

IPOs: No Cure-All For Equipment Suppliers

By Thomas W. Turney

For most entrepreneurs, the pot of gold at the end of the rainbow is an initial public offering (IPO) of their company's stock. And it's easy to understand why the founders of some semiconductor capital equipment companies believe they can realize their dream of riches by selling stock in an IPO. If an Internet company losing money, with no immediate prospects for earnings, can go public at an outrageous price, a profitable semiconductor equipment supplier certainly should be able to command a healthy multiple of earnings in an IPO.

Unfortunately, the market doesn't look at it that way. The sad truth is that few of the hundreds of closely held semiconductor capital equipment companies in the U.S. will be able to go public any time soon.

To understand why, consider some basic facts of life in the financial world. The price of a company's stock depends largely on the industry of which it is part. It also hinges on the company's size and earnings.

The stock of large, public semiconductor equipment companies sells today for an average of 30X to 40X earnings. But firms with market capitalizations below \$150M sell for only about 10X earnings. (Market "cap" is the number of outstanding shares times the stock market price.) Underwriters are extremely reluctant to take a firm public unless the market value of its shares after an IPO will be at least \$100X; some insist the figure be more like \$200M.

This has ominous implications. With a price-earnings ratio of 10, it takes net income of at least \$10M to achieve a \$100M market "cap." That, in turn, means a company must have sizable annual revenues: \$100M if it's earning 10% after taxes, \$200M if after-tax net is a more common 5%.

Of course, the mountain to climb is even steeper if the underwriter wants a market "cap" of \$200M after an offering.

All of this may come as a shock to the owners of some closely held semiconductor equipment companies. But as an investment banker who has worked with many companies in this industry, I assure you it's true.

It is sometimes possible to find an underwriter who will do an IPO even if the company doesn't meet these criteria. But from what I've seen, an IPO done by a sole underwriter leaves a lot to be desired. For its stock to be liquid, a new public company needs a breadth of sponsorship a single underwriter just can't provide. Ideally it should

have several analysts covering it, numerous market makers standing ready to buy or sell its shares, and dozens or hundreds of brokers seeking to generate investor interest in it.

A sole underwriter may promise all of these services, and indeed may provide them for a while after an IPO. But if the analyst covering the company leaves or the underwriter stops supporting the company, the firm has no coverage. If investors have no flow of information on the company, if no one is making a market in its stock, and if no brokers are promoting it, its stock price can collapse.

Facing this bleak outlook, owners should consider alternatives. A common choice is selling either to a financial buyer (typically an institutional investor or a firm representing such investors) or a strategic buyer (a company in the same business or a related field). As a rule, a financial buyer will pay less than a strategic buyer because financial buyers typically aren't able to integrate acquisitions with other business units to create savings.

Purchases by strategic buyers tend to fall into two categories: acquisition of 100% of the seller's stock; or what I call a "19.9" transaction, in which the buyer acquires no more than 19.9% of the stock and thus avoids having to consolidate the acquired company's financial results with its own.

A 19.9 transaction might seem the best of both worlds to an owner who wants to keep control of a company while liquefying some holdings. But the strategic buyer in such a transaction usually insists on the right to participate in all future financings, and often demands the right to acquire all remaining shares at some later point.

A final thought: Even if an IPO is possible, it might not be the best option if an owner's main objective is to achieve total liquidity. A company's founders/owners usually won't be able to sell even a significant amount of their holdings in an IPO. The underwriters usually will insist on a lockup, typically 180 days. Even after the lockup, there usually will be restrictions on the sale of stock.

I believe fewer semiconductor capital equipment companies will be able to rely on public markets for liquidity. Every company's situation will be a little different, so it will behoove each one to consult an experienced investment banker before deciding how to achieve liquidity.

Thomas W. Turney is managing principal of NewCap Partners Inc. (Los Angeles), a private investment banking firm.