

Time for reality check on the return of IPOs

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May 13, 2011 Friday

After a long absence, Silicon Valley is understandably giddy about the return of our cherished IPOs.

The number of tech IPOs is on track to be up this year from last year; it's the best start to the year since 2007. There's a healthy pipeline of companies that have filed to go public. And next week's expected LinkedIn IPO, while not giant, will give the valley's tech economy a psychic boost.

But step outside Silicon Valley, and IPO experts have a sobering message: The IPO drought is far from over. In fact, it may never end.

"As much as I'd like to be optimistic here, I think, realistically, we're going to continue to see a tough IPO market," said Mark Heesen, president of the National Venture Capital Association.

Aside from the ego boost for entrepreneurs, IPOs are important to the valley because companies that go public raise more cash, which means they spend more on infrastructure and hiring people. On the other hand, when startup companies get acquired, the merged companies often cut jobs to save money. And for venture investors, the returns from IPOs are usually better than the payoff from acquisitions or other deals.

Alas, IPOs will remain out of reach for most small and mid-sized companies. I know that's not what many in Silicon Valley want to hear, and may not expect, given all the buzz about mega-IPOs for companies like Facebook, Zynga and Chicago-based Groupon.

There's been a hope that the momentum from these IPOs might blaze a trail for smaller companies.

At first glance, the numbers seem to justify the good mood. According to Renaissance Capital, there have been 21 tech IPOs so far this year, raising \$2.7 billion, compared with 42 for all of 2010. And the NVCA, which tracks IPOs a bit differently, said there were 14 venture-backed IPOs in the U.S. during the first three months of this year, the most in that period since 2007. There have been eight tech and biotech IPOs in the Bay Area this year.

"That's a very strong signal that tech is back," said Lee Simmons, editor of Hoover's, an IPO research service. "There's a lot of investor interest in Silicon Valley again, that can't be denied."

So why all the gloom?

Heesen raised two issues. First, one-third of the venture-backed companies that had IPOs in the U.S. last year and so far this year are based overseas. That's fine for U.S. venture funds that put money into overseas companies, but it's not doing much for the U.S. economy.

Second, while some of the tech companies traded strongly out of the gate, many have

performed poorly since.

According to Renaissance, tech IPOs this year have produced an 11.4 percent return, which is just so-so. One of the highest-profile tech IPOs, Demand Media, is down 28 percent since its January IPO. NeoPhotonics of San Jose is down 45 percent since its February IPO.

"A number of these companies have come out the box and done OK for a week, but then tapered off," Heesen said.

And then there are the larger structural issues facing any company considering an IPO. Even Simmons, who was more optimistic than many folks I interviewed, said it's going to remain incredibly difficult for smaller and mid-sized companies to go public. Investment banks are focused on the very largest deals, such as Facebook and Zynga, and don't have the staff to handle smaller potential IPOs.

"For the small company, the IPO is a lot harder than it was 10 years ago," Simmons said.

Everyone likes to focus on Sarbanes-Oxley, the reform law passed in the wake of the Enron and other corporate scandals, which beefs up the reporting companies must do to investors and the government, to explain why it's so hard to go public. But a report by David Weild, a former vice chairman of Nasdaq, and Edward Kim of research firm Grant Thornton makes it clear that the challenges run far deeper.

Even as the number of IPOs begins to slowly climb, a number of changes to the ways stocks are traded has led to a stunning drop in the number of public companies on U.S. stock exchanges, from 8,823 in 1997 to 5,095 in 2010.

A similar trend has emerged in Silicon Valley, where the number of public companies has fallen from 417 in 2000 to 222 in the Mercury News' latest report on the SV 150.

That is doing two things. Because the cost of trading has fallen and the number of shares to trade is falling, brokerages have had their revenue decimated, and they in turn cut back on things like research and staff that are critical to finding buyers for the stocks of smaller public companies.

Secondly, the pressures that have led to fewer public companies are also holding down the number of companies going public, a trend Weild says will continue.

"There's a lot of happy talk, and maybe it feels good," Weild said. "But the IPO is not going to come back like it used to. And it's really kind of striking. Because if you look at the amount of venture capital that is being raised, you have to wonder how they expect to make a return."

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