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Venture capital-backed IPOs: outperforming the market and creating market leaders

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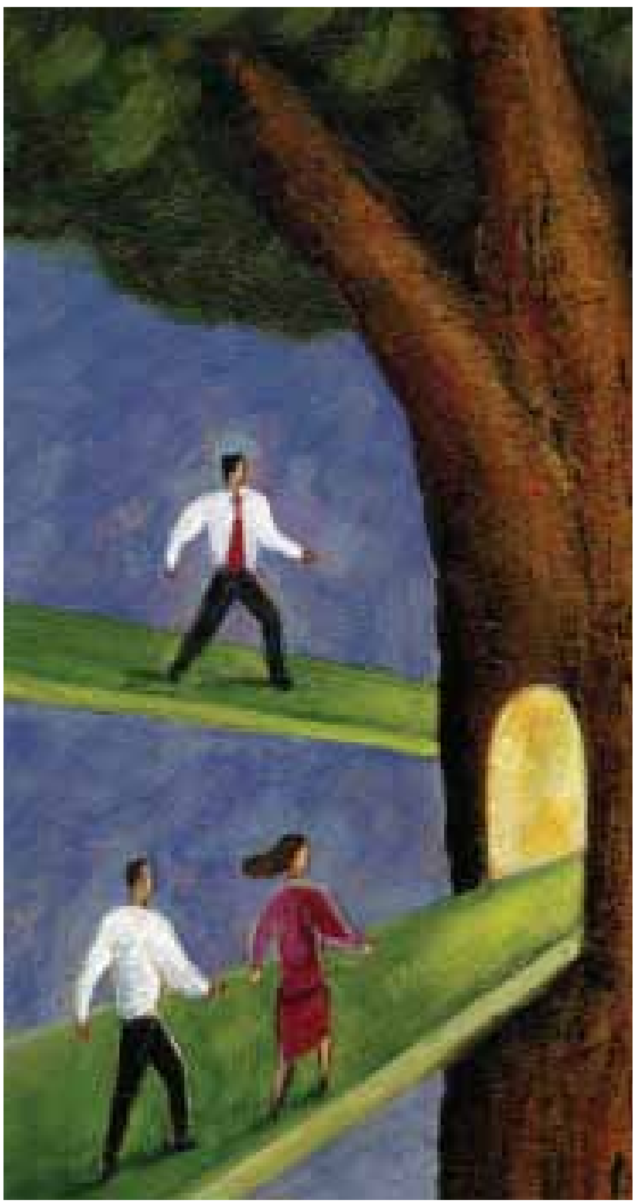

Confirming the invigorating effect venture capitalists have on entrepreneurship in the US, IPOs of venture-capital-backed companies on US exchanges outperform the IPO market in general.

These findings are revealed in a recent Ernst & Young analysis of data provided by Dealogic. [see table]. In this article, we will explore how, in doing much more than providing capital to entrepreneurs, venture capitalists have a significant impact on the market performance of their investees.

The market performance of venture-backed companies that go public is notable. Even in the volatile equities market of the last five years, the average one-day post-IPO return of venture-backed companies between early 2007 and June 2012 was 18.8%, more than three times the return of companies that did not accept venture capital investment. At six months, these same companies still outperformed their counterparts. While the one-year post-IPO performance of all companies was affected by the 2007-08 financial crisis, and more recently by the Eurozone crisis, it is important to note that there have been enormous successes even in a difficult market. In recent years, the one-year post-IPO return of a number of venture-capital-backed companies has exceeded 25%. The standouts include information technology security firm Fortinet, whose one-year post-IPO return topped 150%; the professional social networking site LinkedIn, whose one-year return topped 120%; and the restaurant reservation site OpenTable, whose one-year return topped 105%.

