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Sluggish IPO Market Hurts Private Equity And Venture Capital

BY BRIAN DEAGON

The market for initial public offerings is having a sale!

"It's a good time to buy IPOs," said Kathy Smith, principal of Renaissance Capital. "It's a buyers market because investors are being picky and they want a discount."

But what's good for buyers isn't all that good for venture capital firms and large private equity firms, which rely on a healthy IPO market to cash out some of their investment portfolio. Just 10 venture-backed companies came public in the first quarter, the fewest in six quarters.

That's causing an exit-strategy adjustment.



"It's making the mergers and acquisitions route look more attractive," said Mark Heesen, president of the National Venture Capital Association. "We weren't caught off guard by this lull, but it has been a little more serious than some anticipated."

Meanwhile, the IPO effect on private equity firms showed up most notably this month when Boise Cascade canceled its IPO, citing adverse market conditions.

The underwriters had a strike price of \$24-\$26 for 16 million shares, then dropped it to \$17-\$19. That didn't work, either.

"When we started down this path, market conditions were obviously much different than they were at this time," said Boise CEO Tom Stephens in a statement.

Dearborn Partners acquired the timber, paper and forest-products firm for \$3.7 billion in a deal that closed seven months ago.

Also this month, Warner Music (WMG) priced its IPO at \$17, far short of its lowered target of \$22-\$24. Now trading under 16, the music firm has a market value of \$2.36 billion, or \$300 million less than what an investor group paid for it last year.

Typically, buyout firms seek companies that are underperforming due to inefficient operations. Management experts right the ship, and the company is sold or brought public. The equity firm may earn 10% to 20% on its investment. Venture capital firms mainly bring startups to market, earning similar amounts.

To be sure, the IPO market is not where venture capital and private equity firms make most of their profit. Mergers and acquisitions are the main route. Only 25% of firms that exit VC portfolios do so via an IPO. But an IPO is where venture capital firms look to hit a grand slam.

"You're looking for that grand slam to offset other losses," said Heesen. "That one deal can make a fund, and it's harder to do that through an acquisition."

The cuts in IPO price targets mainly come about as big institutional investors display a lack of interest in buying shares. Investment bankers then cut the asking price to get their attention.

Of 18 IPOs launched since April 1, five cut their price target, two were raised and the rest were unchanged. Four firms, including Boise, pulled their offerings, according to Renaissance Capital, which runs ipohome.com.

Factors that influence IPO price include a company's profit and sales outlook, its age and market position, and management talent.

The overall stock market performance also plays a key role. Here the outlook is improving. After a rocky start to 2005, the Nasdaq, S&P 500 and the Dow have been rallying off their April lows.

But IPOs are still struggling. Two smaller firms had lackluster debuts Thursday. Diamond Rock rose 1% to 10.60 after the hotel REIT's IPO priced at the low end of its range. SSA Global closed flat at 11 after the software firm slashed its offering size and price.

"The sky is not falling, but it does cause venture capital firms to pause when they are trying to exit a number of companies with an IPO market that is uncertain at this point," said Heesen.

That's truer for venture capital firms than it is for most private equity companies.

"The first choice for private equity is not an IPO exit," said Howard Ross, partner with LLR Partners, a midsize private equity firm. "The primary exit is selling a company upstream to bigger players in the industry."

About 90% of private equity deals are for companies bought for less than \$1 billion.

"The IPO window does not have as much impact on most private equity firms out there," said Ross.

He added, "The top 10% will have a difficult time selling bigger companies upstream because the buyers might not be there. They need the IPO."

And large private equity firms are looking at bigger and bigger deals. They've raised \$50 billion this year vs. \$42 billion in all of 2004.

Firms are creating record "megafunds" of \$10 billion.

A group of private equity firms agreed in March to buy SunGard Data (SDS) for \$11.3 billion. That's the largest leveraged buyout since RJR Nabisco was acquired for \$31 billion in 1989.

The funds are getting larger because private equity firms believe that large companies that are insufficiently run now have the best potential for a turnaround and a big investment return, said Ross.

Buying larger firms could mean for double trouble. Opportunities to exit might lessen while the market could become more competitive.

"Two years from now there may be so many megafunds created, all going after the \$5 billion-plus deals, that we'll see more competition and the loss of a bidding edge," Ross said.