

# The Death of the IPO Market for Small Companies

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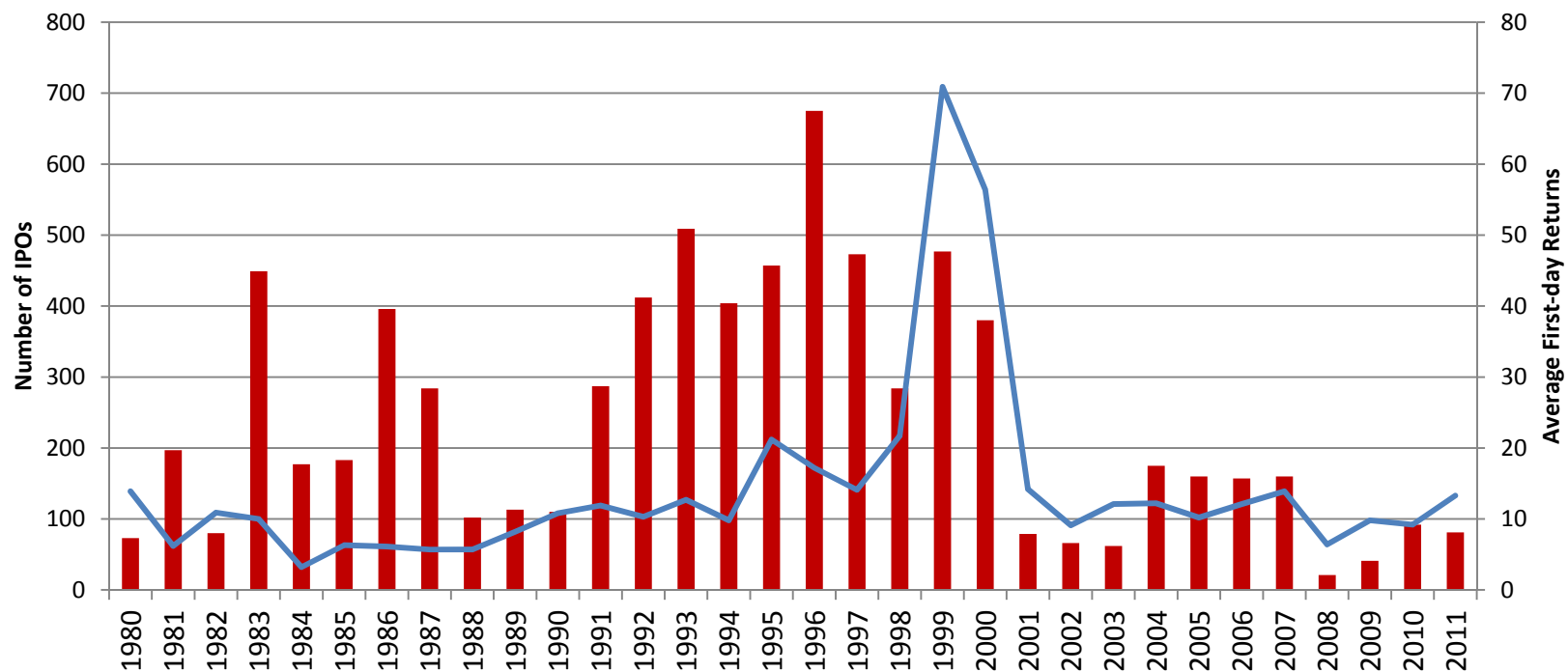
Tuesday, 26 June 2012

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## IPO volume has been very low in the U.S. since 2000

In 1980-2000, an average of **311** firms went public every year

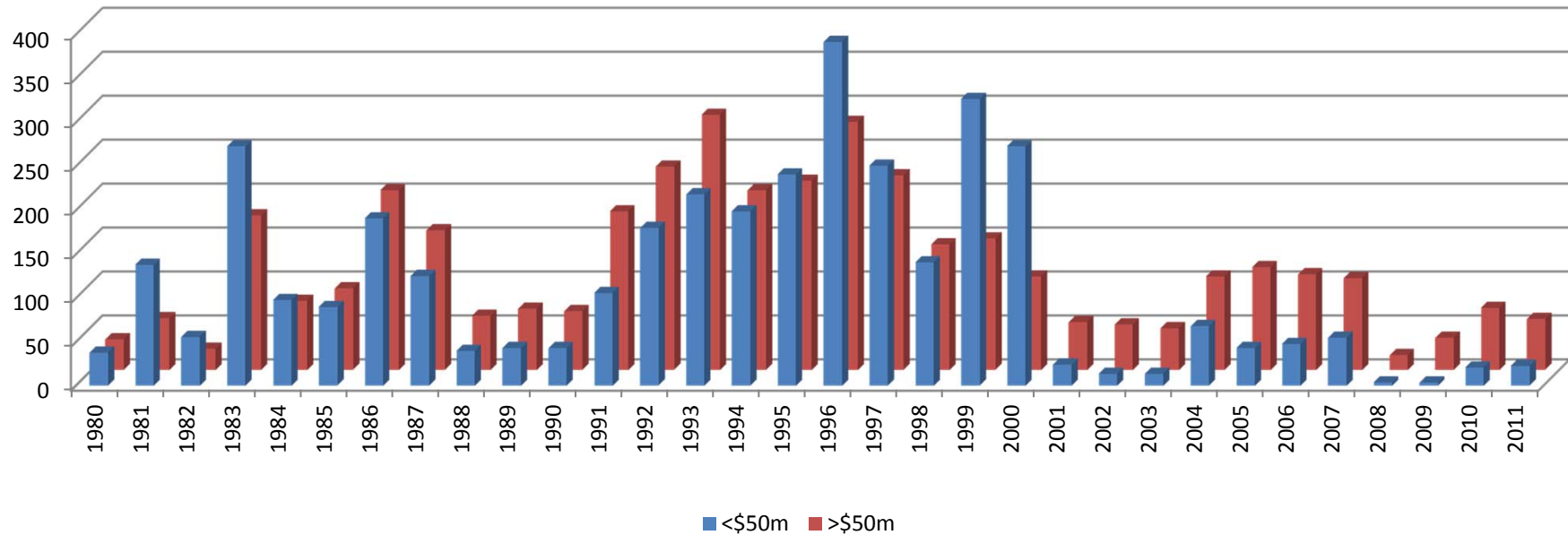
In 2001-2011, an average of **99** firms went public every year



Number of Offerings (bars) and Average First-day Returns (blue) on US IPOs, 1980-2011

# IPO Volume has been particularly low for small firms

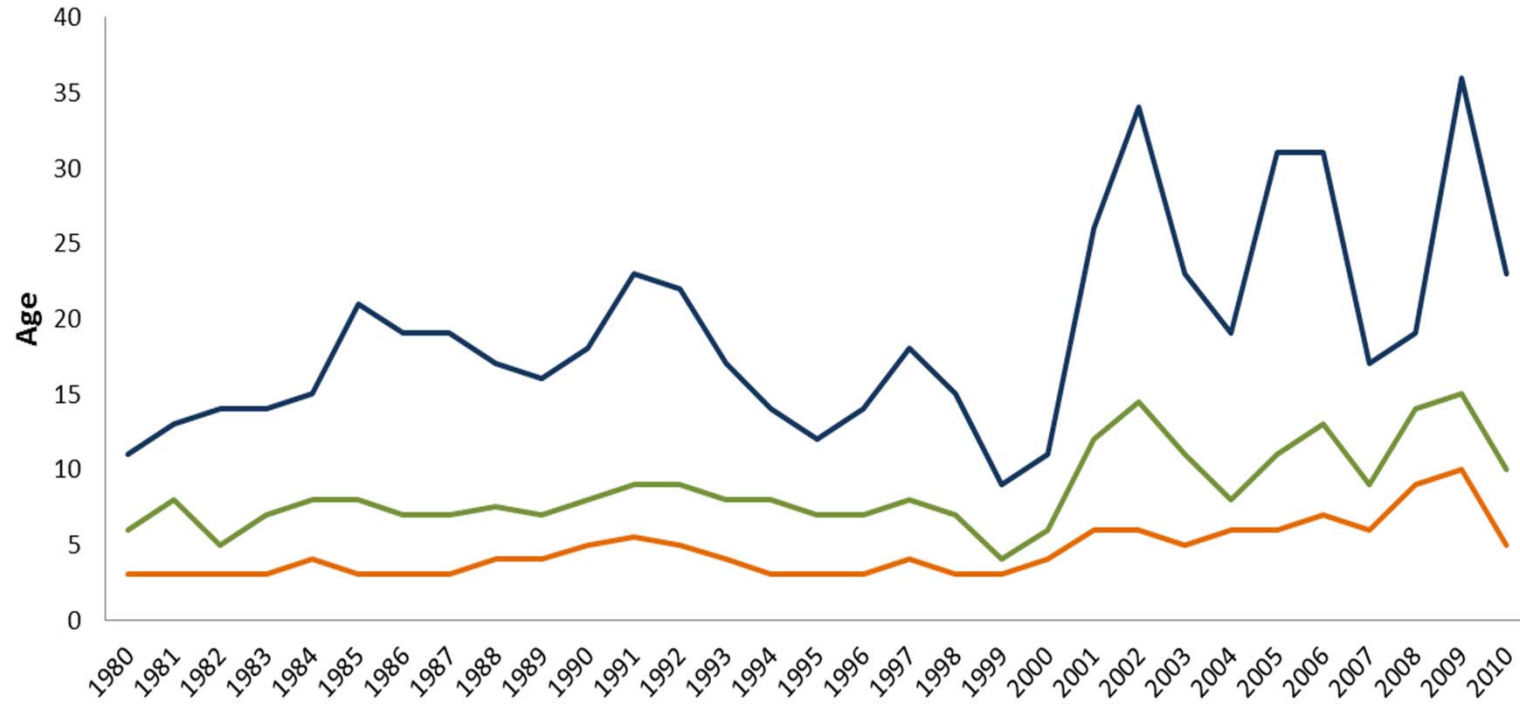
Small firm IPOs are defined as IPOs with less than \$50 million in LTM sales (\$2009)



