Executive summary

- The IPO window for December 31 year-end filers was effectively completed on February 14 (when 2016 audits became required for filings), creating a natural break point to assess the state of the market.
- The broader indices continue to perform, providing a constructive backdrop for the new issue environment.
- While six weeks is a limited sample size, we are encouraged by the deal flow, diversity of issuers and price performance in 2017 to date.
- Early data points on the health of the IPO market are mostly constructive, and our optimism expressed at the end of 2016 has not abated.
  - IPO performance - pricing and aftermarket trading - remains positive.
  - Issuance spread across a broad range of sectors, some of which are typically less active in the 1Q window, indicating issuer confidence in the IPO market.
  - Unemployment, commodity prices, and other economic indicators continue to largely trend positive.
- Dual-track processes are increasingly topical; M&A bids are actively competing with the IPO market / investors in many cases.
- Perhaps the biggest driver of optimism around the IPO market in 2017 is the backlog of quality private companies funded over the past 3-4 years by public style investors seeking to IPO for their next round of funding.
- Many issuers are targeting windows in March, and even more in May / June; issuance and performance over that 2-3 month stretch will influence prospective issuers for 2H17, and will provide for a more informed outlook on IPO activity for the balance of the year.
- While we remain confident in our projections for normalized levels of IPO activity in 2017, there are always exogenous risks that can impact the market over the near- and long-term.
- As always, prepared prospective issuers have option value and the ability to access the market opportunistically, creating leverage with investors.
Level-setting to our previous 2017 outlook

As we have previously discussed, 2015 and 2016 were down years for the IPO market. A confluence of factors contributed to these historically low issuance levels, including:

- Access to attractively sized and priced private capital, allowing the decision on an IPO to be pushed to a later round / date
- Aftermarket performance of the 2015 IPO class was poor, impacting investor appetite for new issue investing
- Historically high public market valuations and an uncertain interest rate environment contributed to a 10%+ market correction in January 2016, driving a risk averse tone with investors
- Given the negative market tone many potential issuers effectively went ‘pencils down’ in early 2016, electing to postpone readiness activities until a later date

However as 2016 progressed and 2017 approached, several factors indicated that a reversion to more normal levels of IPO deal activity over the next 12-18 months was possible. Chief among these considerations:

- A stable macroeconomic environment, with data trending positive
- An interest rate environment that while rising, felt more ‘predictable’ than 12 months prior
- Positive equity market momentum out of the November election season, driven by expectations for significant corporate tax reform and deregulation
- A backlog of quality companies funded over the past 3-4 years by public-style investors, that are more likely to pursue the IPO route to alternative transaction strategies
- And perhaps most importantly, the return of positive aftermarket price performance for IPOs, with the 2016 IPO class significantly outperforming the indices (increasing investor risk appetite)
Six weeks into 2017, underlying trends in the broader market remain constructive

The beginning of 2017 has seen a continuation of the positive market momentum that began in the fourth quarter of 2016. Year-to-date the Dow, S&P 500 and NASDAQ are currently up between 4% and 7%. The Dow crossed the optically important 20,000 threshold on January 25th and has mostly held the level. Within the S&P 500 the technology sector has driven performance, and eight of the ten S&P sectors are in positive territory. Several macro-economic factors have contributed to the broader market tone, including:

- **Employment data continues to trend positively.** In January non-farm payrolls gained 227,000 jobs which exceeded Wall Street's expectation for 174,000 jobs, and was above the 3 month average of 183,000. The increase in the participation rate from 62.7% to 62.9% was viewed positively, and somewhat explained the uptick in the unemployment rate to 4.8% from 4.7% in December.

- **Upside surprises driving strong 4Q earnings season.** With 358 of 500 companies reporting, 75% have met or beaten expectations and year-over-year earnings growth is averaging 13% (ex-energy). The year-over-year comparison is especially favorable for the energy sector given the difficult price environment last year; including energy, overall S&P 500 earnings growth has increased 26% over the comparable period last year.

- **Oil price stability.** In addition to “fueling” energy sector earnings, oil price stability continues to be a stabilizing force across the broader market as well. OPEC’s production agreements at the end of 2016 effectively provided a temporary floor for West Texas Intermediate spot prices, which seems to have stabilized in the $50s. The combination of global supply constraints and price stability has spurred the return of domestic shale drilling, providing the market and business environment with some comfort that energy price volatility will be manageable (absent currently unforeseen events).

Volatility as measured by the Chicago Board Options Exchange Volatility Index (VIX) has also remained at historically low levels, recently trading consistently between 10 and 11. While equity markets seemingly find new highs on a monthly basis, most market participants seem to agree that the new issue and equity environments do not necessarily feel like the “historically low risk” environment that the VIX suggests. While underlying macroeconomic data have remained stable and investors continue to express optimism about the implications of policy actions, the first weeks of the Trump administration have highlighted the chance of unexpected announcements and corresponding volatility along the way. As such there is some question if the VIX is capturing investor anxiety as accurately as it has in the past.

