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Key Insights

There is very little research on what it takes to become a successful IPO candidate.

The general consensus is that only about one in ten thousand start-ups will make it to an IPO.

Future potential and evidence to that effect, has the greatest impact on valuation for an IPO.

The Investment Bank, Professional Advisors and Brokers you use convey a message to the market about how much faith the stakeholders have in your ability to succeed. The best advisors support the best firms.

Cost of listing and supporting an ongoing public listing are very high.

An acquisition strategy can often be a very positive message for a newly listed firm.

Dr. Tom McKaskill



Global serial entrepreneur, consultant, educator and author, Dr. McKaskill has established a reputation for providing insights into how entrepreneurs start, develop and harvest their ventures. Acknowledged as the world's leading authority on exit strategies for high growth enterprises, Dr. McKaskill provides both real world experience with a professional educator's talent for explaining complex management problems that confront entrepreneurs. His talent for teaching executives and his pragmatic approach to management education has gained him a reputation as a popular speaker at conferences, workshops and seminars. His approaches to building sustainable, profitable ventures and to selling businesses at a significant premium, has gained him considerable respect within the entrepreneurial community.

Upon completing his doctorate at London Business School, Dr. McKaskill worked as a management consultant, later co-founding Pioneer Computer Systems in Northampton, UK. After being its President for 13 years, it was sold to Ross Systems Inc. During his tenure at Pioneer, the company grew from 3 to 160 people with offices in England, New Zealand and USA, raised venture capital, undertook two acquisitions and acquired over 2,000 customers. Following the sale of Pioneer to Ross Systems, Dr. McKaskill stayed with Ross for three years and then left to form another company, Distinction Software Inc. In 1997 Atlanta based Distinction raised \$US 2 million in venture capital and after five years,

with a staff of 30, a subsidiary in New Zealand and distributors in five countries, was sold to Peoplesoft Inc. In 1994 Dr. McKaskill started a consulting business in Kansas which was successfully sold in the following year.

After a year as visiting Professor of International Business at Georgia State University, Dr. McKaskill was appointed Professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship (AGSE) in June 2001. Professor McKaskill was the Academic Director of the Master of Entrepreneurship and Innovation program at AGSE for the following 5 years. In 2006 Dr. McKaskill was appointed the Richard Pratt Chair in Entrepreneurship at AGSE. Dr. McKaskill retired from Swinburne University in February 2008.

Dr. McKaskill is the author of eight published paperback books for entrepreneurs covering such topics as new venture growth, raising venture capital, selling a business, acquisitions strategy and angel investing. He conducts workshops and seminars on these topics for entrepreneurs around the world. He has conducted workshops and seminars for educational institutions, associations, private firms and public corporations, including KPMG, St George Bank, AMP, AICD and PWC. Dr. McKaskill is a successful columnist and writer for popular business magazines and entrepreneur portals.

To assist Angel and Venture Capital investors create strategic exits for their investee firms, Dr. McKaskill conducts seminars, workshops and individual strategy sessions for the investor and their investee management teams.

Dr. McKaskill completed six e-books for worldwide distribution. He has also produced over 150 YouTube videos to assist entrepreneurs develop and exit their ventures.

Tom McKaskill is a member of the Brisbane and Melbourne Angel Groups and of the Australian Association of Angel Investors.

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Preface

Entrepreneurs have a fascination with the IPO. They seem to regard this as the mark of success rather than just another stage on the journey. The IPO has also been seen by the venture capital industry as the most desired path to exit and thus has become the high water mark of the VC backed successful firm. If you look over the last 40 years of the VC sector, you will see that their big successes have come through the IPO market.

However, the IPO is somewhat elusive. Few understand the process and even less understand what it takes to set a firm up for a good IPO. Most people think that it is only about proving a business concept to show you are profitable. However, the market is both more sophisticated and more fickle than that. You only have to read the financial pages to see how unpredictable the market is. One minute you have a queue of firms lining up for an IPO, next they all vanish on the advice of their investment bankers. Most of the time it is hard to fathom what happened to make a difference.

When I sold my first business, I sold to a USA firm which was just listed on the NASDAQ. We had contacted them 6 months earlier to ascertain their interest in buying our business. At the time they were heavily pumped up with venture capital and debt. They were, however, riding a wave. This was early in the application software market and they were well positioned to take advantage of their early entrance into the market.

They successfully listed and raised some US\$40 million. They paid off the debt and the VC funds all cashed up. Within a few weeks we had negotiated a deal and did a share swap to become part of the newly listed company, ROSS Systems Inc.

Being a Vice President in a corporation of 450+ people allowed me to see a lot of the strategy which was used both before and after the IPO. Clearly the firm had thrown funds into the business to pump up the revenue and create a leadership position. The VC funds wanted an IPO to cash out and they got one. A lot of manipulation went into creating the right revenue and profit picture prior to the IPO to show constant and predictable growth.

Once the IPO was achieved, the business was on a 3 monthly reporting treadmill. A lot of effort went into staging the large projects to ensure the revenue timing was right and the profit, quarter on quarter, showed the right trend. However, you can't fool the market forever and they didn't have the underlying experience in large software applications projects to get the systems in and paid for so they could gain the referrals. Eighteen months after the IPO, the chickens came home to roost and the referrals dried up. As a result the new sales fell off and the revenue and profit growth disappeared. Shares which had listed for \$10.50 and grown to \$17 plunged over the next year to \$3. I left the firm at that point having lost about 80% of the value I started with.

The market subsequently pushed the price down to 6 cents and eventually the business was sold to CDC. Our software product, PROMIX, which created the momentum for our sale to ROSS and fueled the early sales after the IPO, is still being sold some 18 years later, still very much as we designed it. It just shows that a great product alone is not sufficient to create a business which can survive and prosper on the public market.

However, it was a very enlightening experience for me to see from the inside how the numbers were manipulated to push up the share price but also to see what happened when that buffer could not be maintained.

Some years later, during the time I was professor of Entrepreneurship at the Australian Graduate School of Entrepreneurship, I was approached to become Chairman of Directors of a travel group which was positioning itself for an IPO. The firm employed a small investment bank to advise them on the IPO process and to get them ready. The firm put a lot of effort into creating an experienced Board, undertook a few small acquisitions to gain greater size and hired medium level accounting and legal firms to assist them.

The advisory firm eventually recommended against an IPO, but managed to squeeze about \$700,000 out of them before pulling the plug. I recall that the final decision was put to me this way. 'The consultants are watching the market to see

if the index shows steady growth over three consecutive trading days. At that point they will pull the trigger on the IPO roadshow'. My comment at the time was 'But it will be several weeks before we can commence the roadshow. The roadshow itself will take 6 weeks and the IPO will be several weeks later. How is it possible for three trading days two months before the planned IPO be the trigger for the listing. This is not science this is a joke!'

Without an imminent IPO, they didn't need a large Board and so most of us left. The business subsequently failed and went into receivership. What was obvious in hindsight was that they simply never had the price margins and growth necessary to go for an IPO and should never have been advised to do so. Clearly, too many advisors with snouts in the trough. I have heard similar comments for others who have been advised to undertake an IPO.

Shortly after this experience, I decided to undertake some research into the pre-IPO stage. What I found was that there was no substantive material available. There were no research papers on pre-IPO strategies and there was nothing available in the IPO textbooks to help with the strategy. There was lots written on the process and some comments on minimum requirements but really nothing you could wrap your arms around to give you direction on how you should develop your business to significantly raise your probability of success.

I decided to undertake some interviews of major investment banks to find out how they worked with pre-IPO firms. What I discovered was that they knew not much more than I did, even after advising on numerous IPOs. What I found was that it was more art than science.

One of the great advantages of being a full time academic is that you do have the time to read, think and reflect. You also have the luxury of interviewing people in a very non-threatening way and you can gain insights into events and processes which, in the normal course of business, may not be made public. Thus I had an interesting time trying to work out what makes a difference and which things improve or detract from an IPO listing.

The results of both the research and my conceptual modelling of the pre-IPO process are included in this book. I can't say that I have the magic bullet, but I can say that there is more science to my reasoning than simply creative thinking. I have used this framework on numerous entrepreneurial ventures over the last few years and have received a lot of support from Angels, Venture Capital funds and professional advisors for the insights I have brought to the strategy development

process. Although I have advised on some hundred plus angel and VC backed ventures over that time, I have only recommended an IPO process in three cases. Basically, in my opinion, the hurdle is very high and to pursue an IPO strategy when you don't have all the elements in the venture to give yourself a very good chance of success is foolish.

I hope you enjoy my insights into this very public process.

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IPO GUIDELINES

(Extract from a chapter entitled *Spot the IPO* in my book 'Invest to Exit', 2009, Breakthrough Publications)

IPO Activity

Since the 60's the private equity market has been mesmerized by the IPO exit. This can be tracked back to the early days of venture capital. Fortunes were made by Silicon Valley entrepreneurs and their investors in the rapid growth of the computer industry. Because of the size of the market and the ever increasing demand for computers, peripherals and software and services associated with the sector, it wasn't difficult for a venture to be taken to an IPO. There was sufficient pent-up demand that most reasonable businesses could generate the revenue to support a push into a stock exchange listing.

