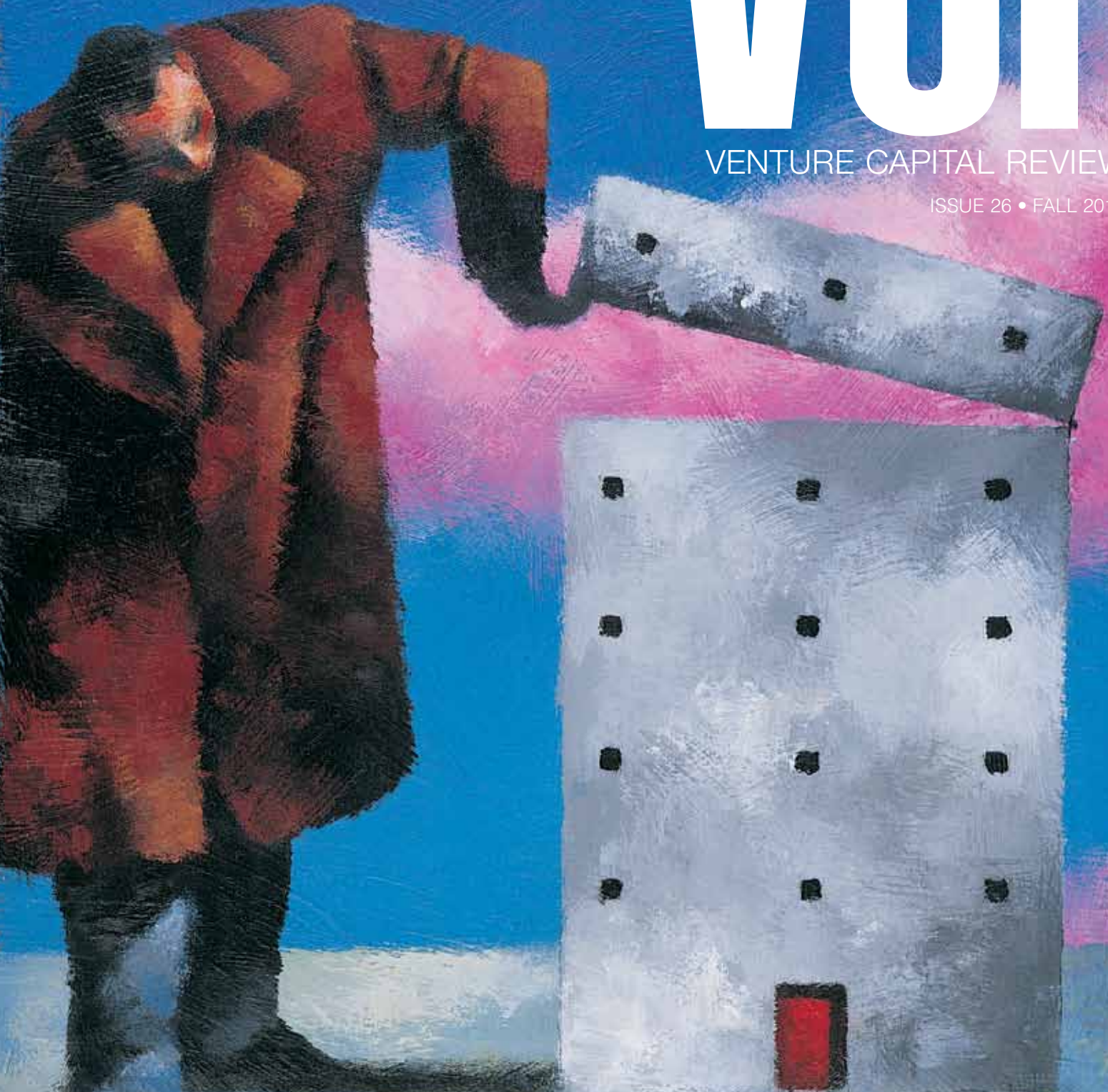


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Considering Liquidity Alternatives — What You Need to Know About the IPO Market Today and the Impact of Current Market Conditions on IPO Planning