	Average IPO Proceeds ($mm)						
	2007	2008	2009	2010	2011	2012 YTD	2007 to June 2012
VC backed IPOs	134.6	128.0	145.1	110.7	201.7	101.0	138.6
PI backed IPOs*	195.7	232.9	287.7	160.8	382.8	168.4	227.6
Non PI-backed IPOs	295.3	175.6	322.8	146.0	190.4	215.4	232.5
All IPOs	222.0	184.2	278.7	143.2	272.4	157.9	208.2
All IPOs without exclusion	222.0	581.4	371.5	220.5	272.4	304.7	271.9

	Total IPO volume							Total IPO Proceeds ($mm)						
	2007	2008	2009	2010	2011	2012 YTD	2007 to June 2012	2007	2008	2009	2010	2011	2012 YTD	2007 to June 2012
VC backed IPOs	57	7	12	64	51	32	223	7,670	896	1,742	7,087	10,288	3,231	30,913
PI backed IPOs*	123	13	36	109	78	53	412	24,069	3,027	10,357	17,527	29,855	8,927	93,763
Non PI-backed IPOs	112	28	29	59	61	22	311	33,074	4,916	9,362	8,614	11,612	4,739	72,317
All IPOs	292	48	77	232	190	107	946	64,813	8,840	21,461	33,228	51,754	16,897	196,993
All IPOs without exclusion	292	49	78	233	190	108	950	64,813	28,490	28,978	51,368	51,754	32,904	258.308

Note: Exclude IPO of Visa Inc; General Motors Co; Banco Santander Brasil SA; Facebook to eliminated skewness of averages
** Private investment backed IPO refers to backing by PE firm or by VC firm or by both*
Source: Dealogic, Thomson Financial, Ernst & Young
US exchanges IPOs

Door number 1, 2 or 3? Which is the best exit?

The data suggests that given the excellent performance of their portfolio company IPOs in recent years, venture capitalists should give closer consideration to an IPO as an exit strategy for more of their portfolio companies. Currently, venture-capital-backed IPOs are just 8% of the total exit pool,[1] in part because the ongoing Eurozone crisis and US election year uncertainty continue to dampen enthusiasm for IPOs among all players. However, in recent years, the percentage of venture-backed companies exiting via an IPO has been as high as 14%.

There are other reasons for optimism about the venture-backed IPO market, as indicated by the fact that two American exchanges, the New York Stock Exchange as well as the NASDAQ, are currently actively competing for venture-backed offerings. In addition, the new Jumpstart Our Business Start-Ups (JOBS) Act has eased the regulations associated with an IPO for emerging-growth companies — those with under $1 billion in revenue (among other tests) — and may be bringing new companies into the IPO pipeline. Under the JOBS Act, emerging-growth companies are now able to file confidential IPO registration statements with the Securities and Exchange Commission (SEC). In just the brief period between April 5 of this year, when the JOBS Act took effect, and late May, about 30 companies took advantage of this and filed confidentially, according to the SEC's Paula Dubberly.[2]

Finally, venture-backed companies continue to perform superbly after their IPOs. The National Venture Capital Association/Thomson Reuters *Exit Poll Report* for the second quarter of 2012 found that 9 out of the 11 venture-backed IPOs brought to market in the quarter were trading above their offering price.[3]

1 VentureSource, Q1 2012 data.

2 Emily Chasen, "Confidential IPO Filings Outpacing Public Ones," *Wall Street Journal*'s CFO Journal, May 30 2012, http://blogs.wsj.com/cfo/2012/05/30/confidential-ipo-filings-outpacing-public-ones, accessed July 19, 2012.

3 *Exit Poll Report* National Venture Capital Association/Thompson Reuters, July 2, 2012.

	Average post IPO performance - 1 day (%)							Average post IPO performance - 1 month (%)						
	2007	2008	2009	2010	2011	2012 YTD	2007 to June 2012	2007	2008	2009	2010	2011	2012 YTD	2007 to June 2012
VC backed IPOs	18.3	6.7	16.7	16.8	20.5	24.6	18.8	15.4	12.4	12.5	19.1	15.7	30.5	18.3
PI backed IPOs*	17.3	7.3	11.0	12.6	16.5	20.6	15.5	16.5	11.7	11.0	14.3	12.9	22.5	15.3
Non PI-backed IPOs	8.9	11.1	5.9	4.4	0.9	2.7	6.0	6.4	(2.9)	16.6	2.5	(2.7)	4.2	3.9

