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Restarting IPOs: The Shortest Path to Recreating Economic Growth in the United States

Foreword

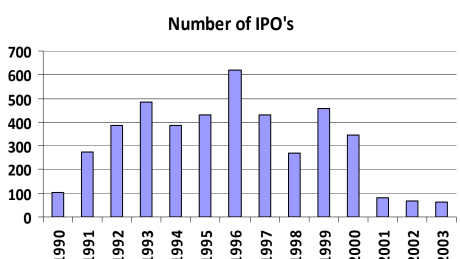
The following paper was written in November 2008, as markets and the economy were entering their steep decline. Since then, the situation described here – of how the Initial Public Offering marketplace is not functioning -- has continued. If anything, jump-starting that market is even more important today than it was when this idea was first floated. Writers such as former Senator Bill Bradley and columnist Thomas Friedman have made similar proposals. This paper represents our case for the urgency and benefits of taking special action to revive the IPO market and our ideas of how it can be done.

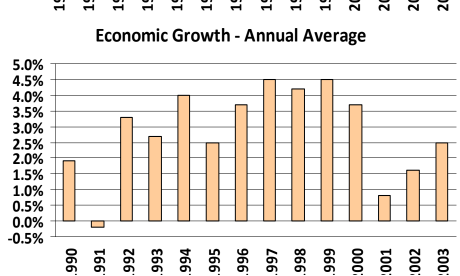
Introduction

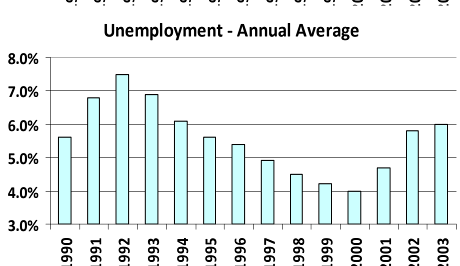
The current economic environment is bleak. Unemployment is rising. Investor confidence continues to decline. The capital markets are broken. These are perilous times as the country slips into a recession or worse. While the government has taken a number of steps meant to stabilize the economy, it must do more to speed our recovery.

The single most important method to revitalize the current economy is to recreate the economic growth seen under the Clinton administration through short term legislation meant to "unclog" the initial public offering (IPO) market. This can be accomplished with a rather simple piece of legislation and at a very small cost to the Treasury. The IPO market will recover regardless - but it would make an enormous difference to the U.S. economy if it happened in the next year, rather than three or four years from now.

There has been a significant decline in the number of IPOs since the beginning of 2008. This decline is the result of an investor flight to quality, the credit crunch, and the disproportionate impact of the Sarbanes-Oxley Act on emerging and high growth companies. The IPO drought is in turn creating a capital market crisis for high growth technology companies, causing many companies to slow growth and tying up significant amounts of risk capital that the economy needs to be reinvested. The government must address these problems because the lack of IPOs has had the most impact on the very companies that have led the growth of the American economy, represent a significant portion of US exports, and are critically important for America's world standing.







A healthy IPO market is terribly important for the government's ability to create jobs, restore investor confidence in the US economy, and maintain our competitive standing in worldwide technological innovation and development. As attention shifts to fostering the development of more green technologies, a healthy IPO market will be even more critical to inspiring innovation. It should also be noted that the necessary funding and interest in technology-based IPOs will have a positive impact on interest in math and science education in the US, an area in which our deficit is widely acknowledged. While "DE-regulation" is typically favored by pro-business constituents, given the severity of the crisis we must pursue short term "RE-regulation" of this important part of our economy, similar to that seen recently in the banking industry.

Background

IPOs, the first-time issuance of common stock by new companies, are a major way for high growth technology companies to access capital to grow operations. Their impact on the broader US economy should not be underestimated: public companies that were once venture-backed currently account for 10.3 million

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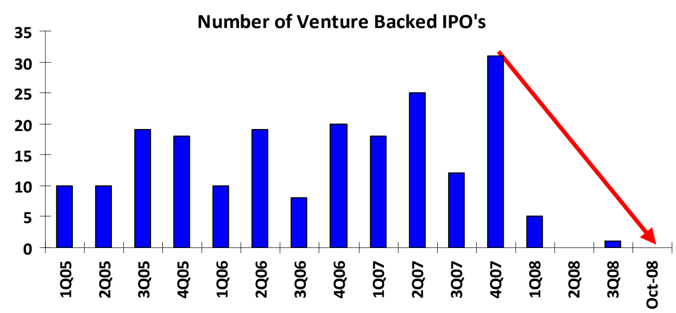
jobs and 18% of the US GDP.[1] Between 1993 and 2000, the United States saw a large number of IPOs and the best economic performance of the past three decades.[2] In 2000, the U.S. economic expansion surpassed in length the expansion of the 1960s, and thus became the longest on record.[3] During Clinton's second term, and as a result of a series of programs enacted by his administration, real economic growth averaged four and one-half percent per year,[4] and unemployment fell to four percent,[5] the level that had been specified by the Humphrey-Hawkins legislation three decades earlier to be the goal of national policy.