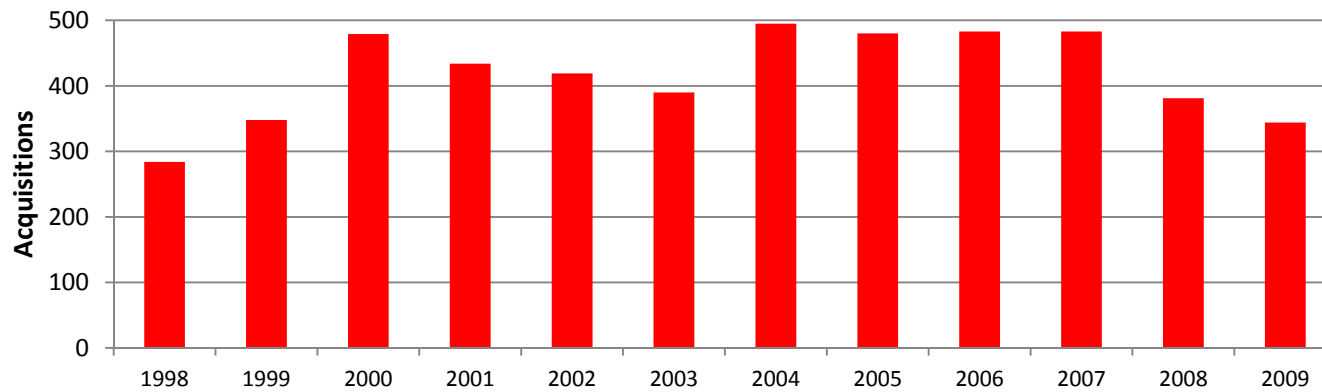
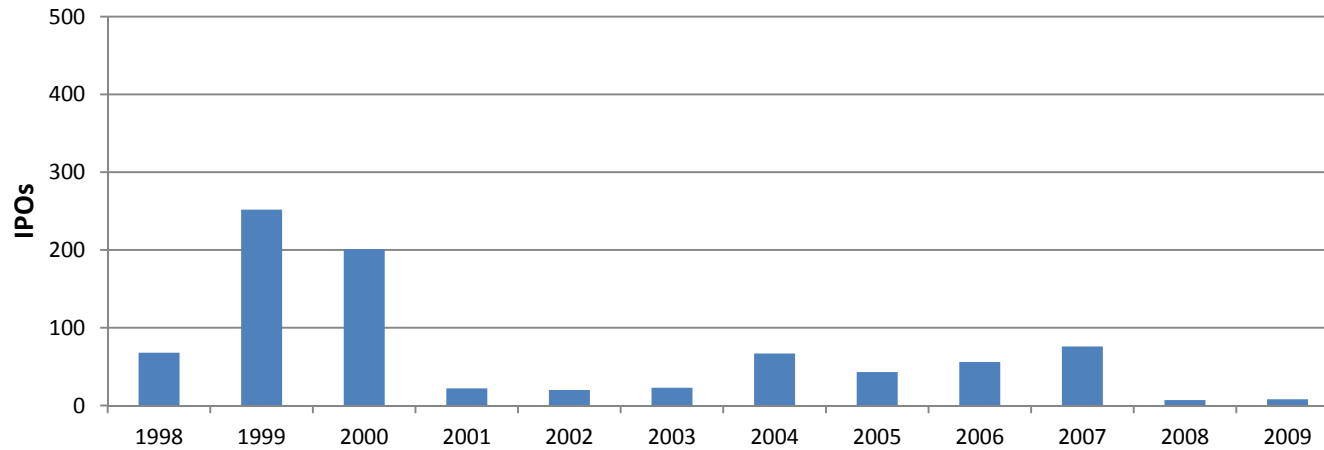
Number of U.S. IPOs with pre-IPO Annual Sales less than or greater than \$50m/Year (\$2009)

# U.S. firms going public have become older, too

Fig. 3: 25<sup>th</sup>, 50<sup>th</sup>, AND 75<sup>th</sup> PERCENTILES OF FIRM AGE AT TIME OF GOING PUBLIC BY YEAR OF IPO



# IPO Exits for VC-backed firms have been limited



Source: Dow Jones Venture One in Wilmer Hale 2010 Venture Capital Report

## Conventional Wisdom: The IPO Market Is Broken

Sarbanes-Oxley Act of 2002 (SOX) has imposed costs on publicly traded firms, especially small firms

Reg FD in 2000 and the Global Settlement in 2003 have led to a drop in analyst coverage for small firms, lowering their P/E ratios

We call these explanations

The regulatory overreach hypothesis

# Our Explanation: A Long-term Structural Change GXH1

Increased economies of scope

Increased importance of speed to market

Xiaohui Gao, Jay R. Ritter, and Zhongyan Zhu  
“Where Have All the IPOs Gone?”  
2012 University of Florida working paper



**Slide 8**

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**GXH1**

Change this to 'A long-term Change'?

Xiaohui Gao, 20/03/2012

We call our explanation

The economies of scope hypothesis

## Structural <sup>GXH2</sup> Changes in the Product Market

The profitability of small independent firms has declined relative to the value created as part of a larger organization that can quickly implement new technology and benefit from economies of scope

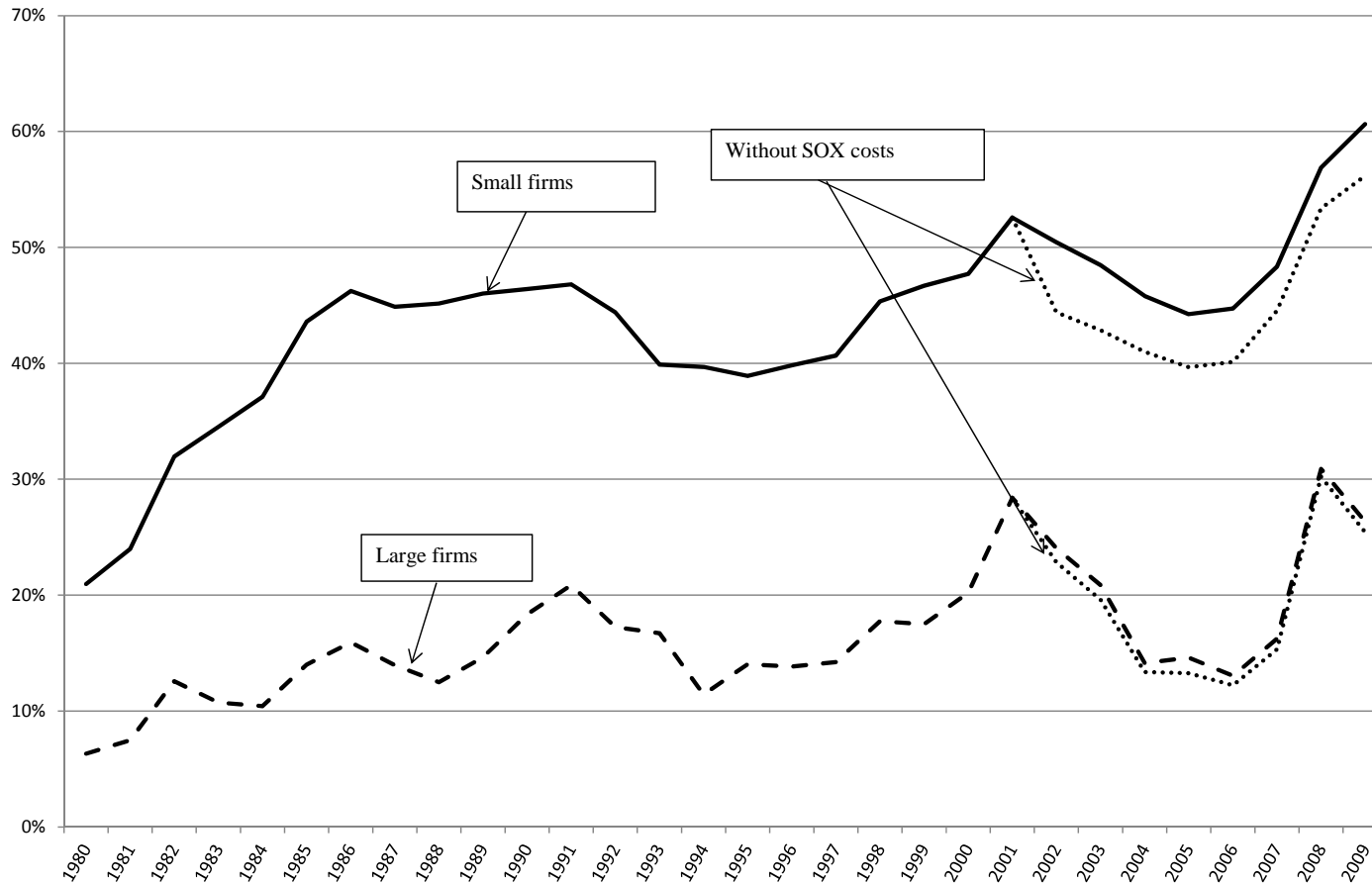
GXH2

Delete the word 'structural' also?

