ANDREESSEN HOROWITZ

Software Is Eating the World

VC INDUSTRY

Where Have All the IPOs Gone?

by Scott Kupor

Where has the initial public offering (IPO) gone? That's a question the capital markets have been asking for some time, and is a leading concern of the Securities and Exchange Commission (SEC), too. But this question matters beyond those interested in investing in, regulating, or even starting companies — as the SEC put it in recent remarks, startups going public is good for the overall economy because "they tend to be *more innovative* than large companies and they account for a *substantial percentage of the jobs created every year*." Simply put, a lack of IPOs means fewer jobs.

So what happened? We need to take a step back to understand how we got here… before we can address a way forward.

Whither and wherefore the IPO?

Here are the facts: About two decades ago, we used to have 300 IPOs per year. Since then, that average has fallen by more than half, which means publicly listed stocks in the U.S. declined by 50% from 1996 to 2016. Even more troubling however is that (1) other developed countries experienced a 50% *increase* in listed companies over the same time period; and that (2) the *type* of IPO candidates have changed as well: "Small-cap IPOs" (< $50M revenue) have declined significantly over this same 20-year period. Besides fewer jobs, companies not going public and staying private longer to "quasi-IPO" in the private markets means all the spoils of new

company creation are only going to private market investors. Public market investors, who rely on the growth to diversify risk, fund retirement obligations and so on, are being left out.

The phenomenon is clear. How we got here isn't. Among the theories various experts offer are:

It costs too much money

Regulatory compliance is expensive as it is, but with the introduction of the Sarbanes-Oxley Act in 2002, the costs of going public have increased significantly. Companies therefore wait to go public, the argument goes, until they are much larger so that they can amortize these costs over a much higher base of earnings.

While companies may not make an up/down decision to go public solely based on the financial and regulatory burdens of being a public company — and we've stated previously that the operational discipline regardless is good for them — these costs do likely delay or impact the decision for many companies. More importantly, dollars spent on regulatory compliance are dollars that could have been devoted to research and development. As it is, the U.S. has fallen to 10th in the world for overall R&D investment relative to GDP.

Efficiency rules disproportionately affect smaller companies

Beginning in the late 1990s, with the introduction of the Order Handling Rules, the SEC began promulgating various rules (Reg Alternative Trading System, Decimalization and Reg National Market System, etc.) to increase the trading efficiency of stocks. It worked: the U.S. equities market, as a whole, is highly efficient and liquid. It's why algorithm-based strategies and things like high-frequency trading (HFT), which accounts for as much as 70% of total trading volume, to flourish; low transaction costs and sub-penny spreads enable traders to profit from rapid, high-volume trading.

But this very efficiency disproportionately affects smaller cap companies: As the spreads narrowed and trading volume lowered (average daily trading volumes as a percentage of total stock float are 40% less than that of large caps), small-cap stocks became unprofitable to trade in. Furthermore, market-making sell-side research, which had been traditionally funded via the trading spreads, also went away: the average small-cap company now has only 2 research analysts vs. 12 for large-cap companies; and almost a third have no analyst coverage at all. Smaller companies are thus loath to go public for fear of being stuck in an illiquid trading environment that doesn't give them the capital to grow their businesses.

Fair disclosures had some inadvertent effects

Two specific regulatory changes over the past 15 years are also often cited as causes of the IPO fall-off: Reg FD (Fair Disclosure) and the Global Research Settlement (GRS). The former requires that public companies disclose all material information to all constituents at the same time, and the latter erects a "Chinese Wall" between the research and investment-banking groups within a bank. The goals of these regulations were to ensure that all market participants had equal access to all material information (Reg FD) and to eliminate the risk that research stock recommendations were biased by potential or realized fees generated by the investment banking side of the house (GRS).

In diminishing the value of analysts as conduits on the buy side, however, Reg FD may have impacted the value ascribed to sell-side research. Similarly, GRS may have changed the underlying economic viability of publishing research in banks even though the intention behind them was good. Banks now focus their research efforts only on large-cap, highly liquid stocks — at the expense of smaller cap ones.

Because bigger is better

Proponents of this theory argue that, independent of any regulatory or other market structure issues, there are now even more economies of scale, particularly in the technology sector, to being a big company. The benefits of technological innovation therefore accrue disproportionately to bigger players with more financial resources.

So small companies, whether public or private, simply can't compete against big companies. As a result, small companies are incented to sell to larger companies rather than risk going public and competing at a disadvantage.

Mutual funds are bigger, too

Mutual funds get paid based upon the amount of assets under management (AUM), the larger the AUM, and the more money (larger fee base) they get. The mutual fund industry has grown 16X from 1990-2000 (reaching $3.4 trillion in AUM) and ~5X since 2000 (topping $16 trillion in AUM in 2016). But the concentration of dollars has also increased significantly among the top mutual funds; over 90% of AUM in 2000 was controlled by the top fifth of mutual funds.

Why does this matter? When mutual funds get big, their holdings tend to be concentrated in large-cap companies, because: (1) they need to be able to trade in/out of stocks without fear of illiquidity trapping them; (2) their increased size demands larger positions in their portfolio companies to justify the effort; and (3) they are restricted by law (if they want to be a "diversified" mutual fund) from holding no more than 10% of the float of a company. Mutual fund holdings therefore tend to be concentrated in large-cap companies at the expense of small-cap ones.