The IPO became the yardstick to measure the worth of a venture as well as the success of the VC fund. Entrepreneurs wanted to list as they saw this as a measure of their own personal success as well as providing an exit for themselves and their investors. VC funds selected investee firms on the basis of their likelihood of delivering an IPO exit rather than a trade sale. Even so, not all ventures made the grade. Even in these years of staggering market growth, only about 20% of investee firms achieved an IPO.

Even in recent years when markets were very receptive, the number of IPOs was relatively small.

In 1999-2000, 24 companies were sold, 12 companies went public, four companies were bought back and 19 investments were liquidated. The value of exits during the year 1999-2000 was \$536 million. The average trade sale was \$3.7 million, while the value of all IPOs was \$346 million.

(Source: Venture Capital in Australia (Research Note 28 2000-01)
(<http://www.aph.gov.au/library/pubs/rn/2000-01/01RN28.htm>. Accessed 31/12/2004)

Data from Q3 2005 from the NVCA showed that there were 19 IPO exits compared to 76 trade sales (25%).

(Source: <http://www.nvca.org/pdf/2005Q3IPOreleasefinal.pdf> Accessed 5/12/05)

Angel investor exits by the Tech Coast Angels, 1997-2001

Activity	Number
Investments	52
Operating Independently	32
Exits	20
- out of business (-1x)	- 10
- Partial return of capital (0 - 9x)	- 5
- Sale to private companies (exit pending)	- 3
- IPO (2x - 3x)	-1
- Sale to public companies (+120X)	-1

Source: William H Payne and Matthew J Macarty, 2002, *The anatomy of an angel investing network: Tech Coast Angels, Venture Capital, Vol. 4. No. 4*

Exit data from the UK for 2004 show that, by value, 28% was from trade sales, 20% were sales to another private equity firm, 13% were write-offs and 10% was from IPO flotations.

(Source: www.bvca.co.uk)

Angel investors have not been as fixated on the IPO as an exit path preferring trade sales as the preferred exit event. However, some ventures were still able to make an IPO exit, but as you can see the percentages are relatively small.

UK experience suggests that IPOs happen less often for UK Angels.

Exit routes for technology and non-technology investments

Exit Route	Investments in technology based firms Number	Investments in technology based firms - %	Investments in non-technology based firms - Number	Investments in non-technology based firms - %
Flotation	6	14.3	3	3.9

Exit Route	Investments in technology based firms Number	Investments in technology based firms - %	Investments in non-technology based firms - Number	Investments in non-technology based firms - %
Trade Sale	12	28.6	19	24.7
Sales of shares to existing shareholders	3	7.1	16	20.8
Sale of shares to 3rd party	6	14.3	6	7.8
Written off/ shares have no value	15	35.7	32	41.6
Asset break-up	0	-	1	1.3
Total	42	100	77	100

Source: Colin Mason and Richard T Harrison, 2004, Does investing in technology-based firms involve higher risk? An exploratory study of the performance of technology and non-technology investments by business angels, Venture Capital, October 2004, Vol. 6. No. 4

We should expect Angel and VC investee firms to have a higher probability of an IPO than the average private firm. After all, VC investees are selected in the first instance for their growth potential and these firms will have professional advisors along the way. The USA experience suggests that about 25% of new listings have had some VC investment. That being the case, we can estimate the chance of a startup going public.

In most western economies about 4 in 10,000 firms will have venture capital investment. If the VC sector achieves an IPO in only 20% of their ventures, we can expect any start-up firm to have about a 1 in 10,000 chance of getting to an IPO. Thus an IPO is a fairly rare outcome for a private venture.

The possibility of an IPO for an Angel or a VC investment, however, needs to be taken with a dose of reality. Many of the IPOs by VC firms over the last 40 years happened during periods of boom markets. Take out the IPOs which occurred during the computer boom of the 70s and 80s, the application software boom of the 70s and 80s, the internet boom of the 90s and the biotech boom of the turn of the century and the number of IPOs is reduced to a much smaller number.

We also need to adjust for IPOs undertaken through large private equity deals.

These are typically large family businesses, MBO and MBI projects and public to private to public turnarounds. In addition, there were a number of rollups and consolidations which would be classed more as a PE deal than a VC investee exit.

Once we make these adjustments to the IPO data, we find that the number left as 'normal' IPOs, even over a long periods of time, is insignificant. It is indeed a very rare venture which can be taken to an IPO, even when the market is receptive.

The table below shows the types of characteristics which best suit an Initial Public Offering (excluding speculative ventures such as biotechnology and resource ventures).

<u>Attribute</u>	<u>Requirements for Long Term Attractive Public Listing</u>
<u>Revenue</u>	\$20 million plus (\$100 million plus the most successful).
<u>Net Profit</u>	Profitable for three years with minimum of \$2 million in the year prior to listing. Projected profits growing over next few years.
<u>Scope</u>	National or international markets.
<u>Portfolio</u>	Range of products with some in different markets.
<u>Potential</u>	Major national leadership or global markets.

<u>Attribute</u>	Requirements for Long Term Attractive Public Listing
<u>Management</u>	Majority with public corporation experience and some with experience in larger corporations.
<u>Board</u>	Significant industry and public corporation experience.
<u>CEO</u>	Able to deal with market analysts, institutions and shareholders.
<u>R&D</u>	Products in various stages of development to ensure continued market leadership.
<u>Cash</u>	Sufficient funds to meet forecast plans without further capital raisings.
<u>Funds use</u>	Funds raised to be used for market development, innovation, overseas expansion, acquisitions, working capital, repayment of debt.
<u>Advantage</u>	Clear competitive advantage based on strong intellectual property and/or proven innovative business model.
<u>Public Awareness</u>	Products and their benefits are easily understood by the public.

<u>Attribute</u>	Requirements for Long Term Attractive Public Listing
<u>Support</u>	Listed shares are large enough in value and number in institutional and public ownership to encourage market analysts to track the stock. Generally this means a market capitalisation of at least \$100 million.

The requirements for listing a firm are quite onerous and expensive. Unless the listing results in a share price that can maintain a position at least as good as the sector index, the listing will not achieve the exit the private equity shareholders anticipated (assuming the private equity shareholders hold shares in the listed company). Just having liquidity of the shares via a market listing does not in itself guarantee that the value achieved by the shareholders will be greater than they would have achieved in an outright sale to a corporation.

Since few companies in private ownership can meet these requirements, an exit strategy aimed at an IPO is not a viable option for most privately held firms. That is not to say that smaller company investors cannot exit through an IPO, but without being able to satisfy the above attributes, it is highly unlikely that an IPO will be possible.

Instead of a formal listing, many firms have taken an indirect path to a public listing by taking advantage of a dormant listed company or a currently listed company which is willing to undertake a merger to reinvigorate the business.

The dormant company approach, referred to as a 'back door listing' is often seen to be quicker and cheaper but it is not without its problems. Typically, back door listings are done with smaller listed companies. The firm undertaking the activity has to deal with a second group of shareholders and their advisors which can be problematic when it comes to valuation and shareholder rights.

Example:

Mr Scrinis paid \$350,000 to Infosentials creditors last year for the right to approach shareholders with an offer. But negotiations

with investors, corporate advisers and other interested parties slowed down the process and forced Moonlighting to postpone its original plans of floating by the end of 2001.

Source: Accessed 22nd April 2008 <http://www.smh.com.au/articles/2002/04/02/1017206193858.html>

Example:

Global Approach and the vendors of Teys agreed to revisit the acquisition structure, including the consideration. Additionally, given the growth of the business and the anticipated future growth, Teys shareholders said they wanted to have a higher equity position in the enlarged company.

Source: <http://www.businessspectator.com.au/bs.nsf/Article/Global-Approach-and-Teys-reverse-backdoor-listing-p-D9K2U> Accessed 22nd April 2008

An alternative indirect approach using a reverse merger can be just as problematic. Again, the firm has to deal with another group of shareholders and their advisors. While this may seem attractive as a quicker path to an IPO, the results are somewhat dubious as it can bring on additional problems. Both backdoor listing and reverse mergers also inherit whatever issues are inherent within the other business. The additional due diligence, negotiations and delays may not be worth the cost of disruption to the firm.

Example:

29 January 2007

SunFuels, Inc., and its operating subsidiary Blue Sun Biodiesel LLC, are executing a reverse merger transaction with M-Wave, a publicly-traded printed circuit board supplier. When the transaction is complete, SunFuels execs will assume control of M-Wave, which will change its name to Blue Sun Holdings, Inc. The operating subsidiary will be renamed Blue Sun Biodiesel, Inc. The resulting company will continue to be publicly traded.

Source: http://www.greencarcongress.com/2007/01/blue_sun_biodie.html Accessed 22nd April 2008

Some private companies undertake an IPO, or a backdoor listing, with the

intention of using it to raise funds or to sell off shares. However, unless the size of the shareholding in public hands is significant, generally thought to be above \$100 million, there will be insufficient liquidity to create a market to sell shares.

Generally it will take a minimum of \$500,000 in legal and accounting expenses for even the smallest and simplest IPO. According to KPMG Corporate Finance's 2004 Australian Capital Markets survey, the average cost of raisings up to \$10 million was 10.1%, falling to 4.7% for raisings greater than \$500 million. If only a small amount is to be raised, this cost is very high for the funds received. At the same time, an IPO usually involves significant work for the top executives. This has often been thought to be 50% of the CEO and CFO's time over the six months prior to the IPO. This is a very significant burden on the firm and requires that the rest of the management team bear the burden of day-to-day management during this time. A USA listing would be more expensive and more costly in annual expenses due to greater disclosure requirements.