Unexpected events, whether geopolitical or policy-based, cause uncertainty that can ripple through the market as investors attempt to assess implications for their existing portfolio at the expense of new investment ideas. Another measure of uncertainty related to the VIX is the CBOE Skew Index, which measures the price premium of forward contracts to protect against dramatic moves in the S&P 500, versus contracts associated with smaller moves. This ratio has jumped in recent weeks, indicating investors likely do in fact perceive greater tail risks than currently conveyed in the traditional VIX measurement (See: Exhibit 2).
IPO activity in the first quarter of 2017 has also been encouraging

The first quarter of the calendar year is a challenging time to evaluate IPO conditions. December 31 fiscal year-end filers only have until February 14 to price their transactions. After this date a Form S-1 filing must include 2016 audited financials, which typically are not available until early-to-mid March at the earliest. As we have noted there are a variety of factors that drive issuers to avoid this initial window of the year including:

- A desire to focus on closing books and completing audits
- Investor questions / disclosure around recently completed periods
- Higher underwriter diligence requirements
- Limited credit for forward year projections in valuation

However, this window can also be advantageous for issuers as investor demand for new issuance can be strong. Coming into a new year, portfolio managers reset their return targets and are seeking new investments to outperform their benchmarks. As such companies that can overcome the January / February listing challenges mentioned earlier benefit from the supply curve (limited issuers coming to market) shifting in and the demand curve (increased investor appetite for investment) shifting out. That said, a theoretical demand curve shift - like most Wall Street wisdom - is of course not a given. Investor willingness to “put money to work” has less to do with the calendar and is more correlated with underlying capital markets conditions. For example the positive IPO market results to date in 2017 are more a product of 2016 IPO class outperformance combined with broader equity market index stability than the theoretical increased investor appetite in the New Year.

Given the broader issues and considerations around the window, January and February are imperfect indicators for market interest and deal receptivity. However the February 14 staleness date for December 31 year-end filers provides a natural checkpoint to evaluate the state of the IPO market. To date in 2017
there have been 13 IPOs in the U.S. raising $5.0 billion, representing a return to “average” activity levels of the past 10 years (See: Exhibit 3).

As discussed there has been much anticipation and excitement coming into the year for a bumper IPO crop, and while activity to date is encouraging, transaction volume in and of itself is not a great indicator either way for projected activity in 2017. Deal performance and composition of this IPO class are equally important indicators for the health of the IPO market vs. simple deal and volume metrics. Factors we are tracking include:

- **Pricing power remaining balanced between issuers and investors.** Of the 13 IPOs priced to date in 2017, nine (69%) have priced in or above the initial marketing range while four offerings priced below. These percentages are incrementally better than results from 2016 on the whole, but slightly worse than the second half of 2016. With a small sample year-to-date it is not productive to read too much into these outcomes, but it is incrementally instructive and worth tracking as we progress into the year. While several deals have not performed as well from a pricing perspective, investors demonstrating selectivity can also be viewed as a positive sign for the health of the market. Indiscriminate momentum / buying across the asset class often correlates to a reversion in the near future.
Equity capital markets update –
Recent U.S. IPO activity and 2017 outlook
February 17, 2017

Aftermarket trading continues to be strong. Last year set investor expectations that IPOs can price at reasonable valuations and trade well in the aftermarket. Aftermarket performance for the class of 2017 IPOs continues to be strong. Offer to 1-day performance is comparable to the strong second half of 2016, and outperforming the class of 2016 as a whole. Offer to current is harder to compare given the difference in time since the IPO; however, the fact that 2017 offer to current is positive and delivering outsized annualized returns to investors is constructive. Also, importantly, the class of 2016 has continued to trade well through their first several earnings seasons - a high risk period for deals and the IPO market in general. If companies miss earnings in their first several quarters, the negative price impact is substantial; a series of “misses” across an IPO class can have broad negative ramifications on IPO investing in general.
Equity capital markets update – Recent U.S. IPO activity and 2017 outlook
February 17, 2017

- **Diversification across sectors.** Traditionally, the January / February window is most popular with biotechnology and other early stage issuers that do not have overly complex financials to close from the prior fiscal year. This year we have seen biotechnology deals come to market, as well as issuers from a variety of other sectors including oil & gas, industrials, technology and real estate.

### Exhibit 6: January 1 - February 14 IPO issuance (by # of deals)

#### 2006-2016

- Biotech: 25%
- TMT: 16%
- Energy & Utility: 14%
- Finance: 10%
- Real Estate: 9%
- Industrials: 10%
- Healthcare: 9%
- Consumer: 7%

#### 2017 YTD

- Industrials: 31%
- Energy & Utility: 23%
- Biotech: 23%
- Real Estate: 15%
- TMT: 8%

Source: Dealogic
Note: As of 14 February 2017. Includes SEC registered IPOs $30mm+ that priced between January 1 and February 14. Excludes BDCs and SPACs.