Xiaohui Gao, 20/03/2012

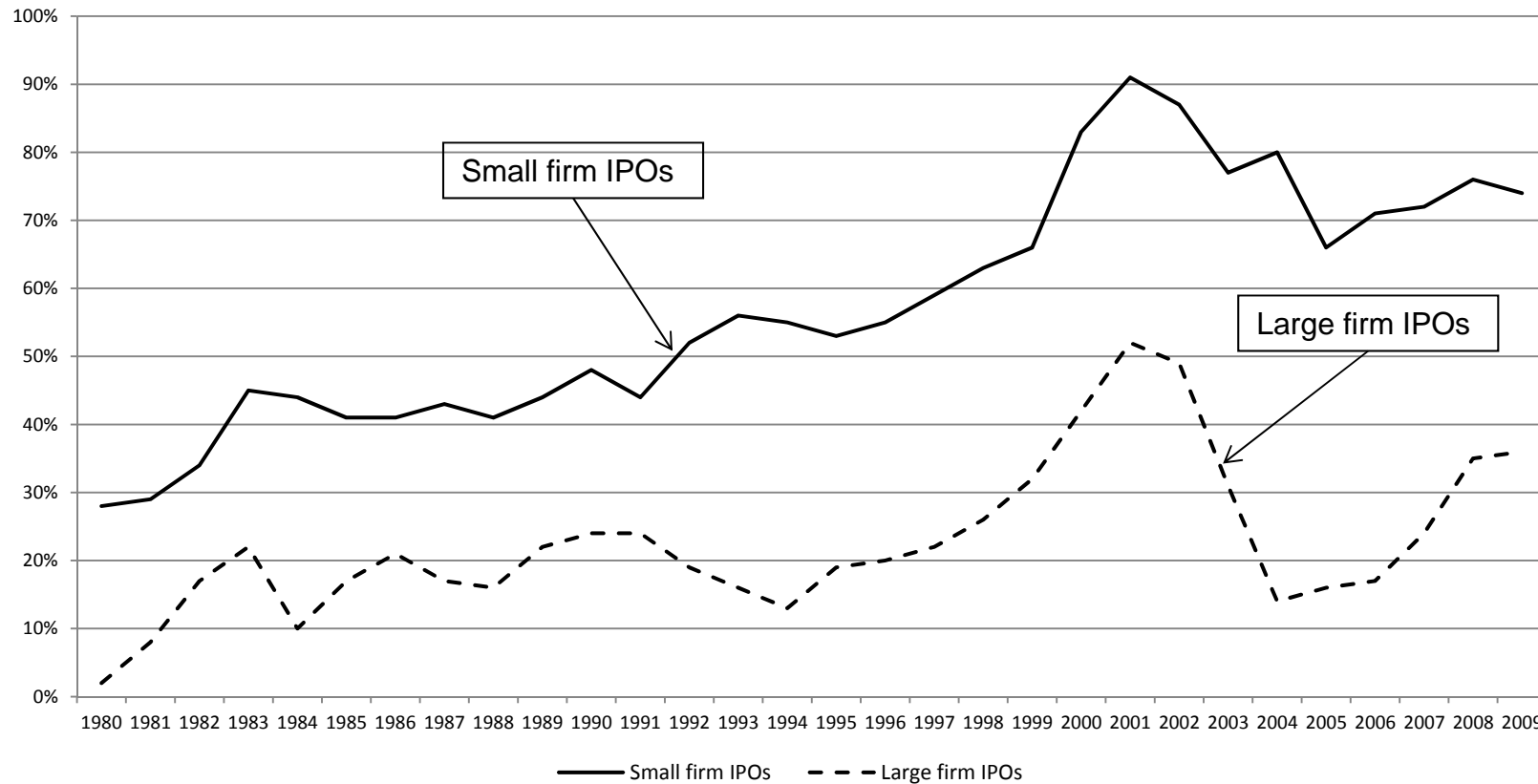
# Our Evidence

The percentage of small firms that are unprofitable has increased



Percentage of seasoned public companies with negative EPS, 1980-2009

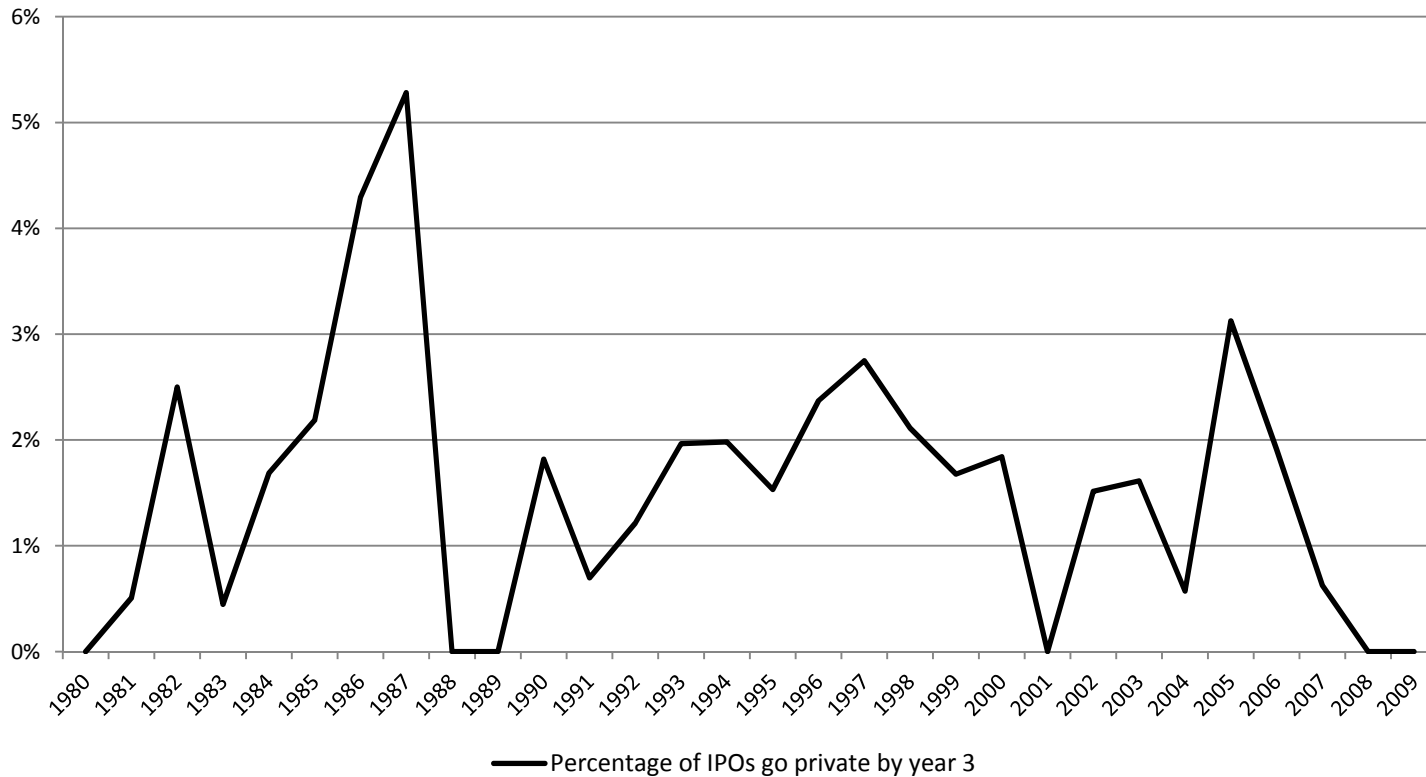
# Small firm IPOs have become less profitable



Percentage of IPOs from the prior 3 years with negative EPS in fiscal year t

Source: Table 2, columns 2 and 4

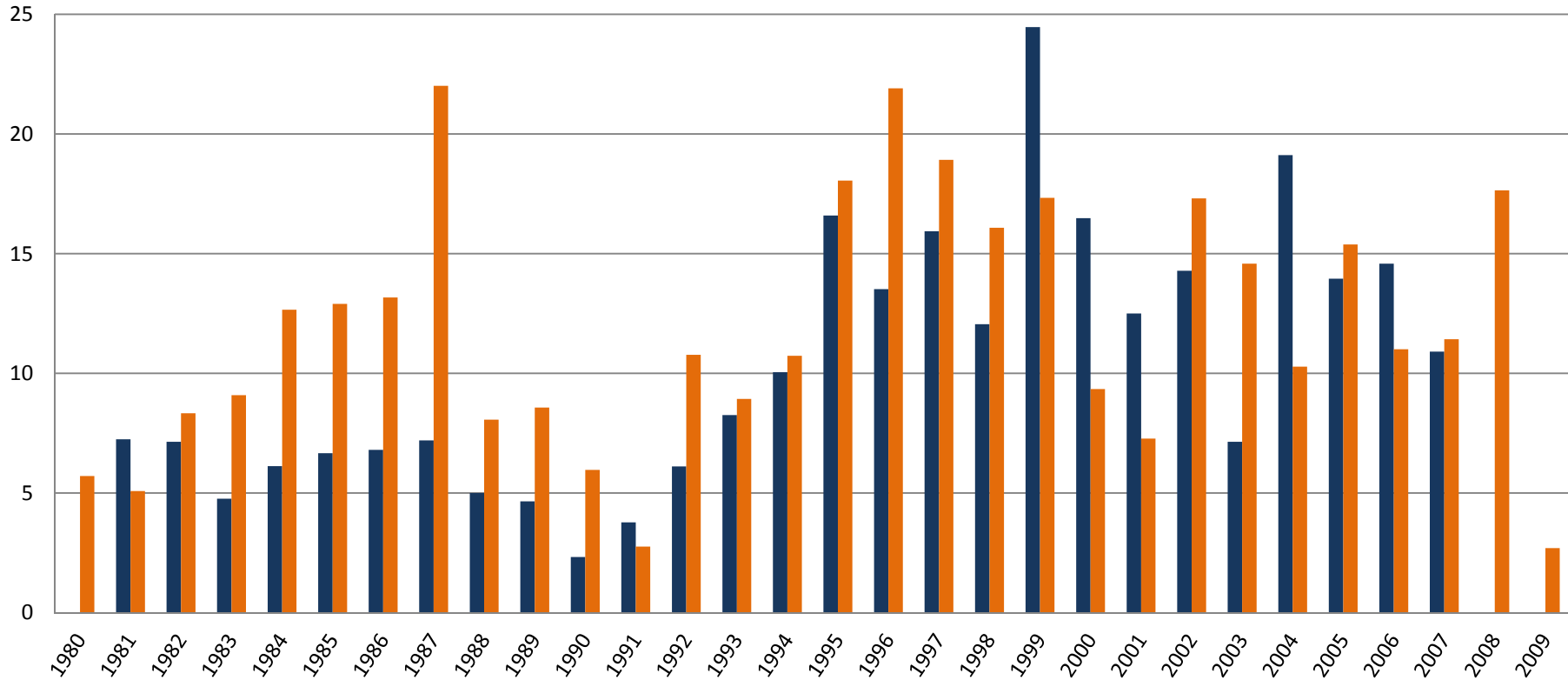
# Are recent IPOs going private more frequently?



Source: Table 7 (both LBOs and acquisitions by private firms)

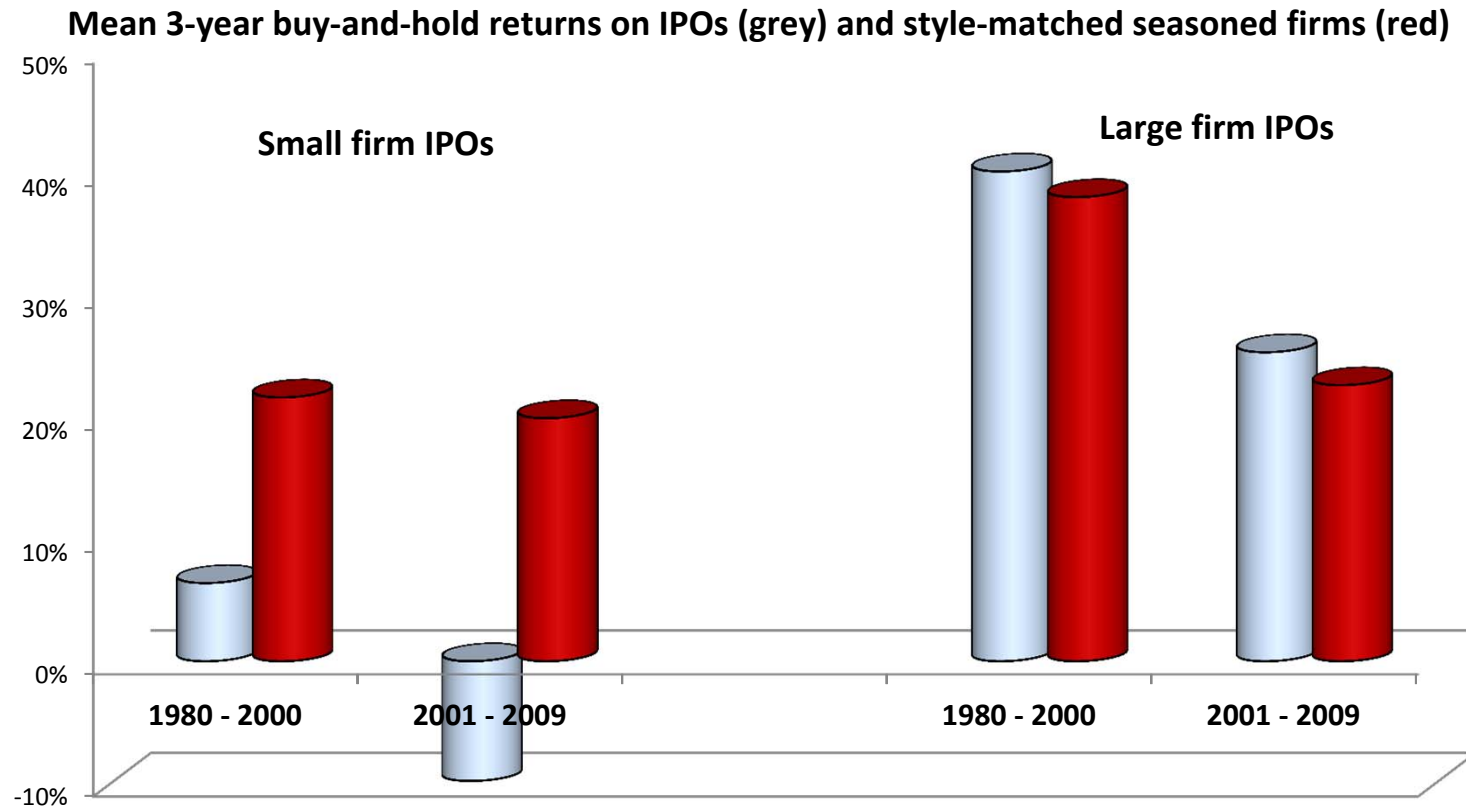
# Are small firm IPOs being acquired more frequently?