It is very difficult to get unbiased, objective and knowledgeable advice on what it takes to prepare a venture for an IPO. The market has a wide variety of IPO listings from very small businesses to quite large family businesses coming on the market. The mix includes highly speculative resource stocks, high stakes biotech drug discovery ventures to the conventional retail and manufacturing concerns. Even then, the number of IPOs is still relatively small. Thus it is hard to get sufficient data to be able to build a predictive model for a specific type of enterprise. Another difficulty is that the market itself can be very fickle, usually driven at the lower end by a herd mentality and a desire for quick returns which creates a feeding frenzy in limited markets for short durations. It is this greed factor which perhaps explains why VC firms are able to list quite limited ventures in boom markets.

There is also the problem of objective advice. Too many advisors earn fees or commissions whether the listing occurs or the after market is successful, thus it is somewhat difficult to find any advisor who will say no.

During my time as Professor of Entrepreneurship, I conducted many interviews with professional advisors on IPO readiness and undertook a survey of a large number of advisors to discover some insights into the preparation process. The overall consensus of private equity advisors is that only four factors are considered critical to a successful IPO.

The first factor is that the venture should have a strong competitive advantage

and sufficient growth potential to achieve a \$100 million capitalization value within about 5 years of listing. Neither the current level of revenue or profit is considered significant compared to anticipated revenue and profit. This factor alone goes a long way to explaining why low growth firms that have low margins either don't make it to a listing or have to be significantly larger before they can.

The next major factor is the depth and experience of the management team and the industry experience of the Board of Directors. Again, this is not surprising when you consider that the shareholders are backing a group of individuals to take them to the size necessary to support a \$100 million capitalization. Thus, a new management team or one that has significant technical depth but little management depth is not going to be received well.

Knowledge of the IPO process itself by the management team is a major factor. This demonstrates just how important the roadshow to the brokers and the presentations to institutional investors are. Achieving significant share purchase commitments up front is almost a necessary condition for a float. Knowledge of retail and institutional investor risk and return requirements and being able to convincingly show growth potential is an imperative. Investors are typically risk averse and will quickly zero in on potential risks in the venture. The management team must be able to convincingly demonstrate during the roadshow a deep knowledge of their business, their industry and of how to mitigate possible risks.

Finally, the firm must have the best possible advisors it can attract. The best advisors and investment bankers are expected to have the best due diligence processes, require the highest standards of preparation but also carry the highest level of credibility to the market. Thus they tend to be very selective in who they represent.

A firm that wants to undertake an IPO exit needs to build out the IPO profile above. So, to the extent that it cannot meet the requirements organically, the additional attributes need to be developed or acquired. With 3- 5 years to execute the IPO strategy and especially with Angel and VC financing, a firm may be able to achieve the necessary characteristics given the right starting point. Many companies which attract Angel funding have already identified strategic acquisition opportunities to bring economies of scale and growth to the company.

Often in emerging markets, there will be several firms with complementary products, often selling to the same customers or working with the same alliance partners. These could be brought together to provide a platform for an IPO vehicle.

However, there needs to be an obvious and demonstrable synergy between the products and the firms. Just lumping a number of firms together to reach the revenue and profit targets is unlikely to convince the institutional investors that they are investing in a sound platform of future growth.

At the same time that the underlying product portfolio is being built, the firm needs to construct the management team that is capable of running a growing public corporation. Public corporation experience, experience with larger businesses, deep experience in the industry and a good track record, are all essential characteristics for the IPO management team.

The IPO strategy needs to show in considerable detail how the IPO prospect profile will be achieved. Underpinning the plan should be documented representations from respected accountants, lawyers, bankers and brokers who are willing to work with the firm on building the IPO strategy.

For an explanation of the USA IPO process and the costs associated with it see:

Note on Exits Prepared by Fred Wainwright and Angela Groeninger
Center for Private Equity and Entrepreneurship, Tuck School of Business
at Dartmouth University 12/2004

What is obvious from this analysis is that high growth and, especially high potential growth, is a key factor in an IPO. What is also critical is that the growth potential must have a high degree of resilience and predictability to secure the market capitalization needed for successful listing. Thus firms ideally should have strong IP, multiple distribution channels into multiple markets, good recurring revenue, a strong pipeline of future products and experienced management for a successful IPO. Given the challenge of high growth, these additional attributes simply make it even more challenging to create a venture which can successfully undertake an IPO.

Timing is Critical

The IPO market is very sensitive to economic conditions and investor confidence. Even though there have been large numbers of VC backed ventures for which an IPO exit would have been attractive, the number which have successfully listed varies greatly over the years. The table below shows that years

with strong economic growth have had significantly larger numbers of IPOs, but when the market is depressed, very few IPOs occurred.

Periods of higher numbers of IPOs also coincided with 'hot markets' in specific sectors. The 1970s and 80s were dominated by computer hardware related IPOs. The 1990s had large number of internet related IPOs and the late 90s by biotech venture IPOs.

Going Public Since 1970 **Initial Public Offerings USA 1970 - 2003**

<u>Year</u>	<u>Number</u>	<u>Year</u>	<u>Number</u>	<u>Year</u>	<u>Number</u>
1970	138	1981	348	1992	597
1971	253	1982	122	1993	808
1972	495	1983	685	1994	631
1973	95	1984	357	1995	570
1974	9	1985	310	1996	853
1975	9	1986	726	1997	615
1976	6	1987	548	1998	370
1977	40	1988	288	1999	541
1978	32	1989	251	2000	446
1979	38	1990	213	2001	99
1980	62	1991	400	2002	92
				2003	87

*Source: [http:// www. ipovitalsigns.com/Content/Going%20Public%20by%20Year%20since%201970.htm](http://www.ipovitalsigns.com/Content/Going%20Public%20by%20Year%20since%201970.htm).
Accessed 26th April 2009*

Hot markets, or boom markets, have a number of characteristics in common.

- The initial fuel is provided by a breakthrough innovation (e.g computer power, disc capacity and memory chips in the 70s and 80s, the internet in the early 90s and the genome project of the late 90s).
- The breakthrough innovation has to be widely available with relatively low cost of entry for new ventures.
- The innovation has to support numerous applications, many of which have global potential.
- New ventures need to be open to external investment, especially through

IPO activity.

- The applications have to be understood by the general investing public.
- Early entrants into the market have very high revenue growth rates.

You can see how these conditions were met by the various computer, internet and biotech booms in the last few decades. In these conditions the public investor sees high growth potential in every venture and wants a part of the action. Putting a startup into an IPO in these conditions is not difficult and certainly explains the high rate of IPOs which occurred during those periods. However, in a market downturn and in the absence of a breakthrough innovation, IPOs are very infrequent for early stage ventures.

The difficulty for the investor is guessing the length of time the boom conditions will last. If it takes 18 months to 2 years to prepare a venture for an IPO, the critical question must be how long the boom will last. If it dies before the venture can list, the investor might be left with a lemon.

Boom conditions do tend to close quickly and are usually associated with an event which questions the high growth expectations of the retail investors. Typically a boom will end when one of the following occur:

- A market leader fails to meet a revenue forecast.
- A market leader is found to have misrepresented revenue recognition or has some other significant reporting irregularity.
- A potential market leading product fails to satisfy a major milestone such as FDA approval or a product release date.
- The whole market enters a downturn because of a major economic crisis.

Example:

Remember the good old 1990's - Webvan, Kozmo, Pets.com and all the other spectacular IPOs that raised hundreds of millions in the dot.com boom? (Pets.com raised \$82.5 million in an IPO in February 2000 before collapsing nine months later.)

Source: <http://www.rumormillnews.com/cgi-bin/forum.cgi?noframes;read=144096> Accessed 27th April 2009

When such events occur, the market revises the growth prospects of the

market leaders and scales back their revenue and profit expectations. Given that significant potential growth underpins the valuations, any major downturn in growth will seriously negatively impact share prices. This usually creates a selling frenzy as retail investors dump the stock. This in turn creates a downturn across the entire sector with a mass sell off of investments. Once this happens, the IPO market in that sector is basically dead.

Without the demand from the retail investor, early stage IPOs are near impossible. Given that market collapses cannot be predicted with any accuracy, any Angel or VC investment in a boom sector has to be something of a gamble.

More recently, the global financial crisis has seen only a trickle of IPOs. VC firms with potential IPO exits have had to wait or seek a trade sale as an exit.

Example:

The number of U.S. initial public offerings (IPOs) decreased 73% for Q1 2008 compared to the same quarter a year ago, as reported today by Hoover's Scorecard. In Q1 2008, only 12 companies went public on the major U.S. stock exchanges, raising \$18.9 billion, compared to Q1 2007 when 44 companies went public, raising \$8.5 billion. However, Visa Inc.'s mega IPO contributed the lion's share - \$17.9 billion - of that Q1 2008 total. This represents the first year-over-year decline in the number of U.S. IPOs since Q3 2006 and is a far cry from the 70 IPOs of the immediately preceding fourth quarter of 2007.

Source:<http://resourceshelf.com/2008/04/15/statistics-business-hoovers-ipo-scorecard-reveals-major-year-over-year-in-new-offerings-for-q1-2008/> Accessed 26th April 2009

What we are also seeing in recent times are more withdrawals from the IPO process, that is companies which intended to list but have pulled out, probably due to the lack of market interest in IPOs at this time.

