-called BRIC countries of Brazil, Russia, India and China. These four emerging-market nations have become key drivers in the global economy, says UBS s Fawell. UBS has been especially busy bringing companies public in Brazil, where businesses of all stripes have been seeking stock-exchange listings and investors have been eagerly snapping up shares.
The volume of IPO issuance has increased dramatically in Latin America, from $5 billion in 2005 to $40 billion in 2007, Fawell says. Last year, we had a massive amount of issuance, of which approximately 80 percent of companies going public were Brazilian. IPOs came from a broad variety of sectors, but predominantly from banking, real estate and industrials.
He attributes this increase largely to the strength of commodities, the rise of consumer spending and the sophistication of equity investors as Latin America has enjoyed an influx of foreign capital.

Russian Firms Come Out in London

Through November 2007, according to E&Y, 382 newly public companies in the BRIC countries raised $106.5 billion, compared with 302 IPOs raising $89.6 billion during the same period of 2006.
Notable Russian financings included the $8 billion IPO for 22.5 percent of government-owned VTB Bank and real estate concern Pik Group s $2.2 billion IPO. Both were listed on the London Stock Exchange, which, E&Y reports, accounted for 10 percent of capital raised worldwide.
The Hong Kong Stock Exchange, which accounted for just 4 percent of the total number of IPOs, was the site, however, of some of last year s largest new listings. These included the $5.4 billion debut of China CITIC Bank, in an April IPO, and China Railway, which raised $3 billion in a December launch. A healthy number of Chinese companies turned to the indigenous exchanges of Hong Kong and Shanghai, notes Martin Magida, managing director at Trenwith Securities in New York. I think that will continue.
Many in the financial world, including Trenwith s Magida, argue that the BRIC countries are increasingly independent of U.S. trends, though Fawell sees no end to the interdependence with the U.S. economy.
India s IPO market, in particular, might be less affected by a downturn in the U.S. economy, says Deepak Kamra, a general partner at Canaan Partners, a Silicon Valley venture capital firm. Will U.S. problems spill over to overseas markets? he asks rhetorically. They already have. But India is driven more by domestic demand, and its economy grows despite the U.S., while China has more of an export economy.
It s true that India has information technology services and software companies that depend on the U.S. markets, he adds, but it has Internet and software companies that focus on the Indian market, and now there s more of a middle-class economy.
Back in the U.S., two seriously affected financial sectors that rely heavily on the IPO market as an exit strategy are venture capital and private equity firms. The view from Silicon Valley is that the door is shut right now on technology companies, says Canaan Partners Kamra.
But, he asks, is that for two months or two years? Experts
say that as the IPO market dries up, it s more likely that many private companies will accede to a merger or acquisition and that as more companies put themselves on the auction block, the glut is likely to result in a buyer s market.
A decade ago, a tough IPO market would have had more of an impact, says Generation Partners Jennings. But today, the private markets have gotten so big that good companies will be able to find investors.
The Sarbanes-Oxley Act had already raised the bar for IPOs: It now costs roughly $1.5 million in investment banking and legal fees to go public, according to research data. In addition, bankers say, it costs $1 million a year, on average, to remain listed on the major stock exchanges.
And, notes Trenwith s Magida, for IPOs to be successful, companies generally must rely on the biggest (and most costly) investment banks to manage the deal. The threshold today for having a proper IPO is much higher revenue and a higher level of maturity than in years past, Magida says. You typically don t see a proper IPO below $100 million.
Companies that don t meet the criteria or would prefer not to spend the big bucks to get listed on the New York Stock Exchange Euronext or the Nasdaq Stock Market are exploring other ways to go public. And, now they could be joined, market experts say, by a passel of companies seeking to circumvent traditional IPO routes.
Alternatives include reverse mergers, in which a private company merges with the shell of a public company. Once completed, the newly reconstituted public company frequently finances itself by raising capital through a PIPE a private investment in public equities.
So called special purpose acquisition companies, or SPACs, offer another strategy. A SPAC raises money through an IPO and uses the proceeds to purchase other companies. If, after 24 months, the SPAC hasn t made an acquisition, it returns the money to its investors, plus interest.
They started with the small underwriting houses, but now we re seeing hedge funds putting more and more money into SPACs, says Bob Frome, an attorney at Olshan Grundman Frome Rosenzweig & Wolosy, a New York law firm specializing in structuring these vehicles. So now, more and more of the big banks are doing them too. He adds: A lot of SPACs have been done in the last 30 months, and we ll know a year from now how successful they ve been.
The Toronto Stock Exchange, which is gaining a reputation for offering liquidity, presents still another alternative. I know of at least a dozen companies in California that are going to the Great White North, says Robert Whyte, managing director at Mosaic Capital, a Los Angeles-based investment bank.
He reports that it costs companies about half as much to go public on the Toronto bourse as in the U.S. We re at the swell of the wave, he says. You re going to see dozens and dozens of companies in the next year or two go through an IPO or a reverse merger on the TSE.
Even so, for newly minted, venture-backed companies, there is still no better avenue to the public markets than an IPO on the U.S. stock exchanges, argues Trenwith s Magida. Liquidity is the most obvious reason that private companies go public, he says. But, with public stock, you now have currency with which can make acquisitions, and the ability to create an option pool with real

liquidity for employees, which makes recruiting talent easier.
Depending on the company, he adds, it s clearly a branding event as well. It s a coming out party that helps create brand equity. We saw that last year with the technology company VMWare. It s still not a household name, but after a big, successful IPO, it s better known.
When the IPO markets reawaken in the U.S., Tracy Lefteroff, global managing partner of the venture capital practice at PricewaterhouseCoopers, reckons that financial services companies will be among the least likely candidates for IPOs. And, although private equity firms like Fortress and Blackstone were among the most impressive IPOs in 2007, he believes that the phase of doing leveraged transactions using cheap money has passed.
Companies with the best chances to effect successful IPOs in the near term, he contends, include those in the healthcare and the life sciences sector. But Lefteroff cautions that medical devices rather than biotechnology companies will probably make the best candidates. And, he thinks Internet companies specializing in social networking, such as Facebook so-called Web 2.0 companies are bound to create buzz.
Perhaps appropriately, another promising niche for IPOs now is risk measurement and management. Two firms in that space, RiskMetrics Group and MSCI Inc., whose Barra unit provides risk management services, have recently gone public. Another area to watch, experts say, is energy, both oil and gas and renewable energy technologies.
That many would be voicing optimism when the marketplace looks so dreary may seem perverse, but veterans insist that it s always necessary to take a longer view. I ve been doing this for 17 years, says Canaan Partners Kamra, and the IPO market always comes back.

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