Percentage of Small Firm (blue) and Large Firm (orange) IPOs that Are Acquired or Bought Out Within 3 Years

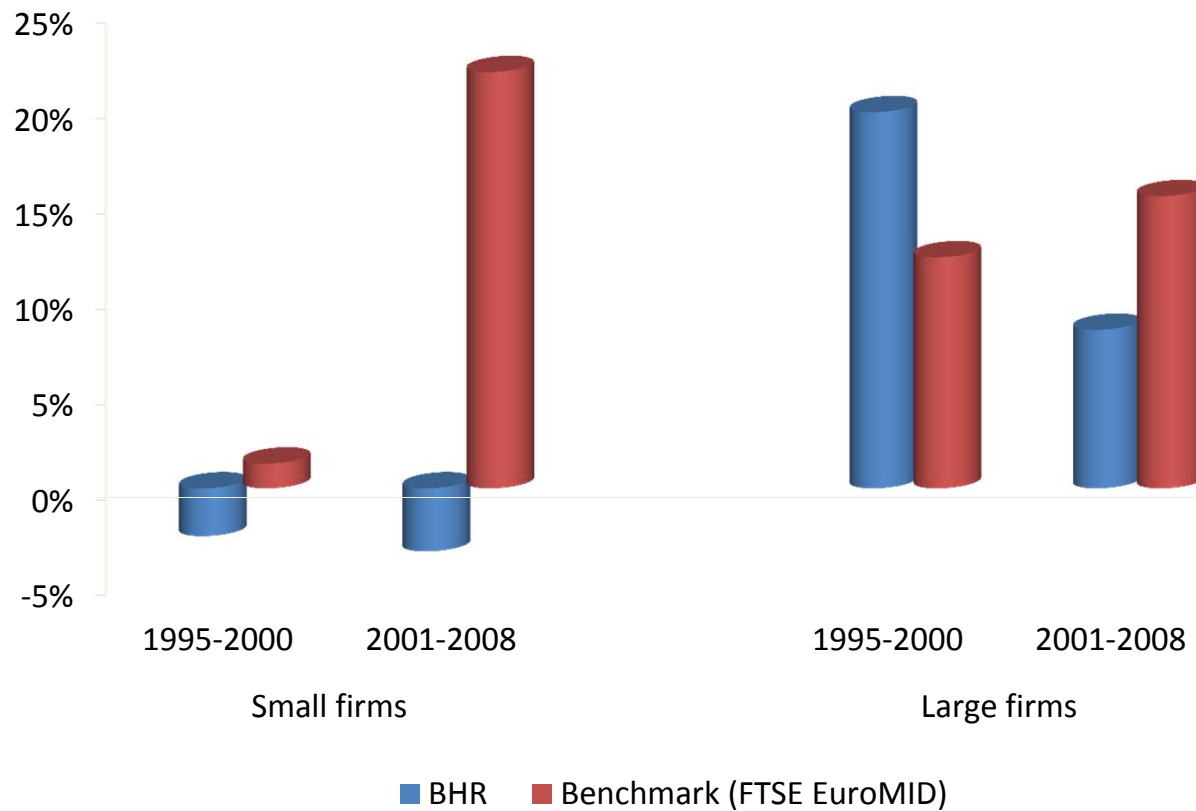




# Small firm IPO returns have been disappointing



## European small firm IPOs returns have also been low



Small firm (<€30m in sales) IPO 3-year buy-and-hold returns are lower than for large firm IPOs (returns are measured from the 22<sup>nd</sup> trading day closing market price)

## Our Main Evidence

Small firm IPOs become less profitable post-IPO

Decline in profitability is not limited to tech firms

Small firm IPOs generate disappointing returns

Eat or be eaten: Many IPOs either make acquisitions or are acquired themselves

## Policy Implications

The stock exchanges and VC industry have argued that structural changes (e.g., subsidizing analyst coverage, lowering regulatory burdens) are needed to boost IPO activity

Our analysis indicates that these will not be effective at generating IPO activity

## Policy Implications

Our analysis suggests that companies are not going public because they have less value as a small independent company than as part of a larger organization

## Conclusions

No one explanation explains all of the prolonged drought in small firm IPOs in the U.S.

**SOX and Analyst Coverage explanations** are of the category “The IPO market is broken”

Our **economies of scope explanation** focuses on increased economies of scope and the importance of speed to market

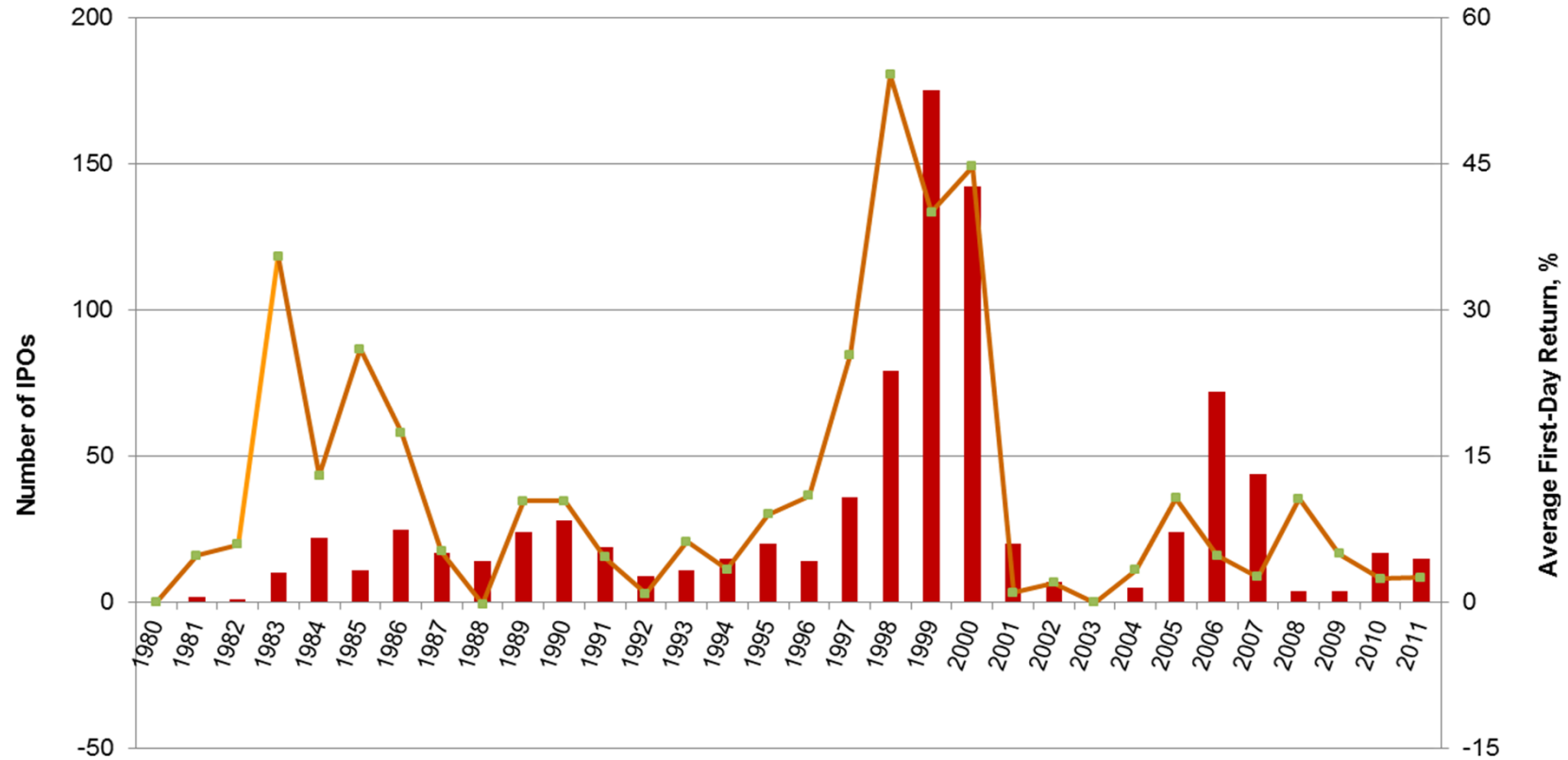
We focus not on public vs. private, but small vs. large firm as the profit-maximizing organizational form

# What Are the Patterns for European IPOs?

Stock exchanges covered: Euronext, Frankfurt, London, Milan

Source: EurIPO<sup>®</sup> database, and forthcoming paper by  
Jay R. Ritter, Andrea Signori, and Silvio Vismara

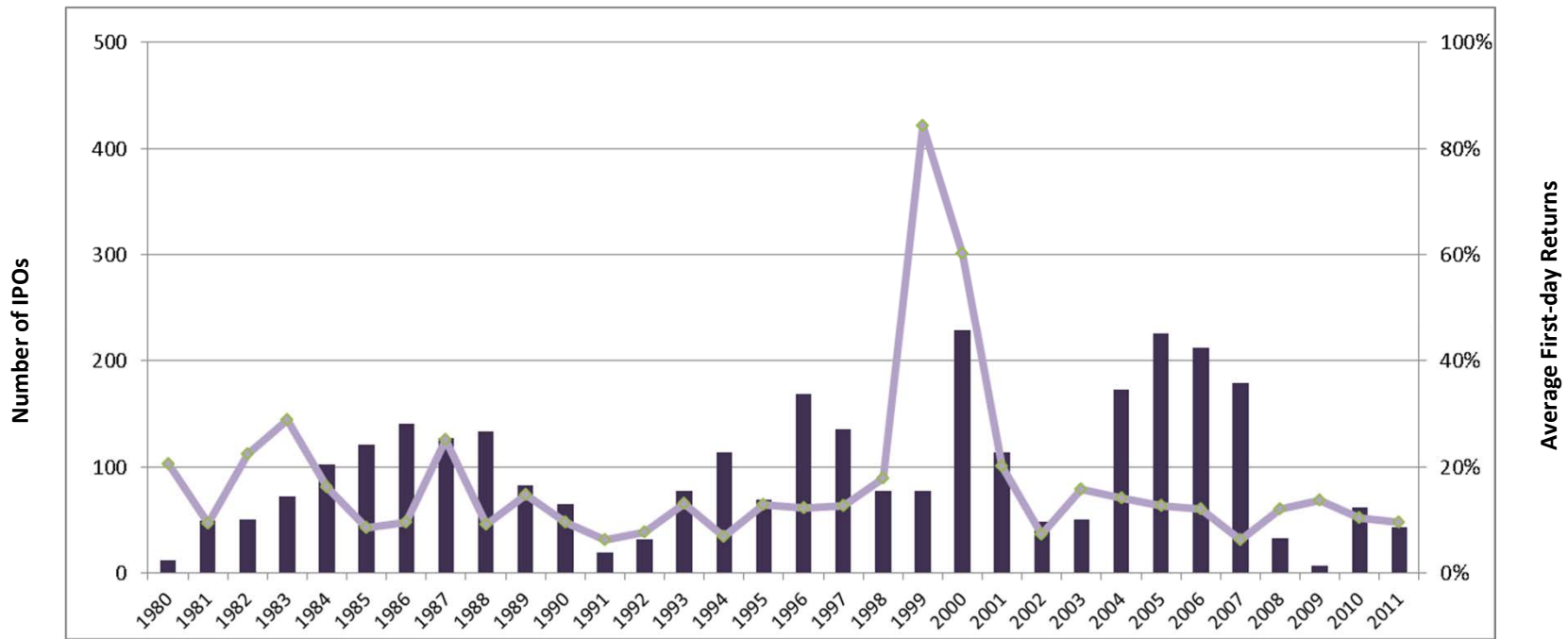
## IPO activity has been modest in other developed countries