Example:

GlassHouse Technologies is the latest in a long string of companies withdrawing IPOs. The IT consulting firm had been in registration for 15 months before finally pulling the plug, citing "market conditions." The company has raised \$64 million through six funding rounds (presumably a seventh is on the horizon). \$30 million of that is already gone: the company did four acquisitions last year.

Source:<http://lawshucks.com/2009/03/11/ipo-withdrawals-coming-fast-and-furious/> Accessed 26th

April 2009

Example:

2008 was the year of withdrawals from the initial public stock offering, with eight New England tech companies pulling their plans to go public, up from as little as one in 2007.

Source:<http://masshightech.com/stories/2009/01/05/weekly18-IPO-withdrawals-increased-in-2008.html> Accessed 26th April 2009

Many of these companies had already incurred significant costs in IPO preparation.

Example:

But going public can require many painful changes for a company — in addition to the considerable regulatory and reporting burdens, say executives. BioTrove already had strong governance and adequate financial accounting processes in place before it ever filed the S-1, said Luderer. However, he noted companies that have prepared for an IPO incur several millions of dollars' worth of legal, accounting and other costs.

Source:<http://masshightech.com/stories/2009/01/05/weekly18-IPO-withdrawals-increased-in-2008.html> Accessed 26th April 2009

Angel and VC investors need to be very wary of planning an IPO exit. Even with the best high growth venture, many things can go wrong both internally and externally. Basically the investor needs to be able to wait until the market is receptive, however, this can significantly delay the exit as markets can sometimes take several years to bounce back to a situation where IPOs are attractive. Even then, if the market is then flooded with a backlog of IPO candidates, the chances of listing are marginal at best.

But what about post IPO?

(When is an IPO not a successful exit?)

Most VC investors believe the IPO is the holy grail of exits, however, this is a hangover from the days of the computer and internet booms. With the hindsight

of a lot of failed boom ventures, the public investor is much more wary of being ripped off by misleading forecasts and management who trade on insider knowledge. Quality Investment Banks and professional advisors are reluctant to put their name to a firm with a poor chance of a successful post IPO performance. Without the right advisors behind the firm, it is doubtful that the IPO itself will get the underwriter support to successfully list.

Also, just because you have managed to get the venture to a public listing is no longer sufficient to guarantee you can exit, or at least when you want to, at an attractive price.

My own experience with the sale of Pioneer Computer Group certainly demonstrates the IPO trap.

WHEN WE SOLD out to Ross Systems, they had only just listed on NASDAQ. We received all our shares at the market price at the time of US\$13.50. ROSS had carefully planned their revenue over the next two quarters following the listing in order to show increased revenue and profit. This pushed the share price to \$18.50. During this period, I was an officer of the company and subject to the purchase agreement escrow and then, later, the blackout dates which applied to any officer of the company.

Even though ROSS had generated significant new sales of the PCG products, they had not planned for the complexity of installing the Pioneer software and thus they were unable to successfully complete the installation of the large number of systems. By the third quarter after the acquisition the early sites were complaining about missed deadlines and budget blowouts on implementation consulting. The effect of this was that we lost nearly all of our reference sites in the USA. By 18 months after the IPO, ROSS was unable to sell anything like the earlier volumes and the revenue and profits declined and so did the share price.

I decided to start selling my shares when the price hit \$17. However, I was immediately asked to withdraw the sell instruction on the basis that I could trigger class action litigation against the Board and the senior managers. Basically, if the share price continued

to fall, it would be held that I knew of impending doom and the market should have been informed of the information that I clearly had. I was forced to hold off selling my shares and eventually was only able to sell out after I resigned some 18 months later. I then sold all my shares but at a price of \$3.50.

What you have to be sensitive to in a public company is that the market has to be told everything relevant to the decision to invest or sell the shares. Thus you may not have the ability to sell whenever you feel like it. A large block of shares being sold by a founder or a key investor can have a very negative effect on the shares. This can trigger an investigation or a class action if the shares decline further.

There is also normally a block on founders and key investors selling shares for some period after the IPO, called the escrow period. If this is one to two years, this extends the lockup period of the investment. A lot can happen in that period and not all of it will be positive. You might find your shares have seriously declined in value.

An effective IPO exit needs to not only achieve a successful public listing but it must ensure that revenue and profit performance over the next few years meets retail and institutional investor expectations. Failure to manage the post IPO performance can result in delays in exiting or a drop in the exit value.

Professional advisors who I consulted on post IPO management identified the following as the most critical aspects of post IPO performance.

- The business must meet or exceed its financial and non-financial prospectus forecasts. Generally over 70% of recently listed IPO firms fail to meet this goal.
- Investor relations need to be managed carefully.
- Current investors and prospective investors need to be encouraged to invest in the company in order to create a liquid market. Many newly listed firms believe that the brokers will continue to support the business after the listing which is often not the case. The firm needs to be proactive about communicating with the market.
- Investor and market expectations have to be managed. This means an

effective public relations activity as well as frequent communications with current and interested prospective investors.

The problem which many newly listed smaller firms face is the lack of an active market. Where there are few transactions, prices tend to fall. Even if the earnings multiple is relatively high at the time of listing, the share price can be expected to fall back to sector norms within a few quarters as the market absorbs the actual financial results. Unless the firm can post significant growth in earnings quarter after quarter, the market expectations will be reset and a more normal PE ratio will apply.

Founders and pre-IPO investors who expect to exit on a high PE who are locked in for some time in an escrow arrangement are likely to be disappointed if the price falls significantly due to the lack of an after market support program or if results do not meet expectations. It is only an exceptional business which can sustain a high PE.

An IPO exit is almost always going to perform better for the early investors than a financial trade sale, however, as I will demonstrate in later chapters, a strategic sale will almost always outperform both in terms of investor ROI. More importantly, there is usually no delay in receiving the exit funds nor is there a requirement to manage the business beyond the exit event to ensure your return.

ACADEMIC RESEARCH PUBLICATIONS

IPO Exit Strategies

Lessons from the Biotechnology Sector

(NOTE: This article has been reworked from extracts of a paper presented at ANZAM 2003 Fremantle, Western Australia.)

Introduction

Entrepreneurial ventures in the high technology sectors typically involve the commercialisation of intellectual property, the potential of global markets and short windows of opportunity. Founders normally require financing beyond their personal resources and seek private equity capital from angels and/or venture capital firms. Most often the founders and the venture capitalist see the public market as the ultimate goal. They see the IPO as the means to exit the private equity holders, provide them with growth capital and provide the founders with a vehicle where they can liquidate part or all of their investment.

Few start up firms however will ever be listed on a public exchange. Even venture capital backed firms have a low probability of being listed. Golis shows that only 12% of all Australian VC backed firms were listed to the end of June 2002 (Golis, 2002: 235). However in boom or 'hot' markets the level of activity increases dramatically. Golis shows that, for VC backed firms, 7 of 17 exits in 1998/9 and 11 of 13 exits in 1999/2000 were floats.

Much of the IPO activity in 1999 to 2002 was in the biotechnology sector. This

sector experienced a boom market (Intersuisse, 2003: 1). This resulted in many small, often inexperienced, biotechnology companies listing ((Deloitte, 2002: 39). However by early 2003 the market had declined by 40% and many of those firms were faced with a funding crisis. With the closure of the market to new initial public offerings (IPO) and no activity for successive rounds of funding, less resilient biotechnology firms were facing a lack of funds to complete necessary product development to enable them to reach profitability (Yakatan, 2003).

The market volatility in biotechnology has seen earlier parallels in other high tech markets with, often, many company failures. The questions that this raises are;

- do the ASX rules need to be tightened so that firms need to be more robust before they can list
- how do we measure robustness or resilience in a pre-IPO venture

Background

Like other sectors before it, enterprise resource planning (ERP), supply chain optimisation, and the internet, the biotechnology capital markets went through a boom between early 1999 and 2002. The market rose 760 percent during the 3 years up to its peak in February 2002 and then fell 30% 10 months later (Intersuisse, 2003: 3). The amount of follow on capital raised in the USA during in Q3 2002 was down 36% and capital raised by medical device firms fell from A\$5.5 billion in Q1 FY2002 to only A\$643 million one year later (PWC, 2003, p2). Australian biotechnology sector had a similar decline falling 36% during the period 2001-2 (Intersuisse, 2003: 6)

Biotechnology IPO activity has dried up along with every other sector. No IPO activity occurred in the USA or Australia during Q1 2003 (PWC, 2003: 2). Not only had the biotechnology burst, the entire public market was frozen.

Biotechnology companies generally need significant public financing to see them through the development phases of their commercialisation processes. Many of the 60 Australian Stock Exchange (ASX) listed companies had used IPO funding to assist them to progress their early stage discoveries. The money was used for a variety of purposes from drug development, pre-clinical trials to early phase clinical trials. However most had undertaken the IPO with the view that subsequent public fund raising would see them through to revenue generating products. With the collapse of the biotechnology boom and the freezing of the public markets generally, the prior levels of public funding and the high valuations are unlikely to return.