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KEY POINTS

- 2010 IPO market conditions represent an improvement from 2009, but have been characterized by inconsistent demand and market volatility
- The present market is most receptive to larger, more mature, more profitable companies with strong revenue growth and profitability
- Dual track strategies, in which the venture backer is simultaneously preparing for an IPO as well as preparing for a sale, provide multiple liquidity options
- In volatile markets, a premium is placed on readiness — in particular, the IPO candidate's management team (both executive and board level), accounting and financial reporting readiness, and any potential acquisition activity leading up to an offering must be critically examined in order to be poised to take advantage of a market opportunity

In today's market, opportunities for liquidity events are of paramount concern to investors across asset classes. Venture capital general partners are once again considering accessing the initial public offering market as a means of generating distributions for their limited partners. In 2010, the equity capital markets experienced a recovery of sorts — both in terms of the number of deals filed and in terms of the number of deals that got to market. A mid-summer CNNMoney.com headline shouted "The IPO market roars back." A closer look at the IPO market, however, reveals that current market conditions remain challenged — and only the strongest and best-prepared portfolio companies will be in a position to execute a successful IPO.

To put the current market into perspective, it is important to consider the IPO market over the past two decades. In the first five years of the 1990s, there was an average of 520 IPOs per year, the overwhelming majority of which raised less than \$50 million. During the so-called technology or dot-com bubble of the second half of the 1990s, there was an average of 539 IPOs per year. In the decade since, the average annual number of IPOs has fallen to 126, with the period from 2004 through 2007 — the post-bubble recovery prior to the financial crisis — accounting for the majority of the deal activity in that period. In addition, by 2009, the number of IPOs raising less than \$50 million represented approximately only 20% of the total market. Median IPO size in 2009 was \$140 million, while 20 years ago \$10 million deals were common.

Over that same 20-year period, there was a significant shift in the dollar amount of funds raised for venture capital. From 1991 to 1995, a total of approximately \$28 billion was raised by venture capital funds. During the bubble from 1996 to 2000, venture capital fundraising soared to \$243.6 billion. Even post-bubble, venture capital fundraising has remained strong, with a total of approximately \$218.2 billion raised during the period from 2001 through 2009. These figures suggest that the IPO market may be unavailable to the majority of venture-backed companies. Given the typical five- to six-year life span of a venture capital investment, the IPO market is significantly lagging the venture capital exit horizon. Even if the IPO market were to return to the modest post-bubble levels of 2004 to 2008, it would not provide sufficient liquidity for the venture capital invested in this decade.

Looking at 2010, while the IPO market has improved dramatically over 2009, the market has been very inconsistent. Investor appetite for new issues has been affected by global economic instability and resulting market volatility. Risk aversion has resulted in periods of extreme pricing pressure and periods of complete inactivity. Of the 85 IPOs priced in 2010 prior to August 24, only 28% are trading above their IPO prices and the total return for all issues combined is slightly negative, although in general technology companies are outperforming other sectors. During the first nine months of 2010, approximately 30 venture-backed technology companies went public. In all of 2009, only 12 venture-backed companies went public, and in 2008, only six.

Following the traditional post-summer pattern, September was marked by an increase in activity. The final week of September was the biggest scheduled for domestic IPOs since October 2009. Fueled in part by the uptick in the stock market, during that week, nine IPOs seeking to raise approximately \$2.66 billion were scheduled to debut, as compared to the weekly average aggregate IPO raise for 2010 of \$400 million. The number of deals in the pipeline is also at a decade-long high — over 170 companies have an IPO registration statement on file (excluding those filed more than two years ago and not since updated). That is three times higher than the backlog one year ago. Approximately one-half of the companies in registration are backed by venture capital or private equity. Of the companies in the pipeline, technology, finance and health care are the

industries that account for the largest percentage of the market.

Most commentators agree that for the near term, the IPO market will be receptive only to the top tier of companies with strong revenue growth and profitability. Current market conditions favor larger, more mature, more profitable companies — a profile that many venture capital portfolio companies will not match. Other positive characteristics that the market demands are revenue visibility and predictability, operating leverage, a large growing market segment and solid management. In addition, there is demand for unique opportunities and compelling stories.