Number of Offerings and Average First-day Returns on German IPOs, 1980-2011

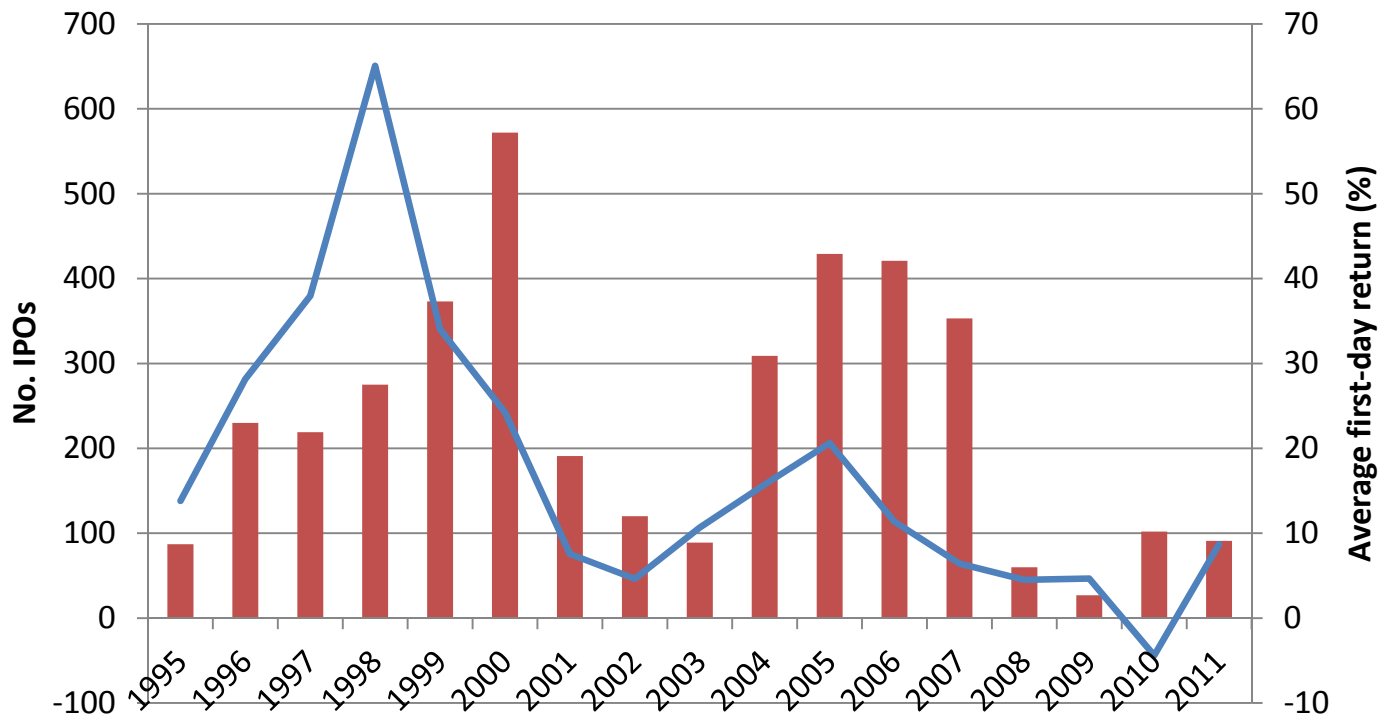


Number of Offerings (bars) and Average First-day Returns on UK IPOs, 1980-2011



# IPO volume in Europe since 1995

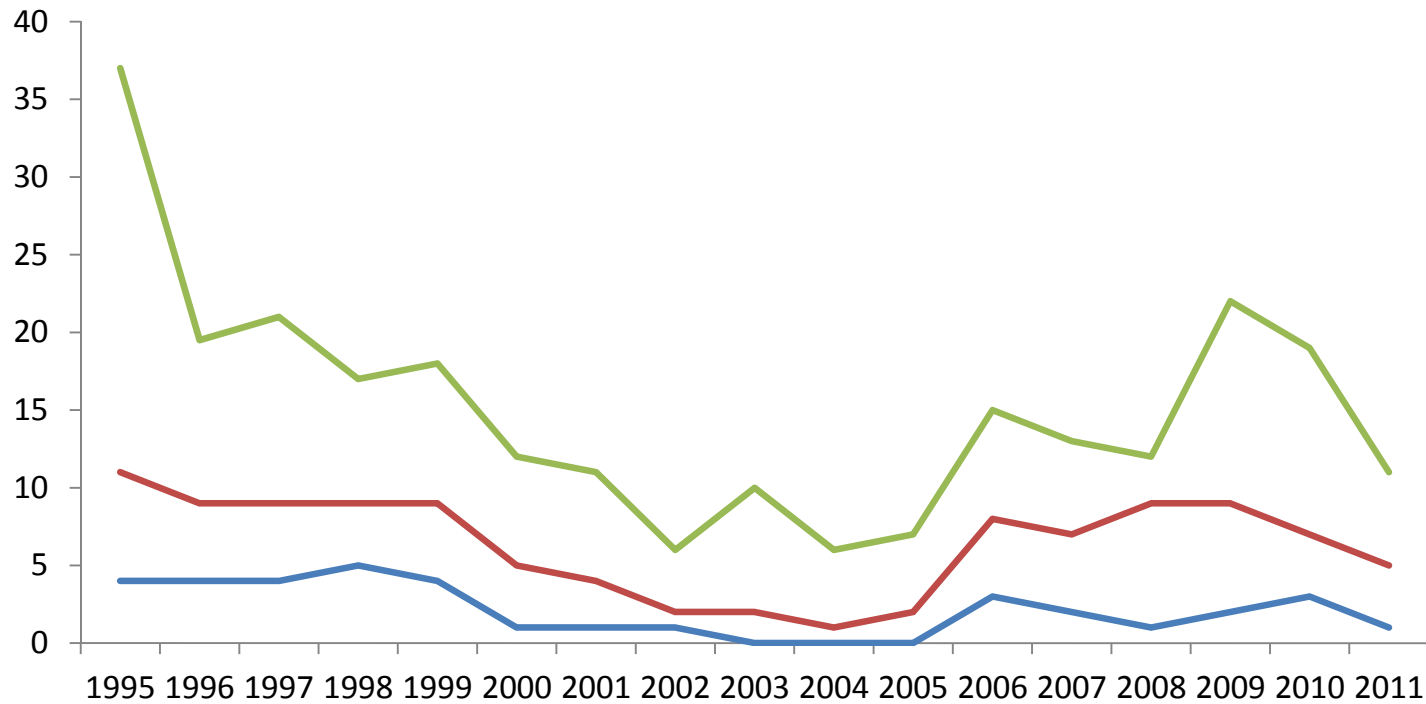
In 1995-2000, an average of 293 firms went public every year  
In 2001-2011, an average of 199 firms went public every year



Number of offerings (bars) and average first-day returns (blue) on European IPOs, 1995-2011

# European firms going public have not become older

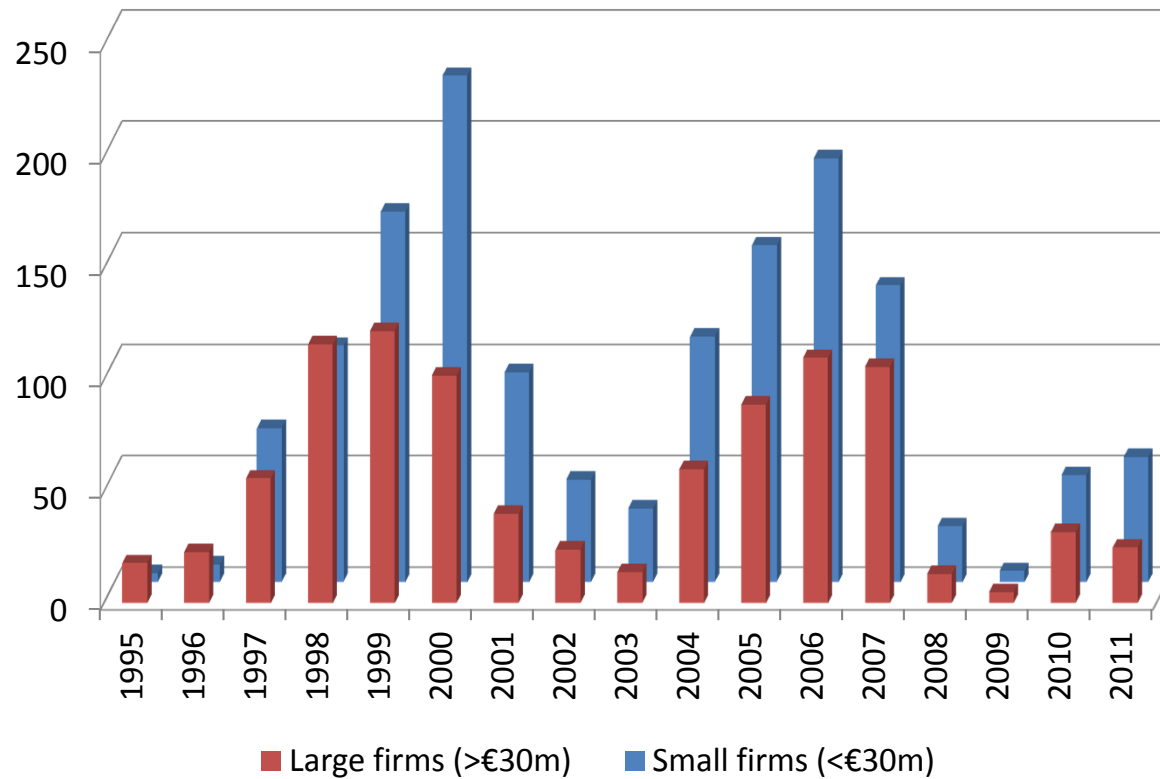
25th, 50th and 75th percentiles of firm age (years) at the IPO



Firms going public have not become older, unlike the US pattern

# IPO volume in Europe by firm size

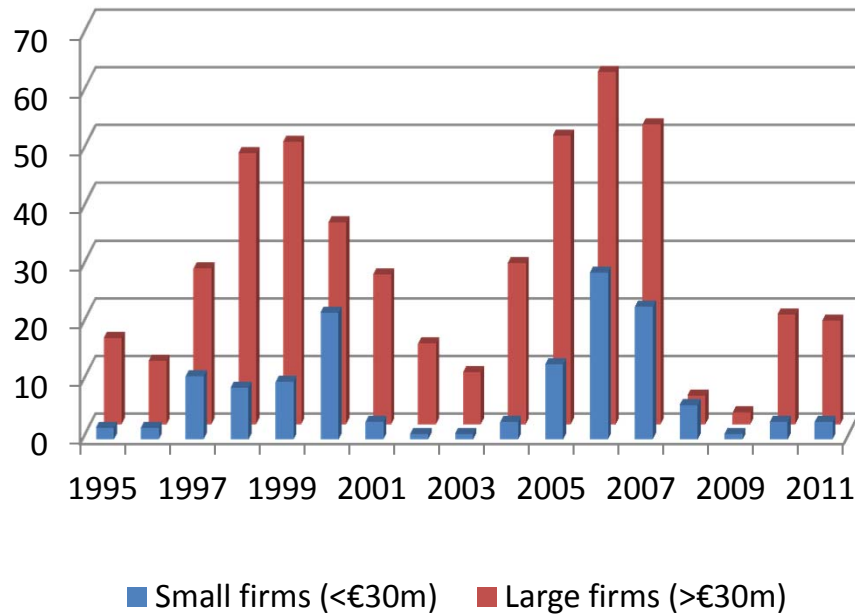
Fraction of European IPOs with pre-IPO Annual Sales less than or greater than €30m/Year (€2009)



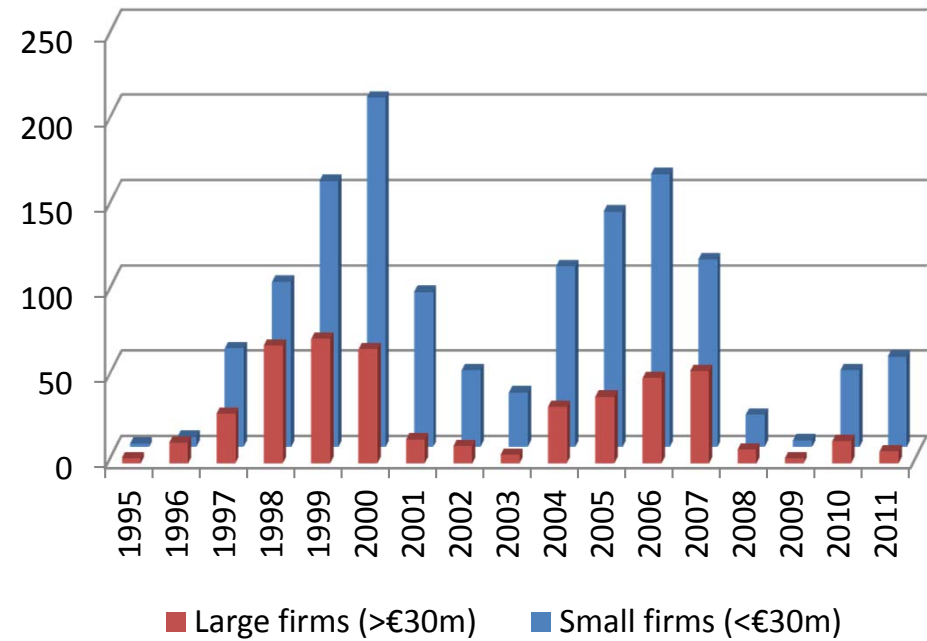
Small firms play a major role in the European IPO market at an aggregate level

