

Where Have All the IPOs Gone?

Executive summary (March 17, 2017)

Based on the 2013 *Journal of Financial and Quantitative Analysis* article by Xiaohui Gao, Jay R. Ritter, and Zhongyan Zhu of the same name, with updates from Prof. Jay Ritter of the University of Florida.

The issue: From 1980-2000, an average of 310 operating company initial public offerings (IPOs) occurred in the U.S. each year. During 2001-2016, the average has been only 108 IPOs per year, in spite of real GDP more than doubling from the 1980s until now. The prolonged drought has been especially severe among small firms.

The conventional wisdom: Many blame the drop in IPO activity on a combination of excessive regulation (e.g., the Sarbanes-Oxley Act of 2002) and changes in how stocks are traded that has resulted in the collapse of the “IPO ecosystem.” Specifically, prior to 1994 almost all Nasdaq-listed stocks had bid-ask spreads of 25 cents, compared to only 1-2 cents per share in recent years. This reduction in bid-ask spreads has made market-making unprofitable, and many securities firms that used to make a market and provide analyst coverage for small company IPOs have ceased doing so, in many cases after having been acquired by large banks in the late 1990s. Regulation FD in 2000 and the Global Settlement in 2003 have also resulted in less analyst coverage. The reduction in analyst coverage has, allegedly, led to lower prices for these smaller companies.

The Gao-Ritter-Zhu alternative explanation: An alternative explanation for the decline in IPO activity, which is most pronounced for young tech companies, is that many small companies, especially tech startups, are selling out rather than going public because they are worth more as part of a larger organization such as Cisco Systems, Facebook, or Oracle. The decline in IPO activity primarily reflects a big vs. small company issue, not a public vs private company issue. In many industries, getting big fast is more important than it used to be, and organic growth in many cases takes too long. Facts that are consistent with this view include:

- 1) In 1990-1991, 20% of the exits of successful venture capital-backed companies were M&A transactions (typically trade sales, selling to a bigger firm in the same industry), and 80% were IPOs. By 1998-2000, 60% of exits were trade sales. From 2001-2016, approximately 90% of exits have been trade sales, with only 10% of successful venture capital-backed companies going public.
- 2) For the firms that do go public, there has been a long-term uptrend in the number that either get acquired or make acquisitions within three years of going public. Of those that get acquired, very few are bought by private equity firms as stand-alone businesses. Almost all of the acquisitions are mergers.
- 3) For both recent IPOs and for companies that have been publicly traded for at least three years, small companies have been having a greater difficulty making money. The uptrend in publicly traded small companies that report losses started in the 1980s and has shown no signs of abating.
- 4) Almost all small IPOs continue to receive analyst coverage, and the price-earnings ratios for companies with positive earnings are not unduly low. But fewer small companies have positive earnings.
- 5) The long-term returns on small companies IPOs in the U.S. have been low in the 1980s, the 1990s, and the 2000s. This pattern has also been true in Europe. If small company IPOs had been undervalued, the returns that investors have earned would be high, not low.