There are alternative forms of financing out there!

The landscape of private investors has now expanded to include public mutual funds, hedge funds, private equity buyout firms, sovereign wealth funds, family offices, and others that all

want to invest in private companies. Why would a so-called "unicorn" IPO when it has raised hundreds of millions (and, in some cases, billions) of dollars in the private markets?

But… which came first, private capital or fewer IPOs? The data actually points to the latter, since the age of companies at time of IPO has increased (from 6.5 to 10.5 years) and the annual number of IPOs decreased (from 300 to 108) years before robust late-stage private financing became available.

There's just too much pressure on public companies these days

The lack of IPOs has also been partly blamed on the rise of activist investors (which were non-existent until the mid-1990s and now exceed $100 billion in AUM) — as well as the short-term orientation of institutional investors (note that the average hold period for stocks has fallen from 8 *years* in 1960 to 8 *months* in 2016). Couple this with the 50% decline in the number of publicly listed U.S. stocks, and it drastically increases the pounds per square inch of short-term pressure that a company experiences in the public markets.

Finally, there are concerns that companies focus on quarterly earnings at the expense of long-term value; for example, almost 80% of CFOs at 400 of America's largest public companies once said they would sacrifice a firm's economic value to meet earning expectations just for that quarter. And the pressure on C-level executives continues today: A recent survey (reported by an organization that focuses on this topic) found that the pressure to deliver short-term results has *increased* in the past five years for 65% of those respondents. Those short-term pressures are also a big reason why we see more dual-class and in some cases tri-class voting structures for companies that do in fact go public — it's to blunt the voting power of short-term shareholders. Compared to their short-term counterparts, companies that focus on the long-term are not only more profitable and less volatile, they also create more jobs.

So where do we go next?

While none of these theories alone explain both the lack of IPOs in general *and* especially in small-cap ones (nor line up precisely with the time-series data), the phenomenon matters to the economy and a few common themes emerge that are worth considering:

All signs point to liquidity as a culprit. If institutional investors have to pay an "illiquidity tax" on every buy or sell stock transaction, they will naturally deploy capital elsewhere. One avenue that might enhance liquidity particularly for small-cap companies is the tick-size pilot that the SEC is conducting, which restricts the increments at which stocks can trade (thus aggregating trading volume). Other approaches to increasing liquidity, particularly for new stock issues, might include reducing the number of trading venues to better aggregate volume and modifying the short interest rules to include volume limits or enhanced disclosures. Increasing the economic attractiveness of research and market-making for small cap stocks is also worth exploring here. Finally, easing mutual fund concentration restrictions that limit their holdings in individual companies might also encourage more investment in the smaller-capitalization end of the trading market.

Short-term pressures reduce long-term investments. Adopting tenure-based voting is one of the best ways to balance the short- and long-term interests of investors and managers. Under this structure, voting rights increase for *all* investors with longer holding periods. "Drive-by" investors who are only seeking to trade short-term would therefore have less governance influence than those who are supporting or building the company long term. Another idea to consider is Nasdaq's recent suggestion of requiring institutional investors to disclose material short positions (just as they already do material long positions) as a way to increase transparency and decrease short-term pressures.

Regulatory costs and burdens should be proportional to potential impact. Compliance clearly matters to ensure the safe functioning of the capital markets for all. But the SEC can still accomplish this goal while also considering that the cost of regulation applied to a company like IBM is grossly disproportionate when applied to a sub-$1B market cap company, especially

since the scale of risk to the public due to bad behavior is much smaller there. So "right-sizing" regulations that scale with the size and market cap of the company makes more sense.

* * *

Interestingly, the JOBS Act was created in 2012 precisely to solve the problem of too few IPOs. Most of the good things it did were about making the *process* of going public easier: confidential filings; enabling companies to test the waters with institutional investors pre-offering; and size-adjusting regulatory burdens for emerging growth companies. Yet in upping SEC registration requirements from 500 to 2000 outside shareholders, the JOBS Act, paradoxically, also made it easier for companies to remain private. Now we need to shift our focus from "on-ramp" to IPO to the "potholes" on the road once a company does go public — what are all the things that could help these companies thrive, while also honoring the multi-modal mandate of the SEC to protect everyone?

Recently, one of the most successful tech companies of the age — Amazon — celebrated its anniversary of 20 years as a public company. But it's also a case study in how government incentives play an important role and can have unintended consequences, for better and worse. Where is the next Amazon? Or perhaps more importantly: where is the smaller-cap company — not the unicorn — that can become the next big tech enterprise, the next high-growth opportunity?

RELATED STORIES

Where Have All the IPOs Gone?
By Scott Kupor

Not All Software M&A Is Created Equal
By Scott Kupor

16 Definitions on the Economics of VC

By Scott Kupor

policy · regulation · VC industry · IPOs

June 19, 2017

Contact

Terms of Use & Privacy

Conduct

LP Login

Powered by WordPress.com VIP