Companies that went public in the 1990s[6]

- Amazon.com, employs over 20,000 people, and generated $14.8 billion in annual (2007) revenue
- EBay, employs over 15,000 people, and generated $7.6 billion in annual (2007) revenue
- Yahoo!, employs over 14,300 people, and generated $6.9 billion in annual (2007) revenue
- Expedia, employs over 7,000 people, and generated $2.6 billion in annual (2007) revenue
- F5 Networks, employs over 1,500 people, and generated $650 million in annual (2007) revenue
- Additional examples include: E*Trade, C/NET, Priceline.com, Razorfish, CareerBulder, TheStreet.com, Edgar Online, Juniper Networks, Drugstore.com, Hotjobs.com, NetZero, HealthStream, Cheap Tickets, iVillage Inc, and MarketWatch.com.

Current IPO Market Crisis

Since the end of 2007 there has been an extremely sharp decline in the number of IPOs. The second quarter of 2008 was the first time since 1978 the US experienced a quarter with no venture-backed IPOs.[7] It has been 15 weeks since a company has held an IPO in the U.S.; since the 1970's the U.S market hasn't gone longer than two consecutive months without an IPO.[8]



While there has been a noticeable absence of venture-backed IPOs, over the last five (5) years, venture capitalists have continued to raise funds and invest in companies. Venture capital funds raised $9.1 billion in the second quarter of 2008, a 3% increase over the second quarter of 2007.[9] Those venture capitalists are no less capable today at investing in promising young companies than they were in the 1990's. It is therefore reasonable to conclude that there are in fact a number of venture backed companies in the IPO pipeline that are not yet able to raise capital in the public markets.

Target Industries

The industries that will catalyze the next high growth cycle in the US economy rely on the risk capital currently tied up in private companies, many of which are seeking liquidity events. Currently thirty-eight venture-backed companies have filed for an IPO with the SEC and twenty-eight venture-backed companies have withdrawn from registration in 2008.[10] It is unknown how many have not filed due to market conditions.

[1] National Venture Capital Association, No Venture-Backed IPOs Issued in the Second Quarter of 2008, http://www.nvca.org/pdf/Q2_08_Exits_Release.pdf (Oct. 27, 2008).
[2] Jeffrey Frankel and Peter Orszag, American Economic Policy In The 1990s, 1st Ed. (The MIT Press, 2002).
[3] Bureau of Economic Analysis, Gross Domestic Product: Percent change from preceding period, http://www.bea.gov/national/index.htm#gdp (Oct. 27, 2008).
[4] http://www.bea.gov/national/index.htm#gdp.
[5] Bureau of Labor Statistics, National Annual Labor Force Statistics, http://data.bls.gov/PDQ/servlet/ (Oct. 27, 2008).
[6] Google Finance Search by company, http:// http://finance.google.com/finance (Oct 28, 2008).
[7] http://www.nvca.org/pdf/Q2_08_Exits_Release.pdf
[8] Lynn Cowan, "Online School Poised to End IPO Drought", Wall Street Journal, Nov 8-9, 2008.
[9] National Venture Capital Association, 2008 Venture Capital Fundraising Activities Strengthens in Second Quarter, http://www.nvca.org/pdf/fundraisingQ308.pdf (Oct. 28, 2008).
[10] National Venture Capital Association, Venture-Backed IPO Drought Continues in the Third Quarter of 2008, http://www.nvca.org/pdf/Q308ExitPollFinal.pdf (Nov. 11, 2008).

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- Environment: According to the United Nations Environment Program, wind, solar and bio-fuel companies received a record $148 billion in new funding in 2007 as rising oil prices and climate change policies encouraged investment in renewable energy (presumably predominately private companies). This technology is expected to reduce the United States' reliance on foreign oil, reduce the enormous transfer of wealth to a "volatile" region of the world, and combat global warming, an urgent threat to the future of human existence. To quote Al Gore, "the bold steps that are needed to solve the climate crisis are exactly the same steps that ought to be taken in order to solve the economic crisis and the energy security crisis."[11] A healthy IPO market is critical to attracting the necessary capital to build companies that will lead to American energy independence.

