

October 2008

## When will the IPO Market Return?

Ever since August, the IPO market has been shut down. Year-to-date there have been a meager 43 US-listed IPOs and 96 non-US IPOs greater than \$100 million in size, down 77% and 69%, respectively, from 2007. Equity capital markets desks from New York to Hong Kong are sitting on their hands. And yet, the global IPO pipeline is full – 190 companies have current IPO filings with the SEC, about the same as last year, and while it is difficult to be precise about the number of prospective non-US issuers because of differing offering procedures, we believe that this number is substantial as well. Capital market desks report that their deal backlogs are big and that they are waiting for the ice to break.

Risk capital will eventually open up to new issuers, but what will it take to get there and when might this happen? After studying the last significant downturn, the recession of 1973-1974, we believe that the past holds some answers.

## What Will It Take?

IPOs are way down the food chain of financial assets. When LIBOR is over 4% and high quality syndicated loans are priced at 20% discounts, IPOs sink low in priorities for capital structure. Non-financial companies' need for new equity capital has been lost as the great sucking sound of deleveraging financial institutions has consumed the resources of central bankers, investors and the public. Yet, after achieving credit stabilization and cauterizing the subprime mess, which will occur globally over the next several weeks, re-equitization is the logical and necessary next step.

The financial industry has already begun this re-equitization process, with billions of new capital added to GE, Goldman Sachs, Met Life, Morgan Stanley and others. In fact, since the beginning of September there have been 28 financial issuers of common stock, all secondaries, which have raised \$43 billion. This does not include the recent infusions of over \$125 billion of preferred stock by the US Government and private investors. In the EU countries, the capital infusions have come largely from the governments.

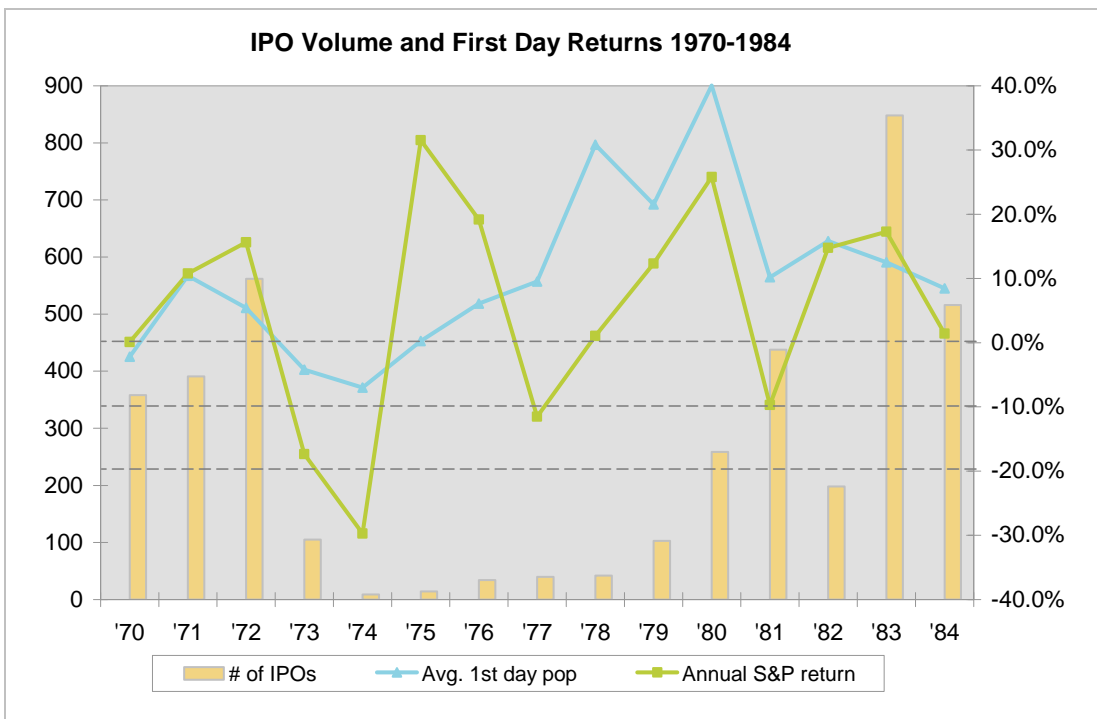
We are not as optimistic about the ice jam breaking for IPOs near-term because we believe that institutional investors are largely focused on the day-to-day drama of routs, liquidations, margin calls and the Treasury/Fed/FDIC bombshell du jour. They are rightly concerning themselves with survival and high level issues.