The lucky firms that went to the market early in the boom and had the opportunity of a subsequent round, either domestically or overseas, may well have built up a sufficient cash reserve to take them to profitability or at least to the development stage where licensing or sale is a real possibility. Later entrants may not be so fortunate. An early IPO may not have raised significant funds, perhaps AUD\$5 – 30 million. With high burn rates this may not see them to revenue generation. Their alternatives at this point are bleak. They may be forced into a fire sale, they may have to sell off assets or they may be forced to sell R&D achievements at a heavily discounted price to survive (PWC, 2003: 20).

The firms that came to market just before the biotechnology crash may not have had sufficient liquidity or after market support to maintain a price higher than their listing price. Where this declined in the first 12 months following the IPO, investors locked up in escrow may not have seen a positive return on their investment, or may not be able to exit without a substantial loss, thus locking them in for some unknown period. At the same time the retail investor may well have suffered with the collapse of the weaker firms. Five firms recently had market capitalisation below net assets (Intersuisse, 2003: 1).

At the same time, lack of cash reserves may be damaging to commercialisation progress. R&D may well have to be scaled back, trials delayed, and development opportunities lost. As at September 2002, smaller firms had an average of only

18 months funding (Intersuisse, 2003: 1). Many of the larger IPOs that were expected in the early part of 2003 have been cancelled or delayed due to market conditions (PWC, 2003: 17).

The public market has become very risk adverse with the decline in the market. The decline was associated with fewer FDA approvals, unfavourable clinical trials, and negative news (PWC, 2003, pp3-8). Future public market fund raising efforts by biotechnology firms may experience much higher hurdles in terms of development progress, existing revenue achievement and established alliances. In the medical devices sector, alpha testing may well be a condition of even venture capital investment. Since venture capital has been the primary source of funding for early stage companies, (AusBiotech, Vol 13 No 1: 28), this may well hinder the start up rate of biotechnology firms in the near future.

The PWC BioForum concluded that “Suffice to say companies and investors remain cautious about IPO as a viable exit strategy” (2003: 22). The report concludes that “Australia needs the formation of larger companies with R&D pipelines, preferably with at least half their products in or near clinical trial and better trained personnel. These companies will be more attractive candidates both in Australia and on a global level” (2003: 28).

Implications for Exit Strategies and the IPO Process

The biotechnology market boom allowed many companies to go to an IPO where in normal times may not have gained the support of the advisor, underwriter or the institutional investors. While some were lucky, the long term costs to the community may well offset these early gains. Longer term implications include:

- Inability for good firms to find angel and VC funding
- Lack of interest from institutional investors

- Brokerage and underwriters being unwilling to support a transaction
- Public investors being unwilling to invest
- Lack of liquidity in the public market depressing the share price (Gompers and Lerner, 2001: 220).
- Inability of existing firms to raise additional funds

Of the 60 ASX listed biotechnology firms, over half were listed between 1999 and 2000 (Intersuisse, 2003: 2). ‘Boom’ markets can create market conditions which are not healthy for the founders nor the VC firms. The self-liquidating structure of the VC funds, for example, can also prompt venture capital organizations to rush young firms to an IPO in order to demonstrate a successful track record – even if the investees aren’t ready to go public (Gompers and Lerner, 2001: 99).

VC firms typically exit some period after the IPO, often after a period of 12 months. Of the 59 firms tracked by the Intersuisse Biotechnology Index 23 had falls during 2002 of over 50%, 18 dropped more than 30%. In the same period the ASX All ordinaries index fell by 11% (2003: 3). Five ASX listed firms recently had market capitalization below net assets (2003: 1). Some VC firms with more recent IPO’s may well have failed to recover their investments in this period. Founders are however typically tied in for longer periods. While they may be able to liquidate some equity, markets are uneasy when founders liquidate substantial holdings. In a declining market, there is also the possibility of ‘insider trading’ claims which may cause founders to hold onto stock.

Where private equity investors have been ‘locked in’ through escrow arrangements, they may be unprepared to go back into a sector which they regard as volatile. Where they cannot see a real possibility of a successful exit due to a volatile market, they may be unprepared to invest (Martin,1997: 71), (Gladstone and Gladstone, 2002: 93). Successful exits are not only important for remuneration of the VC partners, they impact the VC firm’s ability to raise additional funds (Lerner, Josh 2000: 369).

The timing of an IPO is often dependent on conditions outside the company's control, such as general market receptivity to IPOs at the time; whether the relevant industry is 'hot'; whether major institutional investors have exceeded their proportion of their portfolios reserved for investment in the relevant industry; and whether there has been an announcement of disappointing financial or regulatory results by a competitor in the industry that causes the market to be wary of the industry as a whole.(Bagley and Dauchy, 1999: 408).

Finally, it may well be that taking a firm public is the preferred choice for many when the IPO markets are booming however, these markets are unpredictable even for the best IPO candidates (Petty, 1996: 437-8).

Boom markets can create situations where firms are able to undertake an IPO. However due to the unpredictability of boom markets, this may not achieve the successful exit required by the VC firms and the founders. Public listings in 'cold' markets tend to be of higher quality and are much more likely to do better over the long term (Seligman, 2003: P50).

IPO Ready

The IPO is seen by many VC firms as the ideal exit route for their investment, Generally speaking they can achieve a higher ROI in an IPO than in a trade sale (Wang and Sim, 2001: 347). Golis quotes an IRR of 29 percent for an IPO versus 9.5 percent IRR for a trade sale (2002: 342). Thus much of their effort during their investment period is consumed with creating the right attributes within the investee firm that would allow them to take it to an IPO. A boom market seems ideal for the VC firm as the likelihood of taking a firm to an IPO is greatly improved. However, do firms that take advantage of a boom market actually deliver the long term benefits to the VC firm, to the founders and to their shareholders?

The Author worked with several VC firms and merchant banks to develop a list of ‘desirable attributes’ of firms seeking an IPO event. These firms established a list of desirable outcomes of the IPO. These were:

- The level of funds sought to be raised by the IPO was readily achieved without having to offer a substantial discount to the institutional investors
- The after market price was maintained or increased over several years following the IPO (relative to the general movement in the market)
- The firm was able to raise additional funds on the public market at a price above the price of each prior round
- The firm achieved sustainable profitable growth within several years of the IPO
- The reputation of the bank with institutional investors was not damaged by the performance of the firm over several years following the IPO

These objectives seem to be achieved, at a minimum, if the capitalization of the firm over several years subsequent to the IPO is at least equal to the capitalization of the firm at the time of the IPO. For example, Intersuisse reported that, even with the decline in the biotechnology market, seven firms had price increases in 2002, six others were unchanged or fell less than 10% (2003: 3).

Boom Market Conditions

The Biotechnology sector outperformed the overall market over the period July 1999 to January 2003 (Intersuisse 200: 3). For a good portion of that period, it was double the ASX All Ordinaries Index.

To identify the underlying factors of the 'hot' market, the Author interviewed several of the Directors of Intersuisse and a Vice President of Duetsche Bank in Melbourne (Buckley, 2003), (O'Brien, 2003). The Author had also been an active CEO in the 80's during the Enterprise Resource Planning (ERP) software boom, an active CEO in the supply chain optimization (SCM) software boom in the mid 90's and a founder of an internet company during the internet boom in the late 90's. The consensus of these meetings is as follows;

A hot public market is normally created when the following circumstances coincide:

- Economic conditions globally are positive
- There is a breakthrough technology which can spawn major benefits
- The benefits are readily understood by the institutional and public investors
- The new technology is able to support many different applications
- The breakthrough technology is readily available to emerging firms
- The early emerging firms demonstrate very high potential revenues
- Emerging products have a global market of substantial size
- The emerging products solve complex problems which hitherto were not able to be readily solved

The hot public market collapses when the following occurs:

- Global economic conditions significantly slow down

- The most prominent firms in the emerging sector fail to meet significant targets or milestones
- A prominent firm is found to have breached compliance regulations in a significant manner

These attributes of the hot market need to be verified but are supported by the Author's experience over several boom markets. The ERP boom was created by the dramatic increase in computing power, the larger computer memories and the emerging network architecture. The SCM boom was made possible by significant increase in PC memory and the client server architecture. The Internet boom was created by advances in internet technology and major increases in internet bandwidth. The Biotechnology boom was created by the human genome project.

However hot markets are hard to predict. The interviewees from Intersuisse and Duetsche Bank maintained that hot markets can close at any time. While many VC firms were taking advantage of the hot market being open, they argued that many companies would have lost considerable money in IPO preparation when the market collapsed as they would not have been able to go to an IPO in a normal market. Given that most IPOs take from 3 – 12 months to prepare, few market professionals are prepared to guarantee that a hot market will be open at the end of the preparation period.

Johnathan Buckley of Intersuisse maintains that the only firms that demonstrate 'enduring qualities' should be prepared for an IPO (Buckley, 2003). His argument was that hot market conditions were unpredictable and that the only firms that could sustain themselves over longer periods could provide an adequate return to investors.

The only reference a list of pre-IPO attributes is provided by Chris Golis, formerly Executive Chairman of the Sydney based Nanyang Management, a VC firm. Golis lists the following attributes;

- Valuation of at least \$20 million
- Support of the institutional investors such as insurance companies and pension funds where a \$1 million investment would result in less than 5% ownership
- Profit after tax of \$1.5 - \$2 million for the year preceding the float
- Prospective forecast of profit after tax of \$2-\$3 million (2002: 47)

These attributes set hurdle rates higher than the current ASX listing requirements (ASX, 2003).