- Healthcare: In 2007 the global biotechnology industry raised $30 billion in financing.[12] Healthcare represented over 16% of the 2007 U.S. GDP and is expected to reach 20% by 2016.[13] In the last two weeks of October, nearly half of the biotech companies in the IPO pipeline dropped out.[14] If liquidity events do not occur, risk capital will not be redeployed to fund advancements in lowering healthcare costs or lengthening and improving the quality of life. This situation grows more critical by the day: as reported in October 2008 by Jeffries & Co., roughly 50% of the 248 non-profitable biotechnology companies have less than 12 months of cash.

- Infrastructure: Advancements in our infrastructure will lead to energy efficient building materials, an energy efficient transportation grid, emerging technology that expands the demographics of who can engage in commerce, and advancements in our ability to communicate and access information. For example, during the Presidential campaign, President Obama discussed new ways of using spectrum. Unlicensed spectrum presents a potential and much-needed competitive challenge to incumbent telecom duopolies, the capacity for a rural broadband revolution, and sets up the possibility of a flourishing mobile economy. However, while the regulatory environment is already tilting dramatically towards incredible innovation, the lack of financing of new companies through the private sector could present an impediment to what should be an unprecedented era of job growth in the high-risk and high-reward information-driven sectors of the economy that created much of the prosperity of the 1990s.[15]

[11] Al Gore, "The Climate for Change", New York Times, Nov 9, 2008.
[12] Ernst & Young, Global Biotechnology Report 2008, http://www2.eycom.ch/media/mediareleases/releases/20080520/en.aspx (Nov. 10, 2008).
[13] www.nchc.org (Nov 11, 2008).
[14] Reuters, Biotech IPOs dying on the vine, http://www.reuters.com/article/ousiv (October 31,2008)
[15] This example and language courtesy of Matt Stoller, http://www.mattstoller.com/

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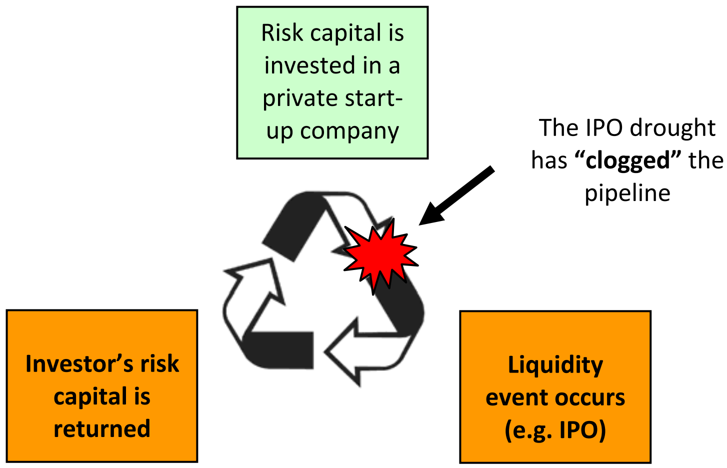

Below are profiles of IPO qualified companies that have not been able to access the public markets. By assisting companies like those below raise capital, we would create jobs, restore confidence, develop technology to increase productivity, and treat diseases, all of which would help revitalize our economy and requires relatively little Federal assistance.

Company Profile 1

Company Profile 2

Company Profile 3

Company Profile 4

Company Profile 5

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There are a significant number of high quality, venture backed companies that are either in the IPO pipeline with a filed S-1 or have postponed a filing due to market conditions. Given sufficient interest in this proposal, Broadmark would collaborate with top tier venture capital firms across the US to develop a list of 12 promising young companies that would be immediate IPO candidates under the program outlined below.

While not venture backed, Arista Networks[16] (formerly Arastra) is an excellent example of the highly significant technologies that germinate in the US economy. Founded by David Cheriton, a seed investor in Google and serial entrepreneur, and Andy Bechtolsheim, a seed investor of Google and co-founder of Sun Microsystems, Arista Networks is developing 10 gigabyte Ethernet switches to enable Cloud Networking™ solutions that will provide network scalability – i.e., a network that can grow as a business grows -- at unprecedented cost effectiveness. Independently funded, Arista Networks' step change advancements in IT speak to the creativity and ingenuity of start-up US companies as a whole. Without funding, Arista Networks would have resembled the hundreds of other companies developing equally important technologies that are currently unable to raise the necessary capital to bring those products to market.

Causes of the IPO Crisis

The three main causes of the recent decline in IPOs are an investor flight to quality, the credit crisis, and disincentives from the Sarbanes Oxley Act.