# IPO volume in Europe by firm size (sales) and market type

Main markets



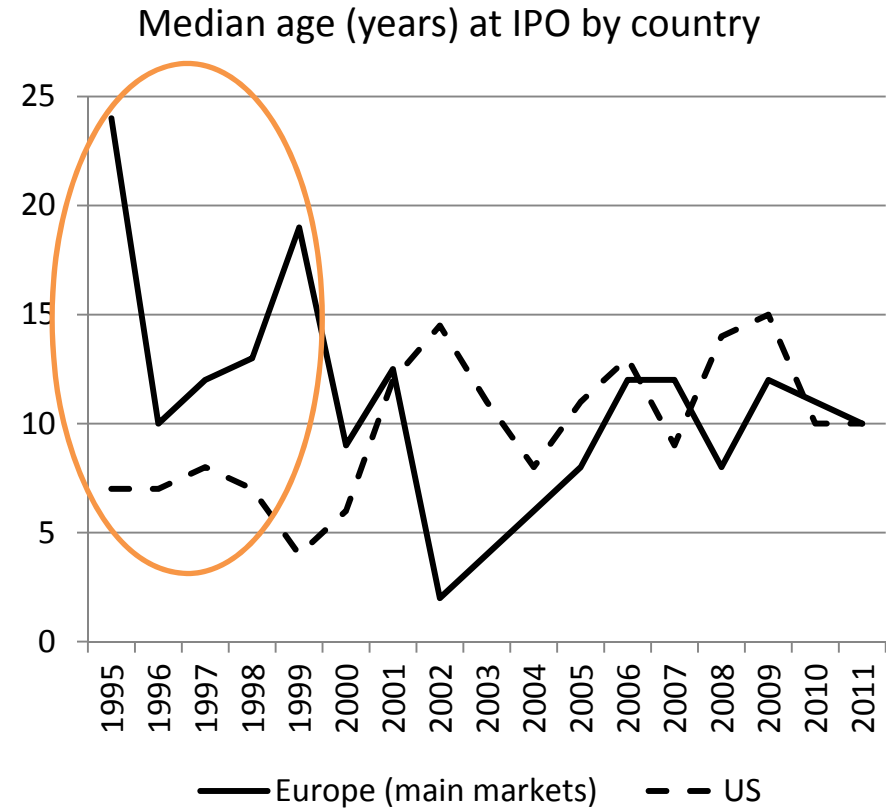
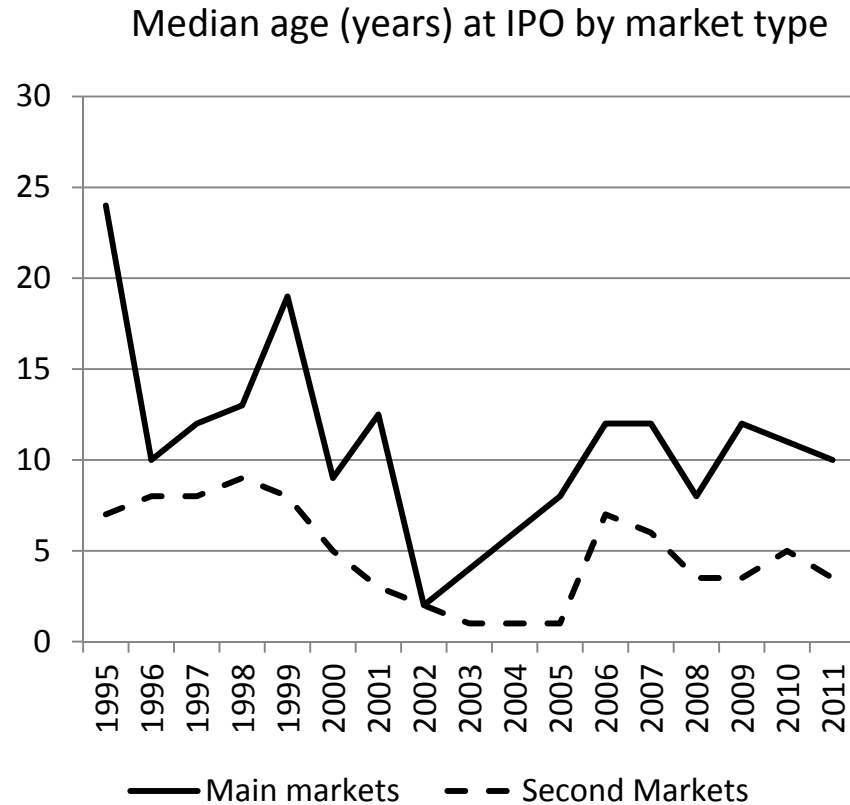
Second markets



The aggregate evidence is driven by second markets

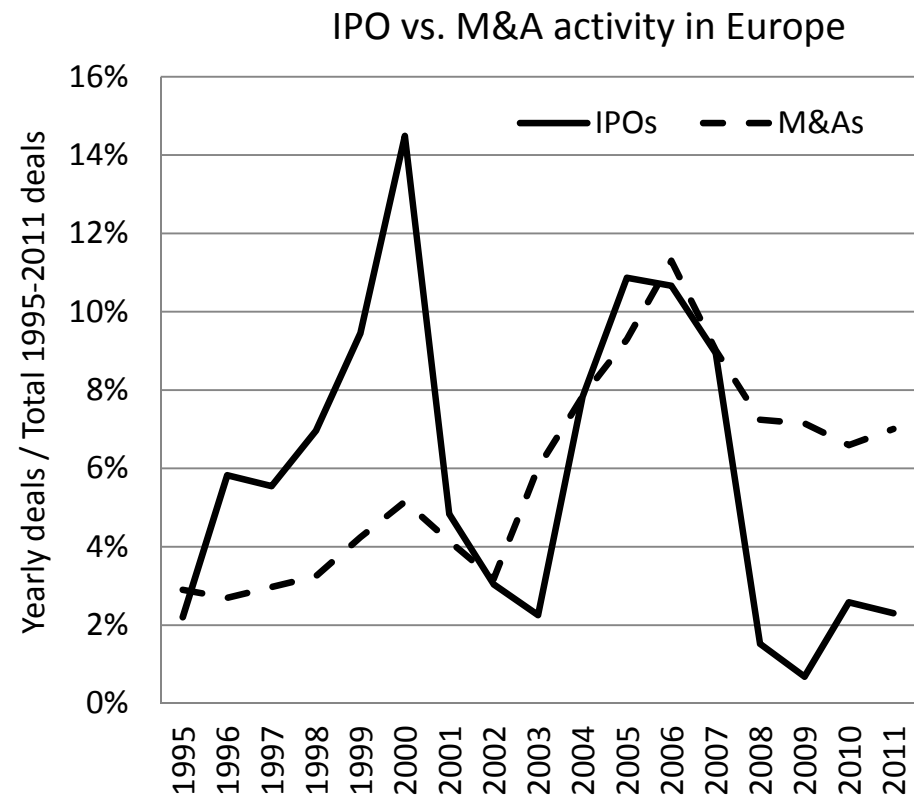
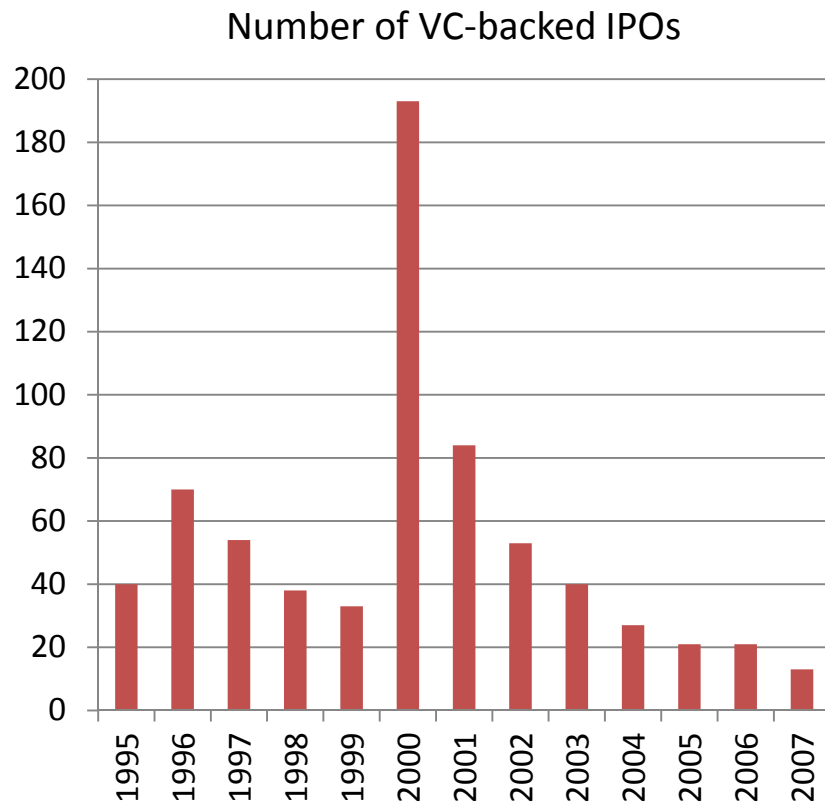
IPO volume has been particularly low for small firms in main markets

# Age of firms going public by market type and country



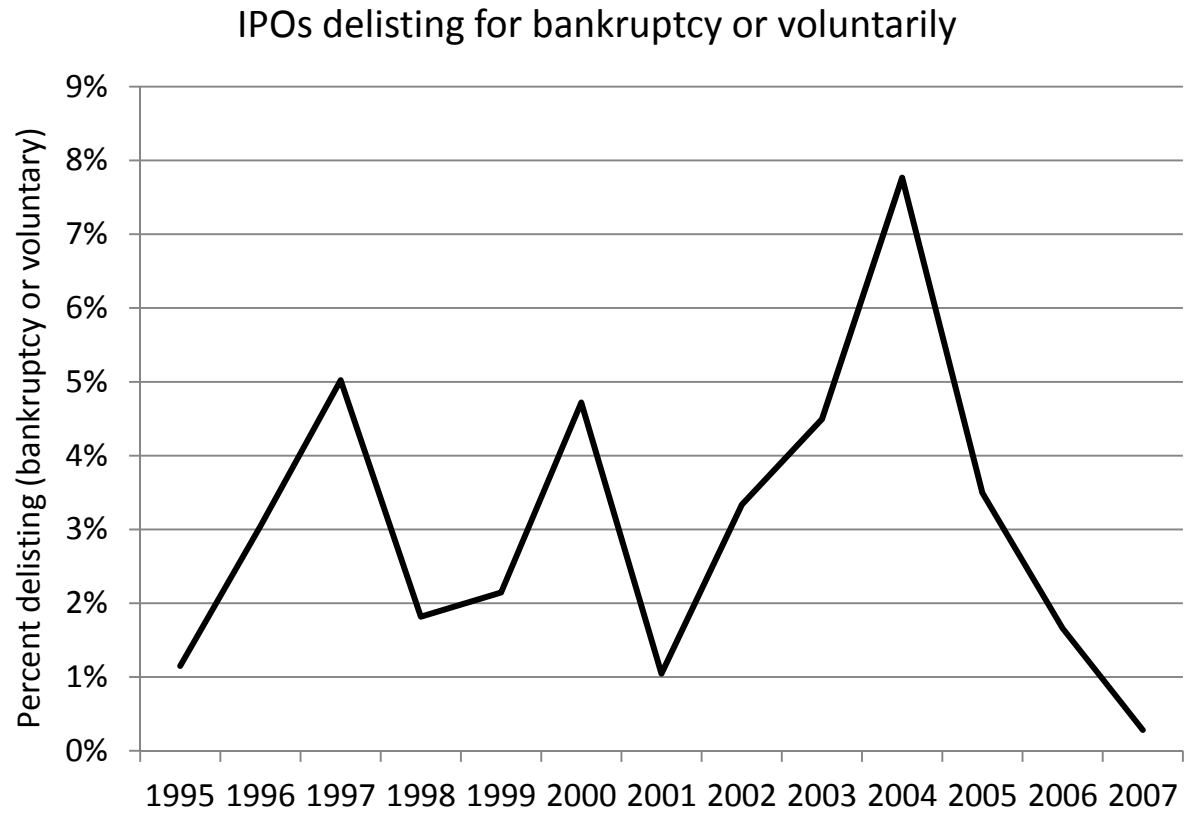
Second markets still provide young firms with the opportunity to go public  
Historical difference in age between EU and US IPO firms

# European IPO exits by VCs and IPO vs. M&A activity



VC exits by IPO have decreased, together with overall IPO volume  
M&A activity has risen: preference for trade sales?