Conclusions

Clearly hot markets create conditions which have unpredictable outcomes for investors. Many VC firms lost money when the internet bubble burst. It is anticipated that the same result will occur with the shake out for the biotechnology sector. This leads to speculation as to whether this outcome would have occurred if the stock exchange had imposed higher requirements on firms wishing to undertake an IPO. There is a growing body of opinion in Australia that the ASX should develop a code of reporting standards and guidelines similar to that used in the mining industry (Green, 2003: P23). While this may have informed investors better, it would not have avoided the situation where less viable firms should have been discouraged from taking the IPO route to funding.

The current listing requirements allow quite small companies to list (ASX, 2003). With tougher listing requirements, fewer emerging companies would have been able to use an IPO event as a possible exit path for the private equity holders. Fund raising would then only have been achieved through further rounds

of VC finance or through equity injections from industry partners (Green, 2003: 23). At the same time, more firms would have considered consolidation in order to meet IPO requirements (Blake and Pachacz, 2003: 44). This perhaps would have resulted in more enduring firms with fewer disappointments to public and institutional investors. Yakatan strongly recommended higher hurdles for listing and said more emphasis should be put on consolidation within the sector to achieve more sustainable businesses (2003).

With tighter listing requirements, more early stage firms would have taken a trade sale exit route, possibly resulting in better returns to the VC firms, thus avoiding the current poor after market situation.

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Candidate Selection for an IPO

(Presented to the Babson Research Conference, June 2005-03-29)

INTRODUCTION

The success of a venture capital fund is often determined by the success to which they can liquidate their investments at a profit. In fact this is a critical aspect of the of the venture capital process. The VC firm will seek to maximize their return through the exit event whether this is an initial public offering (IPO), trade sale, sale to another private equity fund, management buyout or some form of liquidation. Their preference has been the IPO as this has historically yielded superior returns to that of other exit paths (Bygrave and Timmons, 1992) (Jain, 1995)(Wang and Sim, 2001, p. 347)(Gompers, 2001). Results for VC exits in Australia support this view. For the venture capital sector in Australia, Golis quotes an IRR of 29 percent for an IPO versus 9.5 percent IRR for a trade sale (2002, p. 42). Thus preparing an investee for an IPO would seem to be of major interest to the venture capital sector and yet little attention is given in the published textbooks and journal articles on how this might best be achieved.

The field of entrepreneurship provides little guidance to the new venture entrepreneur seeking to exit via an IPO. Most standard texts discuss the importance of creating an exit plan and normally list the alternative exit paths. The IPO is seen by many as the premium path to harvesting and yet seems to assume that the entrepreneur will either know how to structure the business for an IPO or that the entrepreneur can find this information from advisors or underwriters at the time they need it. Well established textbooks such as Timmons and Spinelli, (2004, p. 611), Kaplan (2003, pp. 427-435) and Dolinger (2003, p.230, 250-252) discuss the IPO as an exit path but give no attention to how a business should

be structured for an IPO or what strategies might be employed to improve the probability of success.

There are numerous textbooks on the IPO or public listing process and on the stock exchange requirements for a listing. For example, both Kaplan (2003) and Dolliger (2003) lay out the IPO process. Aaronson (2003) outlines the listing requirements of the UK Stock Exchange and documents the role of the various parties that will be involved. Golis sets out the requirements for listing on the Australian Stock Exchange (ASX) (Golis, 2002, pp. 221-227). Apart from Golis, none of these authors discuss how a business might better position itself for a listing or how they might improve their ability to gain the support of the better underwriters or after market analysts.

In fact, very little is offered by way of pre-IPO strategies. Gladstone and Golis suggest some minimum attributes that should be achieved for IPO candidature. Gladstone and Gladstone in their Venture Capital Handbook state that, in the USA, firms are considered suitable for an IPO if they can demonstrate a growth rate of 30 to 60 percent and at least \$10 million in net after tax income, however there is no discussion of other attributes (2002, p.312).

Golis states that firms should not consider a listing unless they can demonstrate the following attributes:

- Valuation of at least \$20 million
- Support of the institutional investors such as insurance companies and pension funds where a \$1 million investment would result in less than 5% ownership
- Profit after tax of \$1.5 - \$2 million for the year preceding the float
- Prospective forecast of profit after tax of \$2-\$3 million (2002, p. 47)

It is clear that the new venture entrepreneur that desires to list on the public stock market will gain little insight into how they should develop their business to make it more attractive for an IPO from the current entrepreneurship literature. Admission criteria to the established stock exchanges provide minimum conditions rather than desirable conditions, although minimum conditions certainly indicate where likely risk of failure can be best mitigated.

Unlike Australia, included in the criteria for admission to the UK Full List and AIM is a requirement that there is a “minimum track record of management within the business”. The firm has to satisfy the “Sponsor or Advisor” that it is suitable for admission. This might include the following;

- Is the company operating in a growing market
- Is the company likely to grow
- Is there a high quality management team
- Do the directors have the experience to run a public company
- Are there adequate governance safeguards
- Are there suitable non-executive directors
- Does the business have any significant unresolved liabilities

The Advisor or Sponsor must decide if the company is suitable for admission. (Aaronson, 2003)

Some additional insights into desirable pre-IPO attributes can be gleaned from the research on IPO underpricing and post IPO performance.

IPOs and After Market Performance

There has been some research over the last 20 years on pre-IPO firm characteristics as they relate to IPO pricing and to longer term performance and taken together these do provide a list of some attributes that the candidate IPO firm should be considering in building a strategy for an IPO. Certainly the investment bank should be sensitive to this body of knowledge in selecting firms for IPO underwriting. For example, firms that had positive pre-IPO earnings performed better than those with negative pre-IPO earnings (Yi, 2001) although on average, firms undertaking an IPO will experience a decline in their operating performance in the five years beyond their IPO (Jain and Kini, 1994).

Bagley and Duachy discuss whether the firm “is an IPO candidate” and whether it should wait until it can command a higher valuation. They discuss factors outside the firm’s control and influence such as market reactivity to IPOs, whether the market is “hot,” readiness of institutional investors to invest in the sector and industry performance. They indicate that the firm should consider the company’s existing products and product pipeline, the strength and depth of the company’s research, development and management teams, the competitive landscape and the company’s anticipated capital requirements, as factors the firm should evaluate when considering an IPO. However they give no indication of how these items might affect the IPO or how they might be shaped to improve and IPO position. (1999, pp. 407-8).

Up to 1997, the literature contained no references to “time to failure” of IPOs as that event related to firm characteristics at the time of their IPO (Hensler, 1997). Hensler states that a better understanding of the survival rates would provide issuing firms with a sounder base on which to decide whether to support a firm for an IPO. Hensler found in his study of IPO failures that survival time for IPO increased with firm size, firm age at time of IPO, initial return, IPO activity level and the percentage of insider ownership and it decreased with risk characteristics and the public market activity level (1997). Jain and Kinni (1999a) also found that firm size and insider ownership was related to IPO survival. They also found that R&D expenditure, pre-IPO operating performance and the underwriter reputations were positively related to survival rates. Jain and Kinni (2000) found that VC backed firms performed better in the aftermarket, possibly due to the advice from the VC firm as well as better institutional and analysts’ coverage and the more successful IPO road-show. Welbourne found that small and faster growing firms benefit from a senior HRM executive as part of their management team (1999).

Certo et al. found that larger boards and more prestigious boards were associated with less underpricing at the time of the IPO but that greater proportions of outside Directors was associated with greater underpricing. This study did not however extend these variables to longer term performance of the firm post IPO (2001).

Few private equity investments are liquidated at the time of the IPO, instead PE investors typically dissolve their investment by distributing their shares to

their fund investors one to two years after the IPO (Lerner, 2000, p. 370). Since founders and venture capital investors are often not able to harvest or exit during the IPO, a secondary offering would allow them to harvest some or all of their value. Thus an increased price at the secondary offering not only rewards the IPO investors but provides an opportunity to harvest by the founders and venture capital investors. In fact the pre-IPO investors may be better off by delaying their harvesting until a secondary offering (Prasad, 1995). Post IPO performance should be of importance to founders and PE investors.

Industry sector may have a bearing on post IPO ability to raise additional capital through successive public capital raisings. Jain and Kini note that firms in sectors which are attracting few new issues have a higher probability of failure and that the probability of survival is likely to be positively related to industry growth and attractiveness. (1999a). They also found that stronger barriers to entry and more diversification improved survival rates

THE STUDY DESIGN

The prior research on post IPO performance has been undertaken mostly by reference to data sourced from the public domain. Thus only those items or attributes which are able to be identified in public documents, such as a prospectus, have been correlated with operating performance subsequent to the IPO.

To answer the question: “Which candidates should be selected for an IPO?” the author was interested in looking at a wider range of pre-IPO attributes. However since these are not available in published documents and tracking down and interviewing executives involved at the time of past IPOs would be overly expensive, the author undertook to identify the most important attributes through a survey of IPO experts, that is, executives in investment banks, venture capital firms, stock brokers, professional advisors and corporate executives with IPO experience.