	Average post IPO performance - 6 months (%)							Average post IPO performance - 1 year (%)						
	2007	2008	2009	2010	2011	2012 YTD	2007 to June 2012	2007	2008	2009	2010	2011	2012 YTD	2007 to June 2012
VC backed IPOs	11.5	1.8	10.8	28.0	(4.8)	-	10.5	(17.2)	(0.4)	27.4	13.3	(11.4)	-	(1.1)
PI backed IPOs*	5.2	(17.4)	13.7	27.8	(0.3)	-	9.5	(19.0)	(17.9)	27.4	16.0	(2.8)	-	0.0
Non PI-backed IPOs	2.3	(24.4)	17.2	2.3	(4.9)	-	(0.3)	(20.8)	(31.9)	5.3	(12.4)	(12.9)	-	(16.2)

Note: Exclude IPO of Visa Inc; General Motors Co; Banco Santander Brasil SA; Facebook to eliminated skewness of averages
** Private investment backed IPO refers to backing by PE firm or by VC firm or both*
Source: Dealogic, Thomson Financial, Ernst & Young
US exchanges IPOs

Top Sectors (# of Deals)	2011
High Technology	34
Financial	22
Oil & gas	21
Health care	16
Real estate	9

Top Sectors (# of Deals)	2012 YTD
High Technology	20
Financial	10
Oil & gas	8
Health care	6
Retail	5

Top Sectors (capital raised $mm)	2011
High Technology	8,902
Health care	5,879
Oil & gas	5,720
Financial	4,200
Power & utilities	3,372

Top Sectors (capital raised $mm)	2012 YTD
Oil & gas	3,006
High technology	2,320
Financial	2,077
Retail	876

The venture capital effect

Academic studies suggest why venture-backed IPOs perform better than the market.

First, venture capitalists take a long-term view when selecting companies for funding. A forthcoming *Journal of Finance* article considered 25 years of U.S. Census Bureau data that tracks firms from their birth and found that venture capitalists choose their portfolio companies based on their scalability, rather than short-term profitability.[4] Clearly, venture capitalists perform an important function in an economy that depends on groundbreaking technologies. They give initially unprofitable but highly innovative companies that could not possibly fund their own growth the chance to gestate and mature. At the same time, venture capitalists' preference for scalability meets the demands of today's capital markets, which expect companies to have long-term growth potential.

Second, venture capitalists set the stage for further growth by actively professionalizing the young companies in which they invest. Another recent study, which looked at 3,200 entrepreneurial firms that went public between 1993 and 2004, found that venture-backed firms are associated with higher management quality, as measured by factors that include management team size, education, prior experience

4 Manju Puri and Rebecca E. Zarutskie, "On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms," *The Journal of Finance*, http://www.afajof.org/journal/forth_abstract.asp?ref=708, accessed July 19, 2012.

and core functional expertise.[5] Management quality and venture-backing, in turn, certify the firm's value to the IPO markets and have a number of positive effects on venture-backed IPOs, including increasing firm valuations both in the IPO market and in the immediate secondary market.

Finally, since venture capital tends to specialize and concentrate in a few high-growth sectors of the economy — including information technology, life sciences and cleantech — venture capitalists not only understand their portfolio companies' businesses and markets particularly well, but also can offer the management of these companies valuable guidance at every juncture.

This "venture capital effect" can be enormous. Over the period of a typical venture capital investment, venture-capital-financed companies are half as likely to fail as non-venture-capital-financed companies, 32 times more likely to be acquired and 805 times more likely to go public.[6]

Intensifying the venture capital effect: 10 steps to IPO readiness

At Ernst & Young, our experience with these young, high-growth venture-backed companies, supported by substantial research, suggests that companies beginning the process of preparation for an anticipated IPO 12 to 24 months in advance will typically outperform the market when they eventually complete their offerings.

Even when an IPO is not on the immediate agenda, early preparation will allow a company to take advantage of an IPO window should one open unexpectedly — and enhance the company's value should a merger or acquisition be the ultimate outcome.

Are your companies ready for the IPO Value Journey®? Here are the steps we recommend at Ernst & Young.

5 Thomas J. Chemmanur, Hassan Tehranian and Karen Simonyan, "Management Quality, Venture Capital Backing, and Initial Public Offerings," Add name of website here, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2021578, accessed June 17, 2012.

6 Manju Puri and Rebecca E. Zarutskie, "On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms," *The Journal of Finance*, http://www.afajof.org/journal/forth_abstract.asp?ref=708, accessed July 19, 2012.

