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CIO Strategy Bulletin

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The Reopening of the IPO Window

- With a successful new tech offering this week, public markets have unofficially reopened to new issues. We do not expect another IPO boom. Instead, we should see a more measured pace of new issues with a bias towards quality and profitable firms that do choose to go public.
- High-profile listings this year will likely set the tone for the 2024 IPO pipeline. Among US deals raising over $300 million tracked by Bloomberg, new listings are up 21% on average since their debuts this year. This is an encouraging first step for IPO hopefuls. However, our analysis of historical IPO performance shows that performance tends to lag over a 1-2 year horizon. Given this mixed history, we are unlikely to see a true wave of IPOs until the highest profile unicorns choose to take the plunge into the public spotlight.
- As of July 28, there were an estimated 726 “unicorn” companies in the U.S, defined as privately-held startup companies that achieve a $1 billion post-money valuation in a private round of financing. Pitchbook estimates that the current backlog of companies that should have exited via IPO during the IPO drought of the last 18 months is approximately 220. As of this week, only two US unicorns have filed an S-1 to go public.
- The current slate of pending IPOs has the potential to provide a bit of momentum to a tech universe that has been relatively starved of good news beyond the biggest public stocks. Among late-stage IPO hopefuls are firms engaged in fintech and payments infrastructure, cyber security, aerospace, artificial intelligence, internet retail, logistics, marketing and education technology.

The Reopening of the IPO Window

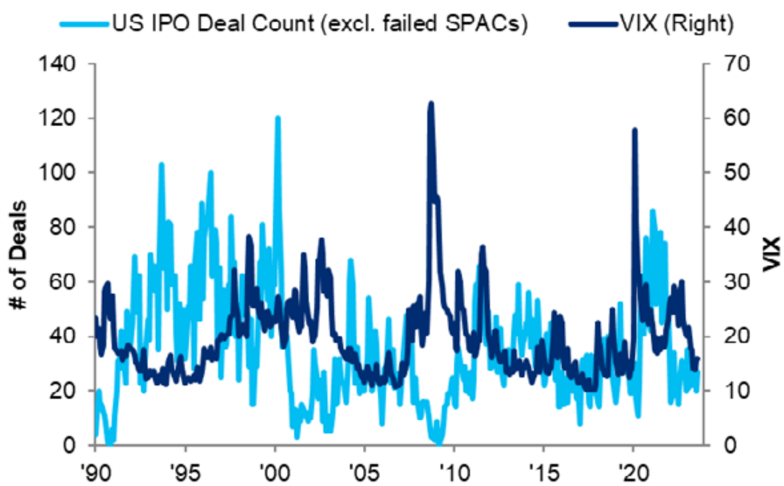
One can imagine venture capitalists and investment bankers holding their collective breath this past week. Excluding biotechs, only 75 US companies with a combined value of $11 billion have gone public in 2023. While this mimics the pace of new issues at this point last year, IPO deal flow is down over 90% relative to 2021[1].

That's why this week's highly anticipated market debut of a large semiconductor design firm may mark a restart of IPO issuance over the coming quarters. A ready pipeline of private firms may now attempt to take advantage of this quieter period in markets to raise capital, providing liquidity for anxious investors.

The calmness that allowed the IPO window to crack open follows a period of heightened market volatility (**Figure 1**). Aggressive Fed tightening, an uncertain inflationary and economic backdrop, the poor performance of unprofitable firms and a war in eastern Europe have been more than enough to keep late-stage private companies from seeking public listings.

Consistent with the quality theme we've pursued in our portfolio guidance, the key to accessing capital markets may be a combination of realistic pricing, profitability and demonstratable growth prospects.

Figure 1: US IPOs vs equity volatility



Source: Bloomberg and Haver Analytics through September 15, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

To the Moon and Back: 2020-22

"Free money" provided the fuel for a boom in IPOs and Special Purpose Acquisition Company (SPAC) listings in 2020-21. The government's fiscal and monetary responses created enormous liquidity that fed investor speculation.

Startups addressing opportunities presented by the pandemic, whether via speculative drugs or internet-based consumer services, were easily absorbed by the public markets. Nascent companies peddling new clean energy technologies, EV solutions, cryptocurrency ventures and space-based communications saw their firms taken public via SPAC or IPO, regardless of the firm's reasonable business prospects.

Issuance of SPACs grew to a frenzied pace in 2020 and 2021. Despite their purpose as vehicles for bringing private companies public, investors bid up these empty shell firms by 90% from July 2020 to February 2021. As we highlighted at the time, these returns were truly irrational. The average SPAC saw its value fall by 43% since the peak of the 2021 bubble, with the vast majority returning cash to shareholders without finding a private target.

In 2020 and 2021, the total value of new US listings reached $483bn, *excluding* SPACs who never found a target to bring public (**Figure 2**). This exceeded the $329bn of IPOs from mid-1998 to mid-2000, adjusted for today's dollars.

[1] Bloomberg as of September 15, 2023

Much like the round-trip in the Nasdaq from 1997 to 2002, the bust that began in 2022 has seen speculative and unprofitable tech shares return to their pre-pandemic levels or less (**Figures 3-4**). While a narrow rally in mega-cap tech stocks has propelled passive large-cap indices higher this year, the Russell 2000 remains 25% off its highs. The S&P 600 index trades at roughly 14x, down from over 20x in mid-2021. Small cap price to book ratios have declined by 33% over that time period.

In our view, public valuations in the small cap space serve as a reasonable proxy for late-stage private firms. This implies more palatable valuations for new investors via IPOs.