The investigation of pre-IPO attributes started with the development of an initial list through intensive independent unstructured interviews with two investment banks. The attribute lists were developed separately by each bank in conjunction with the author. The technique for generating the information was to ask the investment bank to consider a situation where the public market was neither hot nor cold, that they had limited capacity to undertake candidates and

they therefore needed to develop a screening process to decide which of many potential candidates they would choose to work with. These interviews were conducted over March and April of 2003 (Buckley, 2003) (O'Brien, 2003).

In order to develop the list of “attributes” both investment banks established a similar set of desirable outcomes that they wished to achieve from the IPO activity. These were:

- The level of funds sought to be raised by the IPO was readily achieved without having to offer a substantial discount to the institutional investors
- The after market price was maintained or increased over several years following the IPO (relative to the general movement in the market)
- The firm was able to raise additional funds on the public market at a price above the price of each prior round
- The firm achieved sustainable profitable growth within several years of the IPO
- The reputation of the bank with institutional investors was not damaged by the performance of the firm over several years following the IPO

These desirable outcomes are well supported by prior research.

a) Discount to institutional investors (underpricing)

The topic of issue discount has been examined by numerous authors and seems to relate strongly to the level of uncertainty faced by the IPO investor. The more that the IPO candidate can demonstrate credibility, the less the need for a discount to ensure a take up of the shares at initial issue time. This has been demonstrated through a study by Marchand et al. where they showed that, where uncertainty about the firm’s likely profitability was lower, there existed smaller underpricing (1996, p. 60). Lin (1996) was able to show that the reputation of the venture capital pre-IPO investor was able to reduce IPO underpricing and underwriting costs. However underpricing does not appear to convey any signaling information about post IPO performance (Jain, 1996) or subsequent equity raising (Garfinkel, 1993).

Underpricing may also be related to underwriter [investment bank] prestige

since the research shows that those IPOs supported by more prestigious underwriters tend to underprice less. This is also a signal to the market that the firm is likely to be less risky (Chemmanur, 1994). The Johnson (1988) study shows that the more prestigious underwriters support less risky IPOs which are directly related to less underpricing.

b) After market price (post IPO price performance)

This objective seem to be achieved, at a minimum, if the capitalization of the firm over several years subsequent to the IPO is at least equal to the capitalization of the firm at the time of the IPO. Even in a falling market this could be achieved by the better firms. For example, one investment bank reported that, even with the decline in the biotechnology market in 2002, seven firms had price increases in 2002 and six others were unchanged or fell less than 10% (Intersuisse, 2003, p. 3).

Selecting the right IPO candidates is important for long term profitability of the investment bank. Jain and Kini state that investment banks need to continually attract new IPO firms, thus having a successful track record of post-IPO performance will enhance their reputation and help ensure a flow of new business (1999a). Jain and Kini (1999b) found that IPO firms taken public by a prestigious investment banker have a higher survival rate. Prestigious Investment banks typically select low risk firms for IPOs (Cater and Manaster, 1990). The same logic applies to auditing firms. The more prestigious auditing firms will want to be associated with lower risk firms (Titman and Trueman, 1986).

Craig Dunbar studied the consequences of an IPO withdrawal by reviewing all IPOs in the United States between 1980 and 1994. His evidence showed that 20 per cent of public offerings are withdrawn or cancelled. He found that withdrawals were not influenced markedly by large swings in up or down markets and only 8% subsequently undertook an IPO. He also found that cancellation significantly affected the ability of an investment bank to get subsequent deals. His analysis also showed that the market share of all IPOs that an investment bank achieves is influenced by the subsequent performance of the listed firms (2004).

c) Subsequent offerings

Investment banks prefer to choose candidates that have the likelihood of undertaking subsequent public offerings as this leads to subsequent fees. Firms that have a successful experience with the underwriter are less likely to switch,

thus investment banks need to carefully select those firms it works with. As shown above, firms undertaking an IPO wish to work with the most prestigious underwriters, thus lower risk firms will seek out a prestigious underwriter (Carter, 1990). Lower risk firms that undertake an IPO are more likely to undertake a subsequent offering and the more prestigious underwriters tend to handle the subsequent offerings. Thus an underwriter that seeks out lower risk firms is anticipating future earnings through subsequent offerings (Carter, 1992).

d) Sustainable profitable growth (post IPO operating performance)

Poor aftermarket performance emerges as a persistent feature of initial public offerings. (Levis, 1993). Jain and Kini comment that the survival of IPO firms subsequent to going public has been largely ignored. They also state that “approximately a third of IPO issuing firms fail or are acquired within five years of going public” (2000).

e) Reputation

The ability of an underwriter to readily market an IPO stock will depend greatly on the after market performance of their prior listings. Since investors in the stock don't have access to the same level of information as the underwriter, the investor is somewhat dependant on the underwriter undertaking the evaluation for them. The investor thus uses the underwriter's reputation and past performance of the firms that the underwriter has previously represented as a measure of investment quality of a new listing. The underwriter that fails in their selection will end up with a lower reputation. “A lower reputation leads to lower market values for equity sold in the future, and in turn, to lower future fees” (Chemmanur, 1994).

After establishing the desired outcomes, the author then asked the investment bank executives to identify the differences between successful IPO firms and less successful ones. That is; whether the firms that were able to maintain or improve their capitalization value in a declining market demonstrated different attributes at the time of their IPO? To assist the discussion and to sharpen their focus in determining the final list of attributes, the proposition was put to these interviewees in the following form:

“In reviewing possible candidates for a possible IPO, what are the attributes that you look for given that you wish to achieve the objectives identified above?”

The next stage in the development of the attribute list was to have the attribute list reviewed by several venture capital executives and professional advisors. These interviews were confined to clarification of the attribute wording and an evaluation of whether additional items should be added. These interviews were conducted over several months in the middle of 2003.

The final list comprised 45 attributes grouped into four categories; Alignment Activities (3 items), Due Diligence/Governance Activities (19 items), Enduring Market Requirements (19 Items) and Enduring Market Requirements (start up / technology companies) (4 items)

The Mail Survey

The next stage of the project involved a postal survey to executives experienced in IPO activity. A database of names and addresses of executives resident in Australia and New Zealand was provided to the author by the private equity advisory department of a large international accounting firm. The initial survey was sent out in early September 2004 to 504 named executives. The breakdown of the target audience was as follows:

Number of Respondents	Description of Occupation
<u>380</u>	Corporate Finance professionals employed by Private Equity Houses
<u>72</u>	Managing Directors / Directors of companies that have recently listed on the ASX (last 12 months)
<u>46</u>	Other Fund Managers and Corporate Finance professionals

Number of Respondents	Description of Occupation
6	Private Equity Advisors of the accounting firm

A small number were also sent to investment banks but for privacy reasons they were not willing to identify the executives that they were distributed to.

The survey requested respondents to rank each attribute on a 4 point scale using the following headings:

0 Not Important

1 Marginally Important

2 Important

3 Very Important

Additional spaces were provided for respondents to identify additional attributes or to add any comments.

Of the original mailing, 31 were returned unopened where the firm had moved, the executive had left or the address was incorrect. Completed survey forms were returned from 50 executives and a further 2 declined to complete the survey as they either had no experience or their experience was solely in exploration or research ventures which were explicitly excluded. An additional mailing was sent out in late November 2004 to the same destinations, excluding those that had completed the survey and those with incorrect addresses. This second survey yielded a further 43 completed surveys with 10 returned unopened. The response rate overall was thus approximately 18%.

SURVEY RESULTS

Each respondent was asked to indicate the number of years they had been active in the IPO activity and how many IPOs they had actively worked on. While the list had been compiled specifically for the private equity market by the accounting firm, it was expected that executives that had been more active and

with more years of experience would be a more informed source and that their responses would be more consistent as a group than those with less experience. In a small number of cases, respondents did not provide data for one or both of these two questions. Their responses were excluded from subsequent analysis using these questions.

The completed survey forms were characterized by the following occupation and IPO activity attributes.

<u>Occupation</u>	<u>Surveys Returned</u>	<u>Up to 3 yrs IPO experience</u>	<u>Over 3 yrs IPO experience</u>	<u>Active in < 3 IPO</u>	<u>Active in => 3 IPO</u>
Advisor Consultant	6	3	3	2	3
Corporate Executive	17	10	6	13	3
Investment Banker	13	2	11	5	8
Stock Broker	1	0	1	0	1
Venture Capitalist	54	18	31	31	20
Not Provided	2	0	1	1	0
TOTAL	93	33	53	52	35

The respondents were split into two reasonably sized groups within each activity indicator in order to test differences resulting from activity levels. Thus one set of analysis was undertaken with “years of IPO experience” as the underlying variable. This resulted in one group with “up to 3 years IPO experience” and one with “over 3 years”. A similar split was done with “level of IPO activity” with one group “active in up to 3 IPOs” and the balance in a group “active in more than 3 IPOs”. However no statistically significant differences in the weighting of attributes were able to be detected using these groupings.

It was expected that a reasonably high degree of support would be found for all items given the extensive interviews and clarification that was undertaken in developing the list. Due to the limited number of surveys returned it was decided to undertake the analysis by polarizing the responses into two groups: “Not Important and Marginally Important” as one group and “Important and Very Important” as the second group. A good proportion had reasonably high scores on level of “importance”. Twenty six items achieved “Important” scores of 75% or higher across all respondents. These are set out in Appendix One. In the following lists and in the appendices the item is identified by a code followed by a number which represents the percentage of respondents that scored the item in that category of importance.