In addition to the significant challenges presented by current market conditions, venture-backed firms are also competing in the IPO market with private-equity sponsored companies. Private-equity firms typically have a shorter exit horizon (three to five years) than venture capital investors. Their portfolio companies also tend to be more highly leveraged than venture-backed companies. Many sponsors will be looking for a liquidity event in the near term as debt incurred in the 2005 to 2007 credit boom comes due over the next few years.

One liquidity strategy that has been successful for some companies is to pursue a dual track — file for an IPO and commence a sale process to identify a buyer for the business at the same time. The so-called dual track strategy provides multiple liquidity options, more public information to attract interest and potentially more bidders, which often results in a higher acquisition price. Studies have indicated that companies in registration can command as much as a 20% premium in a sale. M&A activity was up in the first half of 2010 over 2009, but market volatility and conditions in the credit market are likely to continue to negatively impact M&A activity. In addition, if the IPO market remains constrained, it is likely to have a negative impact on the level of M&A activity, as investors will be unable to free up cash to fund new investments and acquisitions.

A successful IPO can provide cash to fund growth and expansion, generate liquidity for stakeholders, create a currency for future acquisitions and help attract and retain talented management personnel by providing equity incentives. Of course, an IPO liquidity event also has its disadvantages — distraction of management (which can be prolonged if market



conditions result in transaction delays), expense (which also increases with delay), loss of control and privacy, regulation of corporate governance and pressure for quarterly performance.

Current market conditions put a premium on readiness. Previously, the timing of accessing the market was largely sell-side driven — companies essentially could access the market when they were ready or needed to do so. Today, market windows are short and unpredictable, and driven largely by macroeconomic factors and their impact on buy-side demand. Companies must be ready to take advantage of favorable market conditions opportunistically while they exist. While a typical IPO timeline is approximately four months from kick-off meeting to closing, a significant amount of work needs to be done before the four-month clock even starts ticking in order to maximize a company's ability to hit an open market window.

One critical consideration in IPO preparedness is a portfolio company's need for capital. The decision to file a registration statement in order to be ready to take advantage of a market window needs to be weighed against the limitations on capital-raising that filing imposes. A company can only raise private capital in the absence of general solicitation with respect to its securities. Having a registration statement on file for an IPO is, by definition, general solicitation for the issuer's common equity, which can significantly restrict the company's access to fresh capital. Thus, before a company decides to file, consideration must be given to whether it has adequate capital resources to carry it through the IPO process. In periods of market

volatility, it can take much longer than four months to complete an IPO. Some deals may be in registration for a year or more.

Venture capital general partners and portfolio company management should focus on getting the right team in place for an IPO. The most important part of the team is company management itself. Consideration should be given to the additional demands that will be made on the existing team during the IPO process and the additional obligations of being a public company. Also, venture backers must consider whether the team has the skills and depth to interface with investors and analysts, both during the IPO process and as a public company. In addition to building out the executive management team, most portfolio companies will need to identify and recruit additional independent board members in order to satisfy applicable listing requirements for the board itself and its key committees — audit, compensation, nominating and governance. In addition, consider whether the outside legal and accounting advisors have the appropriate experience and expertise (and independence, in the case of the auditors) to assist in the successful execution of an IPO and to represent a public company. To the extent changes are required or desired, the new advisors will need adequate time to prepare in advance of the IPO process. Finally, in selecting the investment banking team, GPs and management should consider equity capital markets and investment banking experience and ranking, both in general and in the relevant sector, trading capabilities for the after-market and institutional and retail distribution capabilities.



Internally, critical long lead-time items relate to accounting matters. In particular, a company seeking to pursue an IPO exit needs to enhance its internal accounting and audit function by adding breadth and depth to improve financial reporting and develop reliable financial models to project future earnings and processes to measure financial performance. It is essential for an IPO company to be able to provide credible and reliable financial models to analysts and to meet their reporting obligations as a public company on a timely basis. General partners and portfolio company management should bear in mind that even audited financial statements prepared in accordance with generally accepted accounting principles, or GAAP, may require revisions to comply with applicable SEC accounting rules and regulations. Finally, although there is a transition period for newly public companies to comply with Section 404 of the Sarbanes-Oxley Act governing management's assessment and report on internal controls over financial reporting (until their second annual reports on Form 10-K), management must prepare for Section 404 compliance even prior to the IPO to ensure that they will be able to meet the deadline and that they have the necessary internal and external resources in place to do so.