Operate like a public company long before your firm becomes one

At successful companies, an IPO is not a single event, but a transformational process. Long before the company engages in the four phases of the IPO ramp-up — due diligence, drafting, SEC review and marketing — time should be spent on planning and processes. Businesses intending to go public in the next year or two should develop a formal, comprehensive written plan and timeline. They should develop an integrated transaction strategy that formalizes policies, procedures, reporting and communications. They should work on the legal, financial, technological and risk management infrastructure required of a public company. And they should address key financial and reporting issues, including accounting for stock option issuance and revenue recognition.

Keep an open mind

Every year, venture capitalists achieve an exit for significantly more of their portfolio companies through an M&A transaction rather than an IPO. Though such private M&A exits may lack some of the prestige of a stock market listing, they can be an effective and less costly vehicle for raising funds and realizing an optimal company valuation.

Private buyers often appear soon after a company strengthens its infrastructure and signals its intentions to go public. A multitrack approach during the IPO preparation process can therefore help a company improve its chances of raising capital and achieving the highest possible valuation. Multitrack options include:

- A sale to a private equity firm
- A sale to a strategic buyer
- Partnerships, joint ventures and strategic alliances
- Alternative liquidity options, such as Rule 144A placements or private exchanges and cross-border listings

We recommend taking into account all attractive alternatives. It should be noted that the ability to conduct confidential filings under the JOBS Act may impact the multitrack process, as the intentions of companies choosing the confidential filing alternative may not be as well understood in the public markets until later in the public offering process.

Develop a brilliant sense of timing

Timing is crucial to the success of IPOs. Instead of asking whether the stock market is ready for it, a company first needs to ask whether it is ready for the stock market. Input from a variety of external advisors, including investment bankers, attorneys and auditors, can help board members and management develop a realistic timeline for an IPO. It is important to communicate this expected timeline to key stakeholders throughout the process.

Even when the company is ready, it might be necessary to delay the IPO if the markets are unfavorable or there is a glitch in the offering process.

On the other hand, when an IPO is timed perfectly, the company can price its shares to yield an optimal valuation and the highest possible returns for its investors. Every IPO-bound company should be prepared to quickly enter into the registration process when a window of opportunity appears.

Company leadership must strike the right balance between managerial focus on the IPO transaction and the day-to-day operation of the company.

Convene a superb team

Clearly, the market looks for companies with high-quality management teams, and strong IPO performers typically begin the process of strengthening their management team a full one to two years in advance of an offering. It is crucial that venture capitalists work with the board as a whole and the CEO to determine whether key players have the skill sets necessary to run a public company.

A company considering an IPO also needs a strong set of external advisors with significant experience in taking companies public. The selection of a well-regarded team of financial and tax advisors, auditors, attorneys and underwriters carries significant weight with investors. These experienced professionals can help the company anticipate bumps in the road and resolve difficult issues before they are raised externally.

Finally, the CEO and CFO are very important to investors. The CFO must be able to communicate the company's financial results effectively to the investor audience. And the CEO must be able to articulate the company's vision and strategy, as well as execute the business plan and forge good relationships with all external stakeholders.

Assemble a solid infrastructure

Because of the risks and regulations associated with life as a public company, a financial, technological and risk management infrastructure must be built, and the right systems, procedures and controls put into place well before an IPO.

Often, newly public companies find it a challenge to produce quarterly financial statements. We recommend that companies prepare their financial statements as if they were already public for several quarters prior to the IPO.

Information systems need to be aligned both with the company's business objectives and critical reporting requirements. Management should have the information tools that allow it to make good decisions and answer analysts' questions quickly.

Establish excellent corporate governance

With heightened corporate governance standards for public companies and increased liability exposure, the board of an IPO-bound company should include a mix of audit, governance, compensation and compliance specialists, as well as experienced executives. Typically, small-cap company boards should aim for five to six outside directors with a minimum of three independent committees (audit, compensation and governance/nominating). Directors must be able to meet a substantial time commitment of 200 hours or more per year, and companies must be able to draw a definitive line between directors' duties and the responsibilities of executive management. Finally, the company should develop a deep executive bench and an appropriate succession plan.