However, 9 attributes scored 40% or less on importance indicating that a large portion of the respondents did not believe that they contributed much to a successful IPO or to after market performance. This was something of a surprise given the source of the original list. These items are set out in Appendix Two. The remaining 10 attributes were ranked neither important nor unimportant consistently across respondents.

A small number of items were ranked Very Important across a large number of respondents. Items ranked as “Very Important” across all Occupation categories were as follows:

Very Important Attributes

Attribute Code	% Score	Attribute
A3	98	Key shareholders agree to a public listing funding strategy
D14	98	CEO/CFO can articulate the business concept in non-technical terms
D9	98	Management team has significant relevant industry experience
D1	95	Financial reporting provides monthly monitoring of the business
A1	94	Directors agree to a public listing funding strategy
M11	92	The product/market offering has sustainable competitive advantages
D15	90	Management has the capacity to prepare and launch a public listing
M5	88	Business model predicts continued profitability

Four items relate directly to the IPO process itself while the remaining four describe elements of a successful business model.

At the other end of the scale those items which were ranked ‘Not Important’ across all respondents were:

Attribute Code	% Score	Attribute
M12	68	Products have endorsement of name brand global corporations
M10	64	Industry sector has appeal to international investors
M1	61	Revenue is at a minimum of \$20 million
M18	46	The firm has representation in foreign markets where funding is sought

Three of these relate to a possible international dimension to the business. Clearly this is not seen to be of any great importance. The level of revenue however is an interesting result although perhaps attention is better directed at the possible capitalization (item M4).

One result which can be highlighted is that 16 of the top 26 Important items (Appendix 1) relate to the IPO process itself. There is considerable support for having the right parties involved in the process. This includes all the professional advisors such as accountants, lawyers, stock broker, underwriter and public listing advisor (items D5, D6, D2, D3, D4). It would seem that having knowledgeable and reputable advisors with relevant industry experience is a key part of the IPO strategy.

Of similar importance is an understanding the IPO process itself, being able to understand the needs of retail and institutional investors and being able to clearly articulate the business case (items D14, M16, D17, D15, M7, A2, M8). This is also emphasized in the importance of industry and public company experience of the management team and the Board of Directors (items D9, D10, D12, D13). Preparation for the IPO process is the other main set of attributes which are seen as important (items D15, D18, D19, D16).

Of the top 26 items, those attributes that relate to the underlying business model are very few (items D1, M11, M5, M21.). This tends to suggest that, while

many firms may be able to demonstrate earning growth, an understanding of the IPO process itself is critical if the business is to launch an effective IPO strategy.

It was anticipated that there would be some difference in opinion based on occupation. Corporate executives, for example, that have been actively involved in an IPO experience might think differently from advisors, venture capitalists or investment bankers about what was important to the success of their IPO process. Although there was limited data to undertake this analysis, no appreciable differences were able to be detected between different classifications of occupations although perhaps the small size of the survey was insufficient to bring those out.

The additional comments provided by the respondents only provided one clear attribute that was missing from the survey. Multiple respondents included comments about the “quality of the management team”; however the comments provided did not provide an adequate description of what “quality” was defined as.

PRIOR LITERATURE SUPPORT

The criteria suggested by Golis (2002, P. 47) and Gladstone (2002, p. 312) are not well supported. There does not seem to be any strong support in the results of any specific level of revenue, profit or growth. Golis did however link IPO success to institutional support which was confirmed by the survey results.

There was not a lot of support for pre-IPO profit in the survey results although Yi found a relationship between pre-IPO profits and after market performance (Yi, 2001). The importance of the underwriter was put forward by Johnson (1988) and Chemmanur (1994). The survey results certainly supported the importance of the choice of underwriter alongside other professional advisors. The selection of investment bank is also supported by the work of Jain and Kini (1999a)(1999b) and Cater and Manaster (1990). The results also support the selection of the accounting/auditing firm as found by Titman and Trueman, (1986). Choice of underwriter was confirmed through the survey results. This confirms the work of Carter (1990)(1992). No mention was made of the importance of a HRM executive in the management team as being important to the preparation of the firm for the IPO success. While this does not negate the contribution of Welbourne, it also does not support their finding (1999).

CONCLUDING REMARKS

There is little in the prior literature to help a firm decide if it is a good candidate for an IPO, although it is difficult even from these survey results to pin down the size and scope of the business pre-IPO that would be a useful indicator. The best information that comes out of this survey is the potential of the business to achieve \$100 million capitalization within 10 years (item M4), although perhaps that is predicated on having a robust business model with the right management team and a strong competitive advantage.

There is an overriding emphasis in the survey results on understanding the IPO process and having the right preparation internally and externally for the activity. This includes the right people in the management team and on the Board of Directors as well as the right selection of industry knowledgeable and respected advisors.

The aim of this research project was to try to provide some direction to firms in the pre-IPO period as to how they should best structure and prepare themselves for an IPO. To that extent it has certainly uncovered some useful information. However the number of completed surveys is inadequate to draw strong conclusions but it does open up a range of possible future research directions. There needs to be more investigation of the relationship between successful IPOs and the firm characteristics in the period leading up to the IPO event. Unless it is to be accepted that the IPO itself is a matter of chance, firms need to understand how they can better prepare themselves from a management and structural aspect to provide them with a better platform to launch a public funding strategy. It would also be useful to research the difference between firms that continue with an IPO compared to those that withdraw and the reasons for withdrawal. Are firms that withdraw less prepared for an IPO? If so, in what way were they less prepared? What attributes do firms display that successfully launch during weak IPO periods compared to those that withdraw?

There is some concern that the IPO process has been dominated by buyback and turnaround activity from the private equity sector. This provides little comfort for the new venture entrepreneur or the early stage venture capital fund or angel that would like to prepare a firm for an IPO. Further research needs to be undertaken on start-up ventures that made it successfully to an IPO to ascertain what attributes they displayed prior to their IPO activity. Is it possible to find common characteristics among these firms that would better help entrepreneurs

structure their businesses for an IPO?

If a more robust list of desirable attributes can be developed, this will help venture capital firms and investment banks develop better strategies for IPO activities. At the same time those candidates that clearly are not able to achieve the level desired would be encouraged not to waste their time and money on an IPO process.

APPENDICES

Appendix One:

Items that scored 75% or above on “Important” and “Very Important”

Attribute Code	% Score	Attribute Description
A3	98	Key shareholders agree to a public listing funding strategy
D9	98	Management team has significant relevant industry experience
D14	98	CEO/CFO can articulate the business concept in non-technical terms
D1	95	Financial reporting provides monthly monitoring of the business
M16	95	Sufficient free float of shares is available to create liquidity in the market
A1	94	Directors agree to a public listing funding strategy
D10	94	Board of Directors has public company experience
D12	94	Board of Directors has industry knowledgeable members
M11	92	The product/market offering has sustainable competitive advantages
D17	91	Management understand institutional and public investor requirements
D5	90	Industry knowledgeable stock broker appointed
D15	90	Management has the capacity to prepare and launch a public listing
D18	90	Internal due diligence is undertaken as part of a public listing strategy
M7	89	Industry sector has appeal to institutional investors
D6	88	Industry knowledgeable underwriter/book builder appointed

Attribute Code	% Score	Attribute Description
M5	88	Business model predicts continued profitability
D19	87	Internal controls/governance activities are reviewed as part of a public listing strategy
A2	86	Senior managers agree to a public listing funding strategy
D2	86	Industry knowledgeable and respected accountants are appointed
D16	85	The firm can afford the costs of a terminated/delayed listing
M8	84	Industry sector has appeal to retail investors
M21	83	Revenue growth and risk minimisation is anticipated through continued product releases and geographic expansion
D3	81	Industry knowledgeable and respected accountants are appointed
D4	81	Industry knowledgeable public listing advisor appointed
D13	81	Board of Directors has reputable public company experience
M4	75	Expected market capitalisation will exceed \$100 million in 10 years

Appendix Two:

Items that scored 40% or above on “not important” and “marginally important”

Attribute Code	% Score	Attribute Description
M12	68	Products have endorsement on name brand global corporations
M23	66	Technology status is supported by credible international authorities (if applicable)
M10	64	Industry sector has appeal to international investors
M14	59	Post IPO no shareholder holds more than 30% ownership
M9	50	The firm has national appeal
M7	47	Revenue resilience is shown through multiple diversified product offerings
M18	46	The firm has representation in foreign markets where funding is sought

Attribute Code	% Score	Attribute Description
M15	41	Post IPO external shareholders hold more than 40% ownership
D8	40	Senior financial management has IPO listing experience

Appendix Three:

Items that were somewhat evenly balanced. Score shown below is for “Important” and “Very Important”

Attribute Code	% Score	Attribute Description
M20	72	Revenue growth and risk minimization is anticipated through continued product releases or geographic expansion
M22	72	Technology status is supported by creditable international authorities (if applicable)
D7	70	Senior management has public company experience
M13	68	Funds raised will be used for revenue growth
M17	67	The firm has strategic alliances and acquisition strategy to build growth and resilience
M19	66	The firm has been profitable for at least a year
M2	65	Expected revenue within 10 years exceeds \$100 million
M3	62	Market capitalization is at least \$50 million on listing
M1	61	Revenue is at a minimum of \$20 million
D11	60	Board of Directors has a majority of independent Directors

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