For many venture-backed portfolio companies, particularly technology companies, acquisitions are a key part of their growth strategy. The IPO process can be disruptive to acquisition strategies — particularly in challenging markets when it may take additional time to conclude an IPO. Any material acquisition will require additional disclosure in the IPO registration statement, and, if significant, an acquisition will also result in additional audited historical financial statements and pro forma financial statements being included in the registration statement prior to its being declared effective. The standard for whether a potential acquisition is disclosable is the materiality standard outlined by the US Supreme Court in *Basic Inc. et al. v. Levinson et al.*, 485 U.S. 224 (1988) — a sliding scale based on the magnitude of the potential transaction and its likelihood of occurrence. Under this standard, a very large transaction may be material (and thus disclosable) even if still in the early stages of discussion. Thus, it is important to identify any potential acquisitions and consider their significance, timing and impact on the IPO process to identify any issues in advance of commencing the process.

It is also important to consider publicity issues early in the process. The registration process under the federal securities laws is structured to ensure that the shares will be sold pursuant to a prospectus that meets certain federal requirements. Statements by affiliates of an issuer, which includes directors (including venture capital fund designees), officers and principal stockholders (which may include venture capital funds), that may be deemed by the SEC to be instrumental in selling the stock or promoting the company may delay effectiveness of the issuer's registration statement or result in SEC review not otherwise anticipated. The SEC has become increasingly concerned with the activities of companies during the public offering process and has delayed several public offerings due to publicity relating to the issuer and/or the offering. The SEC will review all public statements made for some time prior to the filing of an IPO registration statement. Interviews, speeches, conference appearances and website contents are often the source of problematic pre-offering publicity issues. It is critically important to discuss publicity restrictions with counsel when first even considering the possibility of an IPO to avoid delay, which could result in missing today's narrow market windows.

A final point to consider in IPO preparedness is the importance of cooperation and candor among all participants in the process. In an IPO, there is a single goal that all deal participants should share — a well-executed transaction for which no participant will incur liability. All members of the team should avoid adopting an “us versus them” mentality. Since the focus of the federal securities laws is disclosure, rather than merit,

deal participants can often work together to resolve issues. If identified early, constructive solutions can be crafted for most problems. If discovered later in the process, even modest problems can cause credibility issues, leading to heightened scrutiny and concern, in turn leading to delay. And in volatile capital markets, delay can result in missing a market opportunity all together.

It is also important to remember the role of due diligence in the IPO process. First, rigorous due diligence will result in better compliance with disclosure requirements and better quality disclosure of material information relevant to the issuer and the offering. Second, given that all deal participants other than the issuer itself have a “due diligence defense” to a claim against them for material misstatements or omissions, the underwriters and the legal advisors will be careful to establish this defense. It is important to cooperate fully in the due diligence process in order to facilitate an efficient process.

In summary, venture capital general partners and portfolio company management should approach the IPO market with cautious optimism. Provided that the key players have laid the foundation required to be prepared to hit narrower market windows opportunistically, and provided that they understand, recent spikes aside, the challenges posed by the current market when compared to the bubble or even the post-bubble, pre-crisis recovery period of 2004 through 2007, the IPO market may yield favorable results for well-prepared, nimble portfolio companies and their venture backers. #

About the Author

Julie Allen is a partner in the Corporate Department and a co-head of the Capital Markets Group at Proskauer, a global law firm based in New York. Ms. Allen's practice focuses on general corporate and securities matters. She represents both underwriters and issuers in initial public offerings and follow-on equity offerings. Ms. Allen represents buyers and sellers, activist stockholders, boards of directors and financial advisors in mergers, acquisitions, recapitalizations and tender offers; and also regularly counsels public companies and their affiliates regarding disclosure, governance, Sarbanes-Oxley and other securities law and compliance issues.