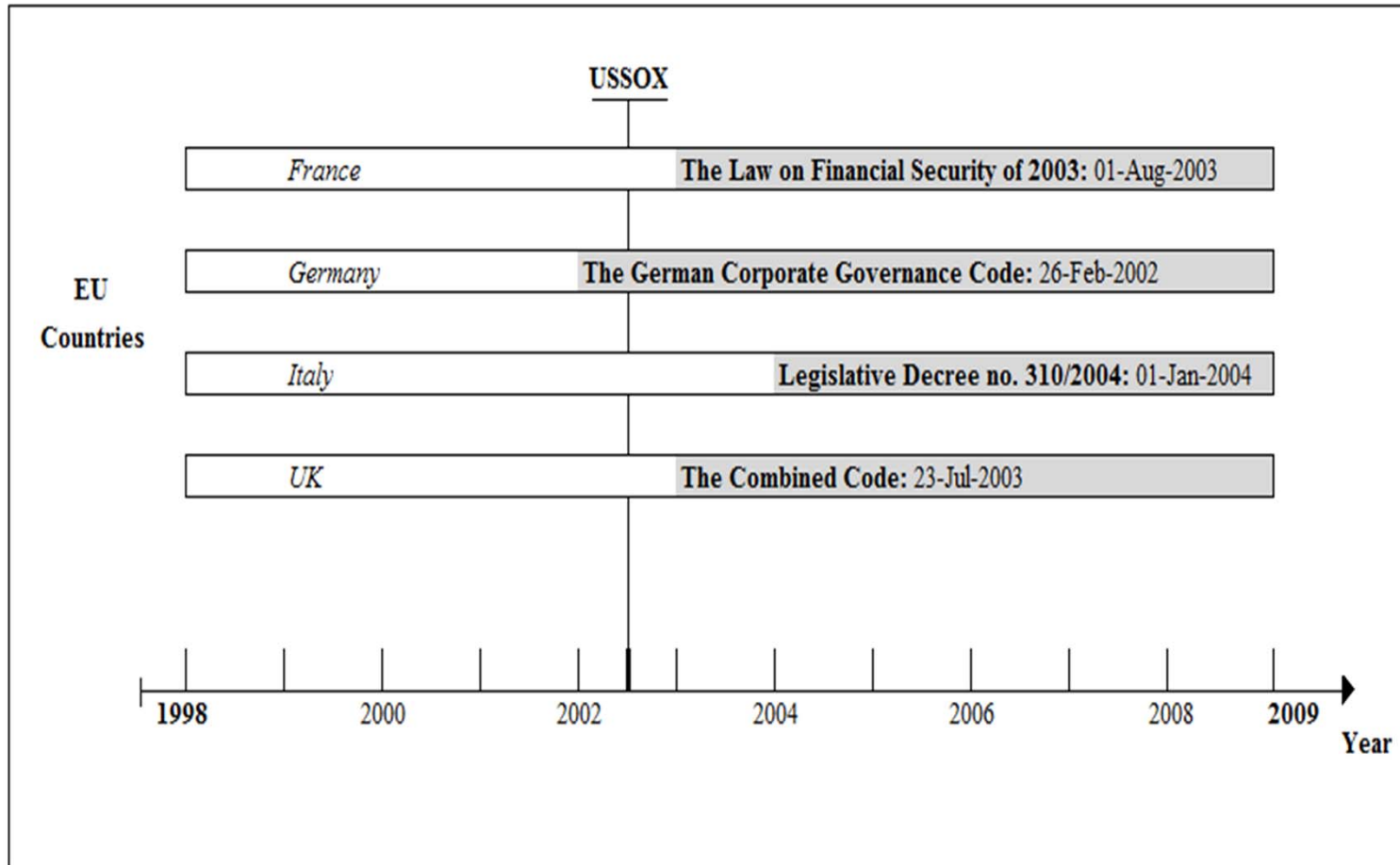
# European IPOs going private



No striking evidence of increased propensity to go private

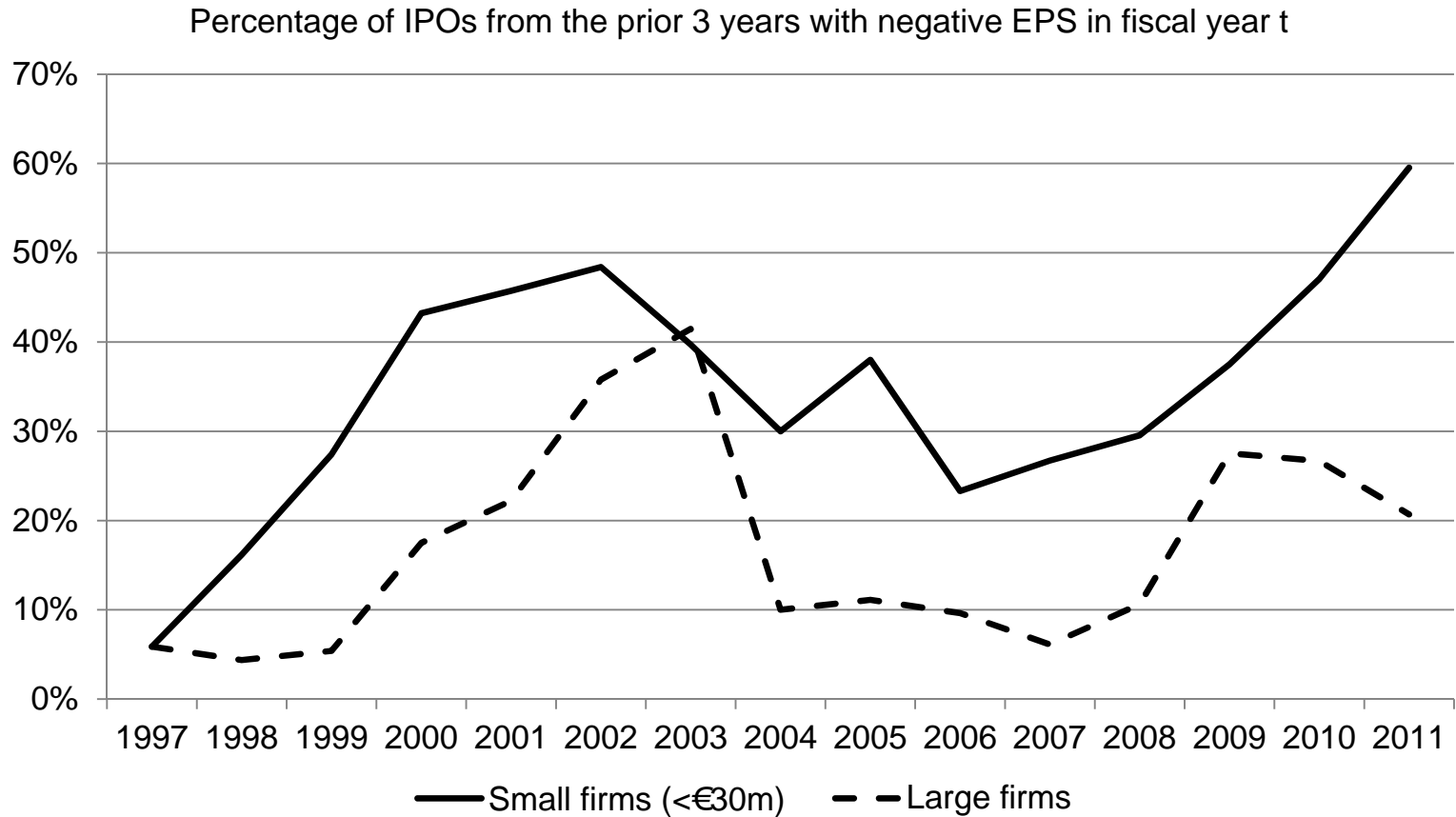


# Changes in Corporate Governance codes in Europe

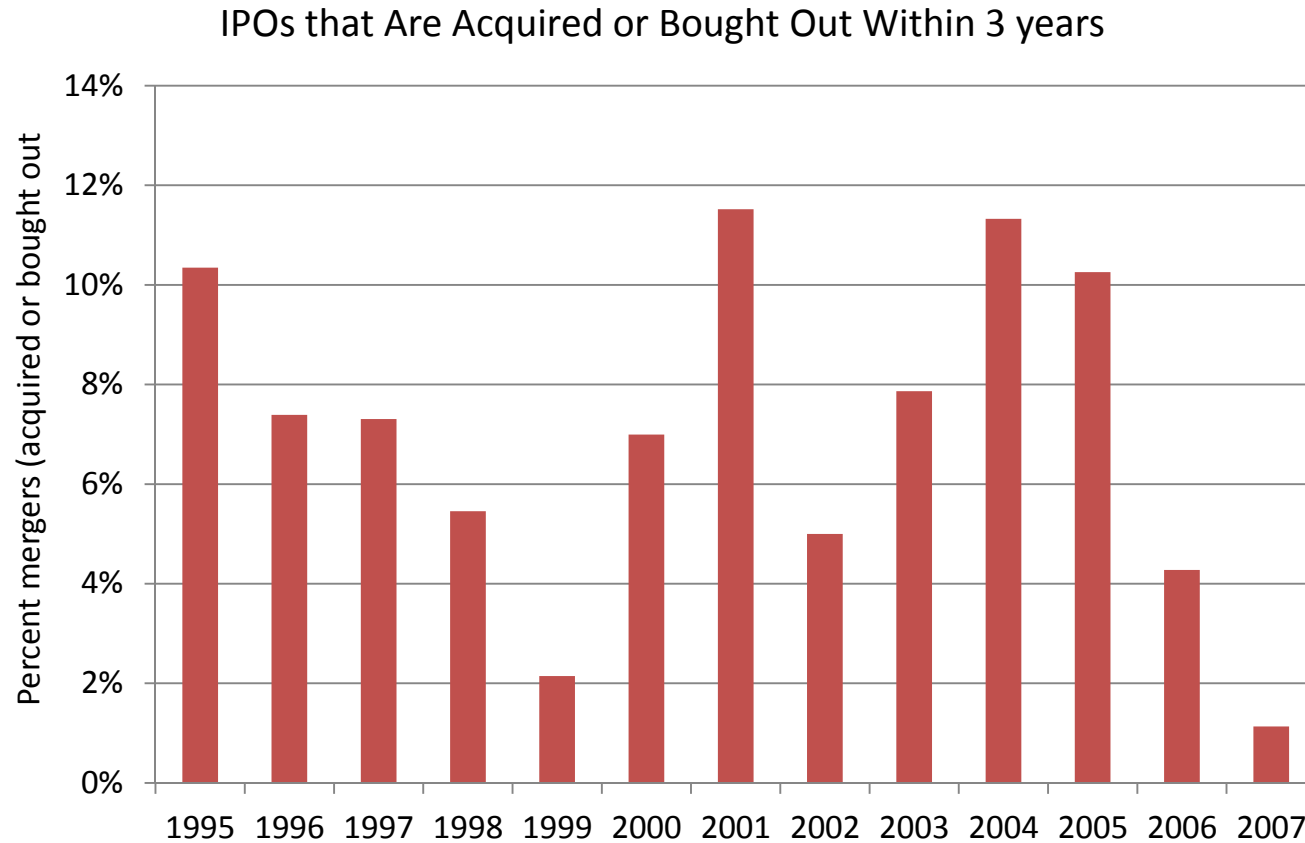


US SOX served as a paradigm that influenced the corporate governance reforms in Europe

