

## **Study shows it's getting tougher for small chip gear companies to go public**

By Robert Henkel  
Semiconductor Business News  
(10/21/99, 01:15:45 PM EDT)

LOS ANGELES -- The road ahead doesn't look good for small chip-equipment makers that want to go public.

The darkening outlook comes from a new study made this past summer by NewCap Partners Inc. "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," declares Thomas W. Turney, managing principal of the Los Angeles-based investment banker.

The study of 47 production gear suppliers -- including large-cap firms with market capitalization of more than \$250 million and small suppliers with a cap of less than \$250 million -- showed that the small caps were being valued a lot less relatively by investors than were companies in the large-cap group, he says. This trend has become more pronounced over the past year, he adds.

The picture doesn't look like it will change anytime soon. "We believe that fewer small companies in the semiconductor capital equipment business will be able to rely on the public markets as a source of liquidity," Turney predicts.

As a result, he expects there will be more mergers and acquisitions in the semiconductor capital equipment industry in the coming months. Large-cap public companies will be acquiring small-caps in order "to arbitrage the relative valuation differentials," he says.

Also contributing to this trend will be small-cap companies seeking higher relative valuations by merging in order to become a large-cap company. And private companies, which typically carry relative valuations below even the small-cap public companies, will become increasingly attractive acquisition candidates to both small- and large-cap chip gear makers, Turney notes.

There are several reasons for this shift. Large institutional investors are playing a major role because they want to make larger investments and be able to move in and out of a stock without impacting the price. Government regulations also are causing big investors to pick the large-cap companies, he notes, because they require public companies to report investment positions of more than 5%.

Another factor hurting the small caps is the globalization of the semiconductor equipment industry, which is causing investors to go with the safer large suppliers, Turney points out. What this means, he says, is that "the smaller companies are going to have to consolidate to compete for the larger investments."

And they will need to be global operators to compete. As a small semiconductor equipment maker, “the ability to sell and service systems worldwide is a critical factor,” he says. “Big competitors have facilities all over the world.” This is the same reason why chip makers “buy from the big guys because the perception is it's safer. And that [attitude] snowballs, killing the smaller companies,” Turney says.

The stock of large, publicly held chip capital equipment companies are now selling for an average of 30 to 40 times earnings, Turney says. But smaller companies, those with market capitalizations below \$150 million, sell for only about 10 times earnings, he says.

On top of that, underwriters are extremely reluctant to take a company public unless the market value of its shares after an offering amount to at least \$100 million, Turney says. In fact, he adds, some of them insist that the company should end up being worth more like \$200 million.

“This has ominous implications for most privately owned semiconductor capital equipment companies,” Turney says. It takes net income of at least \$10 million to achieve a market capitalization of \$100 million, assuming a price-earnings ratio of 10, he notes.

That, in turn, would mean a company would have to have annual revenues of \$100 million if it's earning 10% after taxes, or \$200 million if its after-tax net is a more common 5%. It gets even tougher if an underwriter wants to see a market cap of \$200 million after an offering. That means the company would need revenues of \$200 million if it is earning 10% after taxes, and \$400 million if its after-tax net is 5%. That's a big mountain to climb, Turney notes. “As a result, the small companies are overlooked and often shut out of the public markets.”

Turney concedes that it's “sometimes possible” for a chip gear maker to find an underwriter who will do an IPO even if the company doesn't meet this criteria. But such a deal could leave a lot to be desired, he adds.

For its stock to be liquid, a new public company will need a breadth of sponsorship that a single underwriter just can't provide, Turney says. Ideally, he adds, “it should have several analysts covering it, a number of market makers standing ready to buy or sell its shares in the market, and dozens or hundreds of brokers seeking to generate investor interest in its shares.”

An underwriter seeking to take a company public on its own may promise to provide all of these services, he says, but if the analyst covering the company leaves or if the underwriter decides to stop supporting the company, the company ends up with no coverage. “And if investors have no flow of information on the company, if no one is making a market in its stock, and if there aren't any brokers promoting it, a company's stock price can collapse,” Turney maintains.

Confronted with this bleak outlook, owners of small semiconductor capital equipment companies will end up selling their companies to a financial buyer, typically an

institutional investor or a firm representing such investors, or to a strategic buyer which is a company in the same business as the seller or in a field related to it.

As a rule, Turney notes, a financial buyer will pay less for a company than a strategic buyer. “That’s because financial buyers typically don’t have the ability to integrate acquisitions with other business units to create savings.”