Inform and communicate to potential investors

A highly skilled investor-relations professional — whether in house or on retainer — is essential to help guide a company's strategic communication plan in preparation for an IPO. He or she should be able to draw the market's interest and attract sell-side coverage and potential investors. The investor-relations professional should also be able to manage the risks associated with the external messaging. Once the company has gone public, he or she will have to continually retell the company's story and fine-tune the investment value proposition, as well as provide the appropriate guidance on milestones and financial performance.

Orchestrate a successful road show

For the CEO and CFO, the most exhausting part of going public is the pre-IPO road show, during which they present the company to large investors. The road show typically requires between 8 and 10 long days in the US and an additional few days in Europe or Asia, often with visits to multiple cities in a single day. It is extremely important that despite this grueling schedule, the company's messaging remains consistent. A well-designed road-show presentation with an "elevator pitch" and talking points is essential. Management's presentation coaching and practice are crucial to road show preparedness. Pre-IPO companies often consult professional presentation training specialists to prepare CEOs and CFOs for the unique requirements and rigors of IPO road shows. The presentation team should plan to rehearse formally a number of times before the first day of meetings.

Attract the right investors and analysts

In order to drive a strong post-offering performance, the company's message must continue to resonate, even as the investor pool expands to include thousands of new investors. At first, many newly public companies enjoy high share prices fueled in part by investors' interest in IPOs and by the press coverage for such companies. However, unless this interest is carefully maintained after the IPO, the initial euphoria will quickly fade.

Companies should develop a plan for outreach to equity analysts and shareholders — and actively cultivate a dialogue with them, attend conferences and initiate non-deal marketing visits. Early engagement of investors and analysts prior to the road show can help drive value and avoid surprises.

Prepare to prove that you are true to your word

Once a company goes public, the real work begins: keeping the promises made on the road show. Management has to prove its credibility to investors by using the proceeds of the public offering effectively and executing the business plan. Companies that are about to go public should clearly define the parameters and metrics that analysts and investors can use in tracking the progress of the business. Strong financial planning, analysis and reporting are key.

There will always be factors outside of the company's control — including volatile behavior on the part of the stock market, consumers and the larger economy — that affect operating performance. It is doubly important, therefore, that a company about to go public focuses on the factors it can control, such as managing the business well, meeting revenue numbers and creating value.

Preparing for an IPO is an intense and arduous process, and it's easy for management and employees to become distracted by the enormity of the task. Company leadership must strike the right balance between managerial focus on the IPO transaction and the day-to-day operation of the company. They must remember that preparedness can help lead to a successful IPO outcome, but all of the best financial engineering will not create business prosperity — only robust planning, accurate expectations setting and strong operational execution will forge the path to long-term success.

Conclusion: great public companies, a great contribution

Clearly, venture capitalists play an outsized role in the American economy. They fund innovation and improve productivity. Venture capitalists invest in the cutting edge, in companies with revolutionary ideas that have the potential to spawn whole new industries.

Preparing for the IPO Value Journey®

1. Operate like a public company
2. Keep an open mind
3. Develop a brilliant sense of timing
4. Convene a superb team
5. Assemble a solid infrastructure
6. Establish excellent corporate governance
7. Inform and communicate to potential investors
8. Orchestrate a successful road show
9. Attract the right investors and analysts
10. Prepare to prove that you are true to your word

It is no accident that although venture capitalists' portfolio companies represent only a tiny fraction of all new American firms, those companies create a disproportionate share of the country's employment.[7]

Arguably, however, venture capitalists make their greatest contribution by helping to shape great public companies. A well-managed IPO not only represents the best possible outcome for venture capitalists and their limited partners, but also may well represent the best possible outcome for entrepreneurs and for the economy as a whole. Through an IPO, a promising company can finance its growth while retaining independence and a unique personality that might be lost in an acquisition or other form of private purchase.

By so successfully launching their portfolio companies into the public markets, venture capitalists regularly add new iconic enterprises to our market landscape — many companies with such strong identities and transformative products they change the world for the better.

7 Manju Puri and Rebecca E. Zarutskie, "On the Lifecycle Dynamics of Venture-Capital- and Non-Venture-Capital-Financed Firms," *The Journal of Finance*, http://www.afajof.org/journal/forth_abstract.asp?ref=708, accessed July 19, 2012.

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