# Profitability of European IPOs by firm size



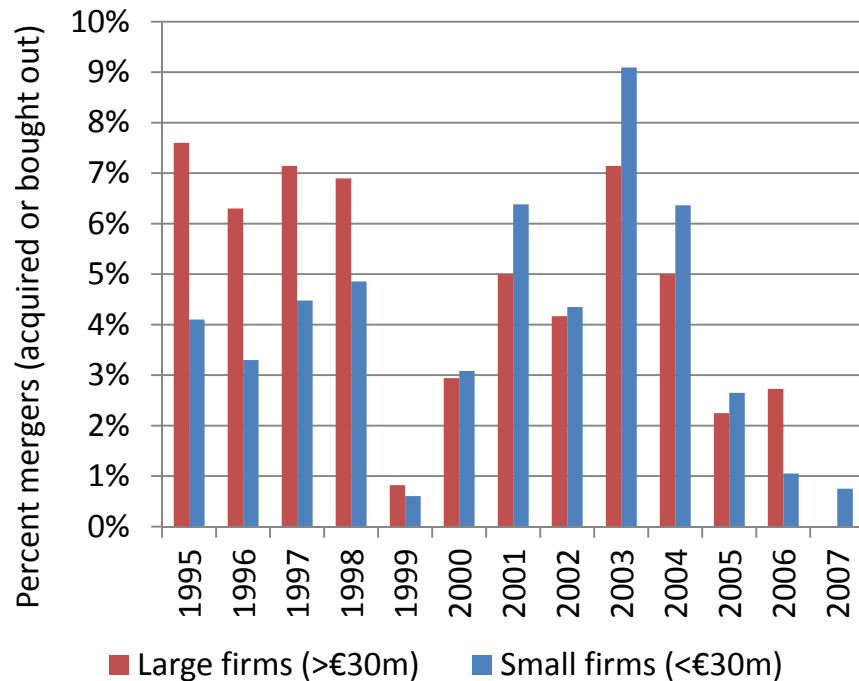
# Percentage of IPOs acquired within 3 years of the IPO



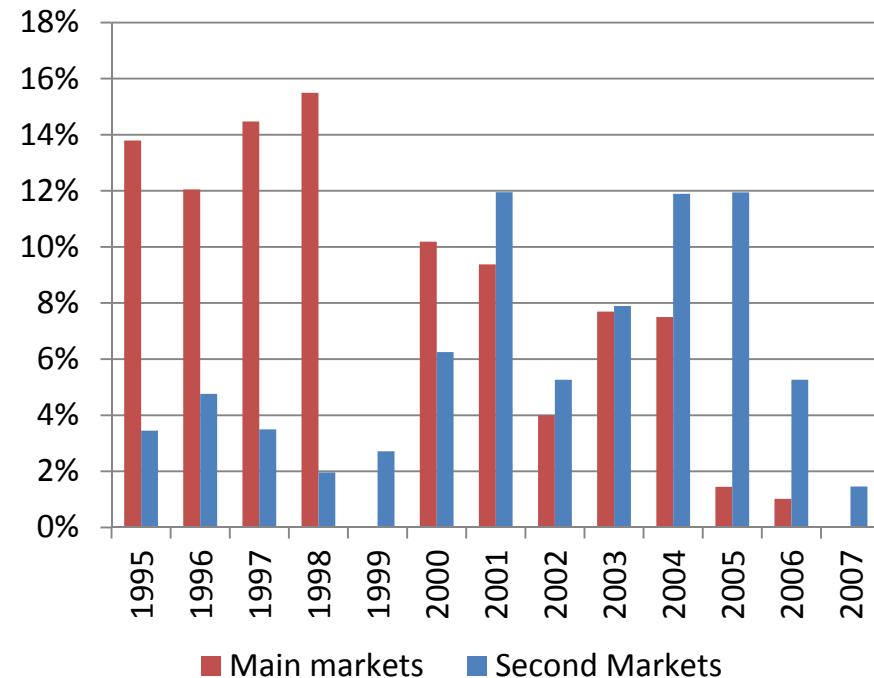
No striking evidence of increased post-IPO acquisitions

# Are small firm IPOs being acquired more frequently?

IPOs Acquired or Bought Out Within 3 Years by firm size



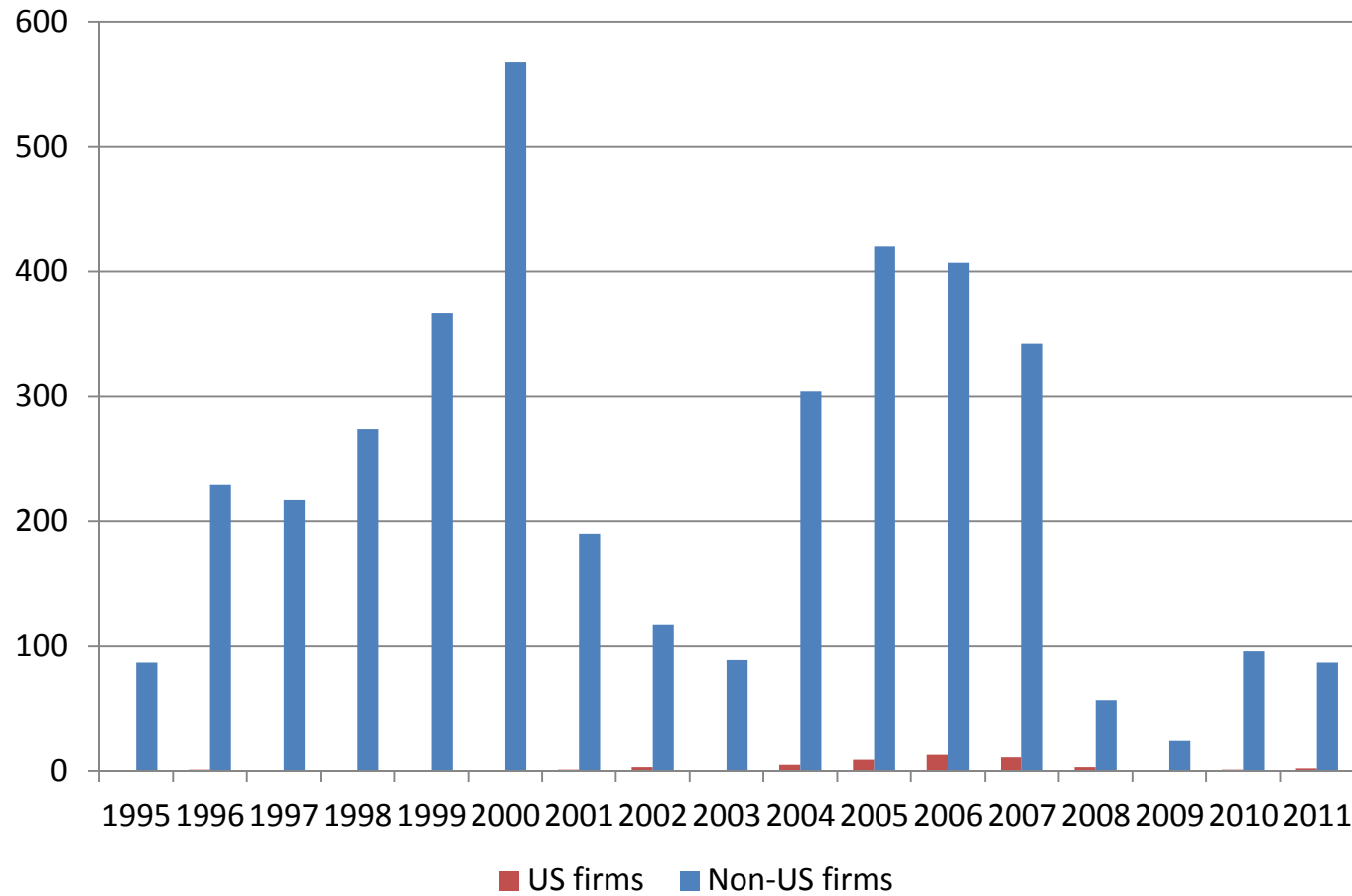
IPOs Acquired or Bought Out Within 3 Years by market type



The post-IPO acquisition rate has recently increased, especially among small firms and second market IPOs

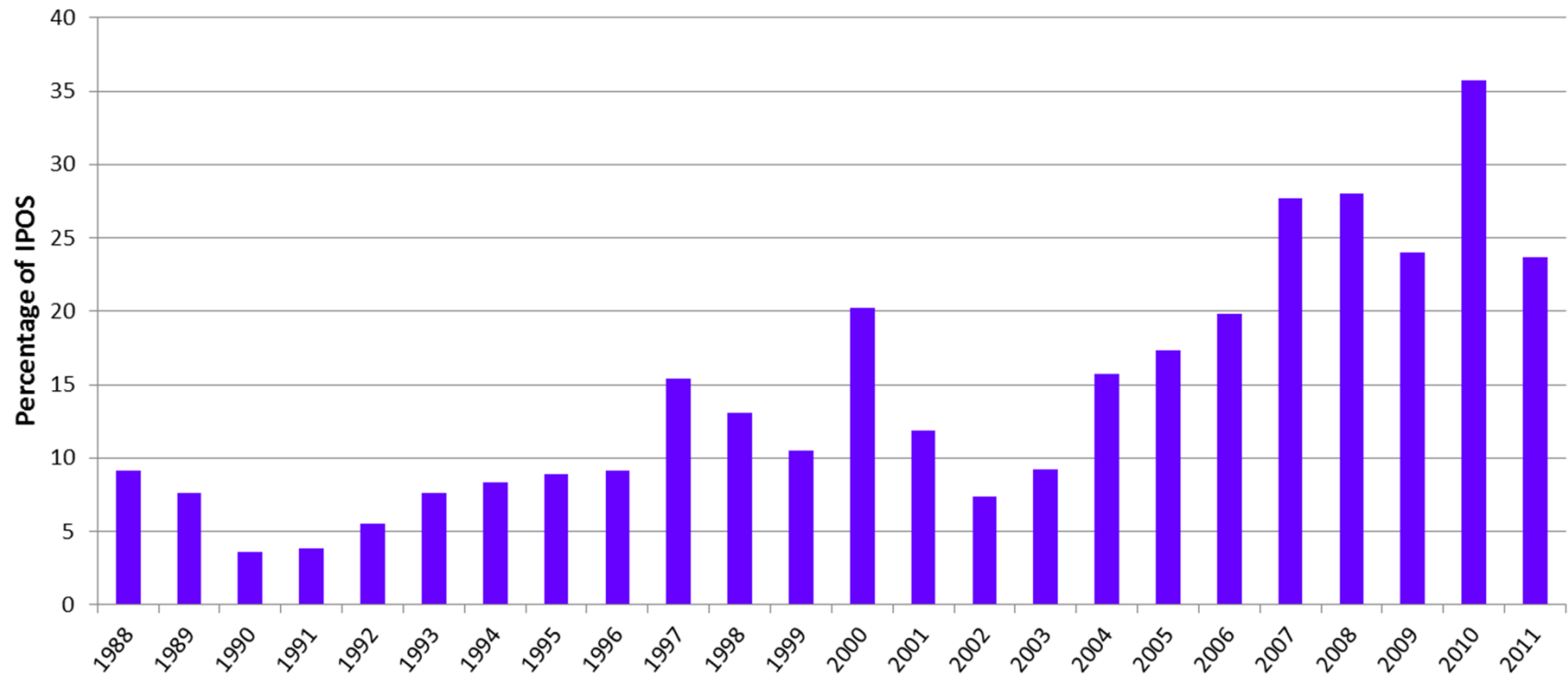
Are non-US IPOs avoiding the US,  
or are US firms going public in Europe?

# US firms listing in Europe



The number of US firm IPOs in Europe is minimal

### Percentage of U.S. IPOs from Non-U.S. Issuers, 1988 - 2011



## Conclusions

The European market for small firm IPOs has not struggled as much as in the US

But small firms going public in Europe have given investors low returns, just as in the US