[16] Neither Broadmark nor affiliated parties of Broadmark are shareholders of Arista Networks

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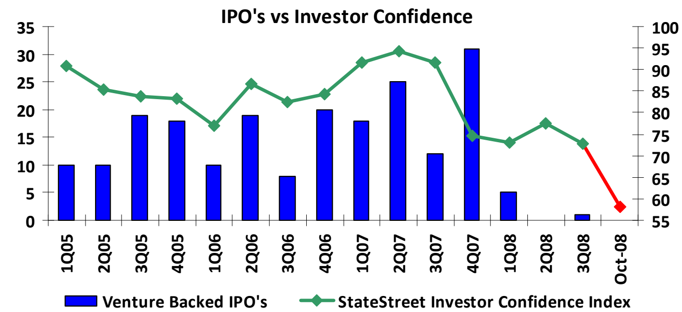
1) Investor Flight to Quality - Investor returns on start-up companies can be very volatile, causing investors to view these investments as "risky." During periods of uncertainly and low investor confidence, investors put their money in low volatility (risk) investments. The graph to the right shows that the number of IPOs can be largely affected by investor confidence. The sudden large drop in investor confidence between Sep-08 and Oct-08 is a strong indication that the worst is yet to come.



2) Impact of the Credit Crisis - In a recent survey of 660 Venture Capital firms conducted by the National Venture Capital Association, 64% attributed the IPO drought, at least in part, to the credit crunch/mortgage crisis.[17]

3) Impact of The Sarbanes Oxley Act (SOX) - Since SOX became law in July 30, 2002, the cost of being a public company has increased. A Finance Executive International (FEI) survey on SOX section 404 found average compliance costs were $1.7M in 2007 and $2.9M in 2006. Of those surveyed only 22% believed the benefits of Section 404 outweighed the costs.[18] Many argue that this disincentive is causing companies to remain private or list on a foreign exchange. As a merchant bank, we routinely hear higher estimates from the lawyers and accountants working on IPOs. While certainly anecdotal, our contacts are warning that average compliance costs range from $3M-$4M per year.

Need for Short Term Legislation

Through short term legislation, the next administration could "unclog" the IPO pipeline and recreate a period of economic growth not seen since the Clinton administration.

- Currently venture capital firms are supporting their private investments. By creating liquidity for those firms, the administration would be creating liquidity for funding the next generation of aspiring Googles and Amazons.

- Moreover, given the dearth of IPOs, venture capital firms would also more likely accept stock listing valuations at a discount to their holdings intrinsic value, i.e. the value of those companies in a healthy market that is reflective of their potential for success. Following the IPO, investors in the secondary market would realize that companies are listing at discounts to their fair value. The demand for those shares would then rise and those secondary market investors would trade the stock up accordingly. The effect would be a series of IPOs that trade at a premium to their listing price resulting in an enormous boost to investor confidence.

Therefore we propose the creation of the Capital Creation Oversight Board (CCOB), a non-partisan group of three individuals (two retired venture capital professionals and a well credentialed professor). Their task would be to select a series of companies in the IPO pipeline that would receive a package of federally mandated benefits meant to nurse the IPO market back to health. The administration would by no means guarantee performance but simply enable and support these companies in their pursuit of a public listing. Moreover the administration would invite additional oversight by FINRA for the benefit and protection of investors participating in these federally "sponsored" IPOs. It would also be useful if the administration, through its various governmental departments and agencies, "encouraged" Wall Street underwriters towards a reinvigorated IPO marketplace.

[17] http://www.nvca.org/pdf/Q2_08_Exits_Release.pdf
[18] Financial Executives International, FEI 2006 Survey of SOX 404 Costs, http://fei.mediaroom.com/index.php?s=press_releases&item=187 (Oct. 27, 2008)

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While a more detailed plan[19] regarding the exact legislation is necessary, we would envision that legislation to include some or all of the following benefits:

- 50% reduction of the capital gains tax on investing in an IPO
- 24 month depreciation on capital assets purchased up to 12 months after the listing date
- Federal loan program for newly listed companies allowing them to borrow up to 50% of their IPO proceeds at discounted rates in exchange for granting the government a two (2) year warrant to purchase 10% of the IPO shares at the IPO price
- Two (2) year SOX Section 404 compliance exemption
- Federal net operating loss (NOL) tax credit / transfer program

The establishment of the CCOB would send a clear message to Wall Street that the administration is committed to the revitalization of the IPO market. However the legislation is only a short term catalyst meant to be phased out as dictated by the market or legislated by Congress; for example, once the IPO market gathers momentum, the CCOB would then be phased out or discontinued over a period of time by restricting the number of companies it can select to receive the CCOB benefit package.

If the administration does not take action to "unclog" the IPO market and create liquidity for investors focused on developing early stage companies, the market will recover over the next 3 – 4 years as there are just too many high quality companies in the pipeline to remain stagnant for longer. While currently overly cautious, investors in the US will begin to seek the "next" great opportunity naturally over this time period. However by choosing to take action today, the administration could +shorten that recovery time significantly thereby restoring confidence in the health of our capital markets.

[19] Broadmark would be willing to contribute to such a plan as appropriate.