- **Acquisition bids are competing with IPOs.** Cash is often king for private equity investors, and a sale can provide attractive transaction rationale such as return certainty, reduced market risk and accelerated timing for return on investment. An IPO process will often become an official (or unofficial) “dual-track” process, which can run parallel to IPO preparation and execution. Several recent dual-tracks resulted in companies accepting acquisition offers just prior to the roadshow launch, or even after the company was on the road. Recent deal activity and the cash war chests of potential acquirors (both strategic and financial) suggest that the M&A bid will continue to compete with the IPO market for certain deals, and with IPO investors in pricing discussions. In order to leverage the benefits of a dual-track process, issuers often budget time and resources during an IPO process for discussions with acquirors - either proactively or reactively. One side note - companies often pursue dual-tracks to create pricing tension and increase the value an IPO or a sale. Within this context, it is critical to run viable processes for both tracks, and in particular a well-paced IPO process. Companies that prefer a sale, and file S-1s largely just to stimulate valuation and price discovery, typically are not successful in leveraging the dual-track into a higher price and better outcome. In fact if the process erodes credibility, the value impact can potentially be negative.

**Our new issue market outlook remains constructive**

Based on early IPO activity in 2017 we remain optimistic about the outlook for IPO issuance in 2017, and expect deal activity to return to historical averages or better. We are encouraged by a number of factors including this year’s volumes and diversity across sectors and deal sizes. We are also highly encouraged...
anecdotally by the volume and tone of conversations across our client base with respect to plans for IPO execution over the next 6-18 months.

While there will be a lull in activity over the coming weeks as issuers with December 31 fiscal year-ends complete audits, we see many issuers positioning for the next traditional windows. While some companies may be able to accelerate their audit process and get to market in late February or early March, the bulk of deals will come either in late March or May / June.

Typically the May / June window, after March 31 results are available, is the longest and one of the most active IPO windows on the annual deal calendar. From a process perspective it allows ample time to complete year-end audits and the first quarter review. Additionally, it is traditionally the first window of the calendar year that investors give valuation credit for the next full calendar year projections, which can improve deal values. If current market conditions persist, the combination of these factors should draw a healthy number of issuers to market during that window. IPO performance statistics (pricings relative to range, aftermarket price appreciation) in that window will be a driver of deal volumes in the second half of 2017, and ultimately whether or not issuance lives up to current expectations.

While our IPO outlook remains constructive, there are several risks to deal flow including:

- Underprepared companies racing to market before their enterprise is “ready.” Urgency to take advantage of business momentum and financing conditions is encouraged, but sacrificing readiness can have ramifications if it impacts longer-term performance. A series of deals that trip up in their first several quarters in the public eye could taint the new issue market in general
- The perceived risk and uncertainty evident in the CBOE skew data could spread to more traditional measures, and reduce investor appetite for new investment opportunities
- The market is expecting a number of business-friendly initiatives and policies out of Washington, most of which are still to be presented and debated. If tax reform and/or certain financial regulatory roll-backs were to be delayed or deferred, we would expect the market to react negatively which in turn could impact the IPO market
- An exogenous macro / news event could impact the May / June window, crowding issuance into the 2H17 windows

Conclusion

We take a long-term view of the IPO markets and recognize that predicting annual IPO volumes is a reliably difficult task. However, as we have noted throughout this update, our view is that the new issue market is poised to improve in 2017. Several trends that bear watching include:

- Aftermarket performance of recent transactions has the largest impact on future investor receptivity
  - Most of the 2017 YTD issuers won’t have catalysts until they formally announce their first quarter financials in April / May
  - Issuers ability to hit revenue and earnings targets will be critical to the tone of the IPO market and impact access
- Dual- track processes have become increasingly prevalent. Getting in front of potential discussions requires foresight and planning, which allows the organization to react and manage both transaction paths if desired
- With the market at all-time highs and investors adjusting to policy announcements under the new administration, periods of market uncertainty seem inevitable. When these events occur in relation to IPO windows is obviously unpredictable. The best course for motivated issuers is to aggressively pursue
and complete preparations as soon as practicable, preserving the option to evaluate market conditions at an opportunistic time.

In the current environment, execution risk is heightened by the potential for crowded issuance windows, distracted advisors and unpredictable exogenous shocks. As such the value of an independent perspective to help navigate transactions and processes is elevated. EY’s Equity Capital Markets team can tailor a unique value proposition to potential IPO issuers including:

- Designing an efficient transaction process (strategy, options, timing)
- Perspective on transaction structuring alternatives and market conditions
- Preparation for communications and meetings with external constituencies such as investors, research analysts, and bankers
- Providing additional resources to leverage throughout transaction preparation, planning and execution

As always, prepared prospective issuers have option value and the ability to access the market opportunistically, creating leverage with investors. We look forward to working with clients to help create this flexibility and advantage. Please reach out with any questions.

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