The obstacle specific to the IPO market is that issuers and their financial backers are still stuck in yesterday's valuation Lalaland and are not willing to readjust their expectations. If AA syndicated loans are getting discounted 20%, how is a risky IPO going to sell at full price? Indeed, the history of other market downturns proves that investors are coaxed back

into riskier investment sectors when prices are heavily discounted. Private equity and venture capitalists must capitulate to the need to heavily discount prices to move merchandise, because doing an IPO is their main exit strategy.

Based on our study of U.S. IPOs in the 1970s, which is the most recent period of prolonged IPO inactivity, IPO issuance dried up after a period of negative IPO returns and gradually returned after a long period of positive returns. While the data that we have is imperfect – Renaissance Capital data goes back only to 1994 and the 1970s data is derived from University of Florida professor Jay Ritter’s 1970s series – the degrees of magnitude prove the point.

While the financial specifics during the 1970s were not as critical worldwide as they are today, it was nevertheless pretty depressing, with the recession broad and deep. Recall that the US was battling OPEC’s cuts in oil production and food price inflation that resulted in a government-mandated price freeze. The US had declared a ceasefire in Vietnam, the economy was in a recession and the wildly partisan Watergate scandal was in progress. The Dow bottomed in 1974 at 578, down 45% from its early 1973 high, and interest rates were rising to record levels.

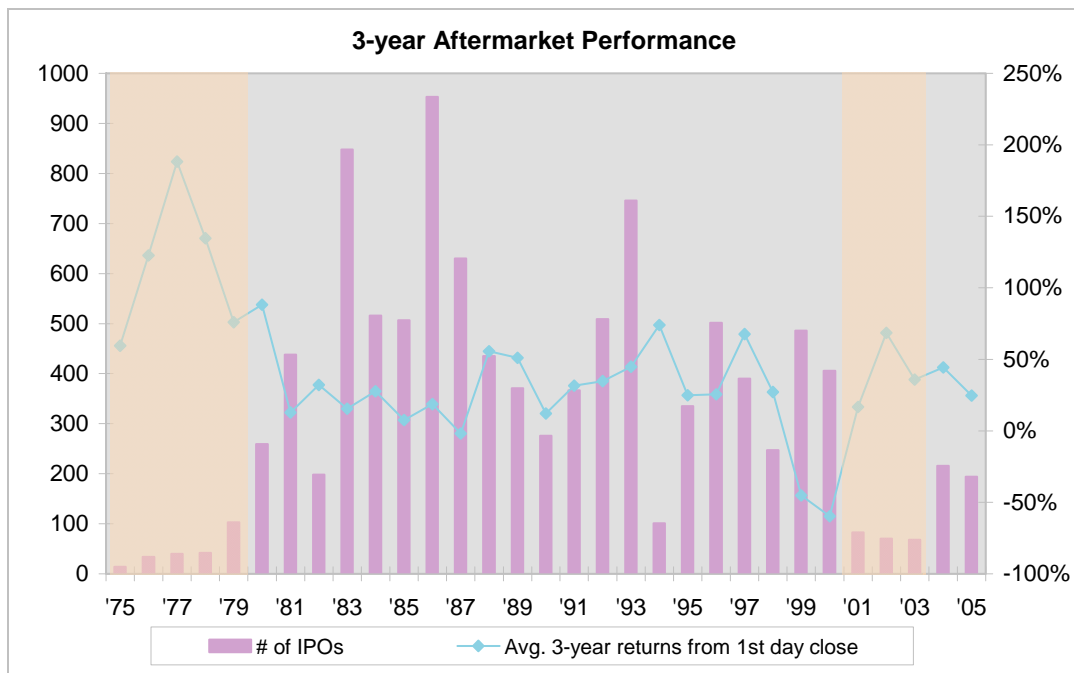


Source: Renaissance Capital and Jay Ritter, University of Florida

After a period of strong IPO activity and returns from 1970 through part of 1972, returns soured in 1973 and continued to be flattish to slightly negative for the next three years. During that period only a handful of IPOs priced. However, in 1977 IPO returns improved dramatically and over the next three years, IPO issuance gradually returned. In fact, on average IPOs traded up 19% in the aftermarket during that period. Note also that IPOs were greeted positively in 1976 and 1977 even as the S&P dropped. IPO returns from 1978 to 1980 were helped by positive broad market returns.

