

M & A Today

BUSINESS AT THE CROSSROADS - TO IPO OR NOT TO IPO

by Franz von Bradsky, CPA

During the lifecycle of every privately owned company, especially one that is rapidly growing, there comes a critical juncture. The decision to *go it alone, sellout or refinance* the business is a turning point from which there is no retreat. Whatever the decision, it will have a dramatic impact on the company's future.

If the decision is to sell the company, there is another set of options that confront the owner: sell it in a privately negotiated transaction, which is generally less expensive; or stage an Initial Public Offering (IPO). I think almost every business owner dreams of selling stock via an IPO to fuel the growth of their company or provide themselves with personal liquidity.

Whether or not they have actually thought about an IPO and, even more important, whether or not the company could truly be considered a candidate for an IPO, most owners certainly have thought about IPO valuations and what they believe to be the value of their own company. Rarely in the ten years that I have been providing investment banking services to privately owned "middle market" companies have I found a business owner with a reasonable understanding of the true value of their business. More often than not, the valuation was a figment of someone's fertile imagination. That, however, is a subject for another time.

CONSIDERATIONS

After an IPO, a business owner will lose one of their most cherished rights - not having to open their books and records to public scrutiny. As a publicly traded company, they are subject to the rules and regulations promulgated by the Securities and Exchange Commission (SEC) which requires public companies to file frequent detailed reports with the SEC (10-K's, 10-Q's, 8-K's, proxy statements, etc.) which are time consuming and expensive. Additional annual costs as a result of being a public company can easily be \$100,000. Orchestrating an IPO requires an immense amount of preparation and

management time. The process often can take six months or more to complete. Further, it is not an inexpensive process and, therefore, should not be undertaken by the typical penurious entrepreneur (more about the cost involved later).

An owner should give serious consideration as to whether or not the company is truly a candidate for a public offering, one with a good record of sales and earnings as well as a good story to tell. There are many businesses that are not suitable for an IPO even though they may have a good record of sales and earnings because of an absence of interest on the part of the investment community, i.e., the industry is out of vogue or is viewed as too speculative or a host of other reasons.

Most investment bankers that specialize in underwriting IPO's would like to see several of the following characteristics present when considering to undertake an offering on behalf of a client: a) products or services that are highly visible to the public; b) products or services for which there is a great demand and a large or potentially large market; c) a demonstrated record of a high sustained rate of growth; d) a high probability of achieving a high level of future growth in sales and earnings; and e) a crackerjack management team capable of successfully executing the company's business plan.

MANAGEMENT

The secret of completing an IPO hinges not only on the company's products or services but on its management team, and I can't emphasize enough the importance of the "management team." In real estate, the old adage when buying a piece of property is *location, location, location!* In investing, be it a venture capitalist or a sophisticated institutional investor purchasing an IPO, it's *management, management, management!* How often have you seen more than two or three key executives in a company including the owner, and then rarely with more than minimal responsibility.

Very often, companies scrimp on management and adequate control systems which often begets trouble, even for large

public companies. *Professional advisor, regularly counsel clients that if a privately owned company wants to go public it should begin it act like a public for several years prior to actually going public in order to prepare themselves for the rigors of being public.*

UNDERWRITERS

Before approaching prospective underwriters, the company should have three years of audited financial statements, -, comprehensive business plan that tells it: story succinctly, a formal board of independent directors in place that meet: regularly and most important, a broad based management team with formal incentive compensation plans in place.

One of the key decisions will be selecting which firm is the right underwriter for the offering. For IPO's of less than \$10 million, the selection of an underwriter is even trickier because major Wall Street firms and the large regional investment banking firms usually are not very interested in them, except perhaps during the period from 1988 to 1991. There are and have been a multitude of offerings that are of less than \$10 million, as evidenced by the numerous tombstones seen in the business press, but many of the firms that underwrite these offerings do not windup making a real market in the securities nor are they likely to publish research reports or the company. As a result there tends not to be as much liquidity as with a larger underwriting and the price of the stock weakens in the aftermarket.

Today, the stockmarket is dominated by large institutional investors such as private money managers, mutual funds, pension funds, insurance companies, etc. which probably account for some 55% to 60% of all stock ownership in the United States. They live and die by research reports from analyst: at investment banking firms and require that there is a liquid market for their holdings. Consequently, smaller IPO's will have lower valuations because of the absence or lack of institutional support in the aftermarket. These offerings tend to be sold to individual investors, usually on the basis of price.

Good underwriters will price the securities at less than what the securities are expected to trade at in the aftermarket. By doing so, the stock is likely to rise in the market when trading begins, keeping investors who bought the IPO happy. Something should always be left on the table which often goes against the grain of an entrepreneur. In addition, most underwriters do not allow owners to sell more than 30% to 35% of their stock in the offering.

There is a substantial cost involved in going public, very often running into the millions of dollars when all of the professional fees and expenses of accountants, lawyers, printers, underwriters, etc. are toted up. On a \$20 million IPO, the underwriting fee alone will probably be in the range of \$1,400,000 and for offerings smaller than \$10 million will run as high as 10% of the offering. Other professional fees will add several hundreds of thousands of dollars to the total cost of the IPO. The smaller the IPO, the higher the costs will be as a percentage of the total offering.

TIMING

A major prerequisite in determining whether to proceed with an IPO is the status of the stockmarket. As the saying goes, "timing is everything." Investment banking professionals often refer to the IPO market euphemistically as "the window is open or the window is shut." An "open window" is the optimum time to be staging an IPO. After the crash in October of 1987, the window was slammed shut for three years. It opened again in 1991 and has boomed through most

of 1993 until slowing down in 1994. There have only been 427 IPO's through the end of August which have raised \$19.6 billion.

<u>YEAR</u>	<u>NUMBER OF IPO'S</u>	<u>BILLIONS OF \$ RAISED</u>
1986	698	\$17.5
1987	514	13.5
1988	223	4.9
1989	206	5.5
1990	170	4.4
1991	362	15.6
1992	502	21.8
1993	677	38.2

Source: Securities Data Corporation

The industry within which a company operates also has an affect on the success of the offering. At various times, an industry will fall out of favor with investors and the investment community. In the case of the biotechnology industry, for example, the window closed last year after being wide open in 1991 and 1992 when there was overwhelming investor interest. Investor fervor has a dramatic effect on most company's stock price.

Investor interest will be the ultimate determinant of the pricing of a company's securities. If there is weak demand for the issue, valuation expectations have to drop or the offering will have to be scrubbed. After the precipitous drop of the market in October of 1987, it is estimated that less than one-third of the companies in registration with the SEC at the time of the crash went public in the following nine months and those that did so, went out at significantly lower multiples.

CONCLUSION

Going public is often viewed as the pinnacle of success and many times it is. It is not, however, the be all and the end all. There are a great many companies, large and small, that have remained privately owned and been very successful in the process such as Bechtel, Levi Strauss and Crowley Maritime to name just a few Bay Area companies.

If the IPO market continues at the same pace for the balance of the year, it will finish well *off* of last year's record of \$38.2 billion, perhaps as much as 25%. Business owners are truly at a crossroads now. Should they continue the status quo and go forward alone or sell out or stage an IPO? At the moment the IPO market is soft and the M&A market is red-hot, precipitating the question: *to IPO or not to IPO?*

For those intent on pursuing their IPO dream, however, a final word to the wise is in order - *always expect the unexpected!*

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