Our research also reveals that the most powerful IPO returns occur during these periods, because companies with strong prospects are well priced. Below is some of the top crop from 1976 to 1979.

Year	Company	1 <sup>st</sup> Day	2 Year
1976	Cray Research	29%	63%
	Rolm	2%	608%
1977	St. Jude Medical	79%	514%
	Tandem Computers	30%	260%
1978	Federal Express	29%	318%
1979	Safety Kleen	24%	242%
	Stryker	-1%	152%



Source: Renaissance Capital and Jay Ritter, University of Florida

### When will the IPO market return?

Again, let us return to the 1970s for an answer. 1974, the last year of the recession, was the slowest year for IPOs in the 1960 to 2008 period. Focusing only on the US, during that period the only times when there were no IPOs in a particular month were in the 1970s and the present decade. In 1974 there were only nine offerings, all of them in the first half of the year. There were no IPOs for the next six months, which was the longest IPO drought in the last fifty years. After another three-month lull in 1975, the next IPO outages occurred after the tech bubble burst and these were short in duration. Even the Long Term Capital Management blow up in 1998 caused little alarm in IPOland.

Period	Consecutive months without an IPO
12/73-1/74	2
4/74-5/74	2
7/74-12/74	6
3/75-5/75	3
4/76	1
9/01	1
8/02-9/02	2
8/08-???	So far...2

When there is a period of heightened IPO activity, as there was from 1995 to 1999, followed by a decline in the broad stock market, subsequent IPO issuance is sluggish. However, when there is a period of lower-than-normal IPO issuance, as was the case in the 1970s and for the last seven years, a bounceback can occur without a strong overall stock market simply because there is pent-up demand for capital by private companies. We believe that this is now what will play out. Given the rapidity with which investors and corporations respond to changing financial and economic circumstances, we do not believe that the return to the positive performance cycle will take as long as it did in the 1970s.

Guided by this framework, worst case is that IPO activity in the U.S. will not return until March 2009 and then sputter on for several months. Best case is that after the elections, motivated issuers will swallow the bitter pill and price their deals right. However, given the fact the US and other major countries are in the process of applying credit market initiatives that will continue past the election, we think it is reasonable to assume that the IPO market will attempt at least a modest comeback in January 2009.

Here are the factors Renaissance Capital believes are vital for helping to cure the ailing IPO market:

1. IPOs must be priced low to attract investors
2. Private equity and venture investors need to postpone the instant gratification of selling on the IPO offering and instead must wait to sell shares in a secondary
3. IPOs must have solid stories, even if they are unprofitable.

Right now private equity, venture capitalists and management teams are anchored in a prior valuation reality and refuse to face the facts. They are like home owners who are stuck emotionally on getting 2006 prices in a 2008 market. While we are not advocating that issuers accept low ball “stink bids” on their companies, IPO valuations must be reset.

Having analyzed previous market cycles we know that the IPO market and its investors can prosper even in the face of a declining GNP, rising inflation and interest rates and negative global or national circumstances, as was the case in the late 1970s. However, IPO activity is highly correlated to returns and therefore, to unclog the IPO pipeline, deals must build in a larger-than-average 15% to 20% discount.

For example, two recent US offerings, biotech Fluidigm and lube oil recycler Safety Kleen refused to lower their offering ranges despite heightened price sensitivity by investors. We suspect that backers may be reluctant to reduce prices because that would hurt their IRR reported to their investors, but if they want to monetize, that is what they are going to have to do. In contrast, this week Hong Kong Stock Exchange issuer Renhe Commercial Holdings, a Chinese operator of underground malls, priced its 3 billion share offering 27% lower than the proposed range, and the stock is now valued at 5.5x 2009 projected EPS.

The second sticking point is insider selling. New investors will not provide liquidity to private equity investors who are trying to bail out. New investors want deals like those Warren Buffet and Mitsubishi are cutting.

Lastly, the first IPOs to succeed out of the drought must have solid stories. They will have had longer incubation periods in the hands of private investors. The longer operating experience should be reflected in revenues and margins.

Investors in the first decade of the 21<sup>st</sup> century have been battered by a seemingly never-ending series of financial crises – bubble bursts, SARS scares, financial meltdowns, soaring oil prices, credit crunches and falling home equity. These crises weighted down the IPO market, which never returned to normal after the tech and internet bubbles burst. With pent-up demand for equity, a large pipeline of deals and realistic sellers, there is every reason to believe that 2009 will be the beginning of an active and profitable period for IPOs.