Figure 2: IPOs during the tech and post-pandemic booms

	IPO value ($bn, CPI-adj)	IPO Value (% of S&P Mkt Cap)	# of deals
2020/2021	483.17	1.3%	1197
mid 1998-mid 2000	329.60	1.6%	1435

Source: Bloomberg as of September 15, 2023

Figure 3: Nasdaq during the tech bubble and bust

Figure 4: IPOs and profitless tech during the post-pandemic boom and bust

Source: Haver Analytics through September 5, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Don't Expect a Flood of New Issues

While the IPO tap appears to be opening, we expect only a modest rate of IPO issuance in the near-term. The equity market bounce from October's lows has moved investors away from their complete bearishness, though we are far from normal enthusiasm (**Figure 5**).

There are natural barriers to a new wave of IPOs. As financing costs remain high and volatile, IPO pricing will be well below 2021 levels (**Figure 6**). With the Fed yet to declare an end to its war on inflation and rates staying higher for longer, the bar for new equity issuance relies on high expected investor returns. This necessitates a focus on high quality and profitable firms.

Figure 5: Investor sentiment has improved, though is far from euphoric

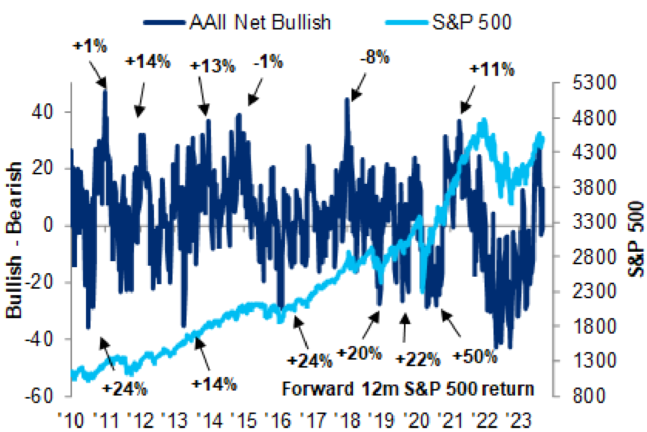
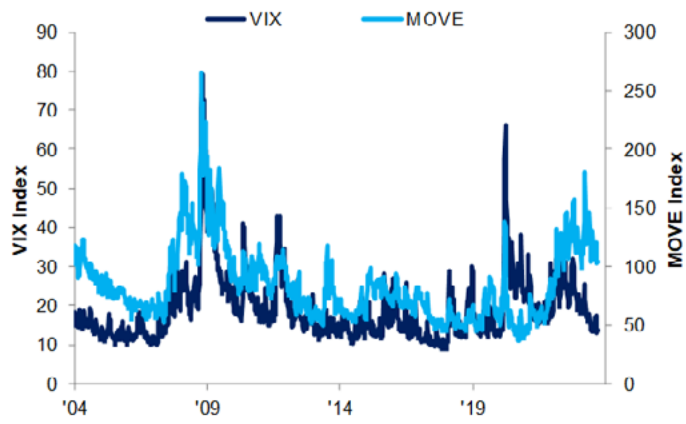


Figure 6: Elevated rate volatility makes it challenging to value risky assets



Source: Haver Analytics through September 5, 2023. Left chart: Percentages show forward 12-month return of S&P 500 from each extreme in investor positioning. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

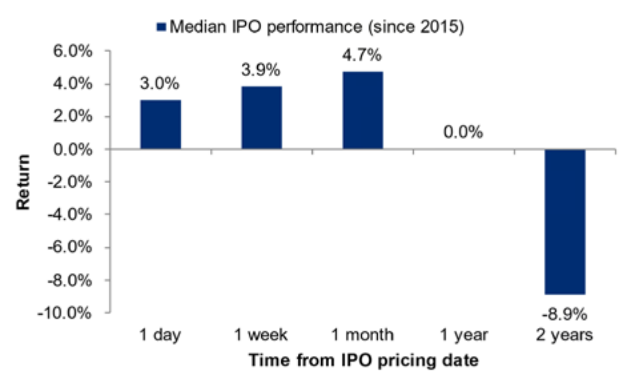
High-profile listings this year will likely set the tone for the 2024 IPO pipeline. Among US deals raising over $300 million, shares of newly listed companies are up 21% on average since their debuts this year (**Figure 7**). This is an encouraging first step for IPO hopefuls.

Even then, the long-term track record for the typical IPO is mixed (**Figure 8**). For syndicate investors able to access new offerings before their first official trade on the exchange, performance in the first few days of trading tends to be positive. But once insider share lockups expire, and as firms adjust from the private mindset of delivering top-line growth to the demands of public shareholders for actual free cash flow, performance tends to dip. The median IPO since 2015 saw roughly flat performance a year after its debut, and a nearly 9% decline over 2 years.

This is the cautionary tale keeping many private company CEOs up at night. While market-cap weighted indexing and financial media leave the impression that most IPOs are successful, the average IPO does not outperform over the medium term. Given this mixed history of post-IPO performance, despite some recent successful IPOs, we are unlikely to see a true wave of IPOs until the highest profile unicorns choose to take the public stage.

Figure 7: Average return since listing among 2023 US IPOs

Figure 8: Median IPO performance tends to lag after several months in the public spotlight



Source: Bloomberg through September 5, 2023. Right chart shows median IPO performance since 2015, excluding SPACs and offering sizes <$100mm, as tracked by Bloomberg.

From a Unicorn's Perspective

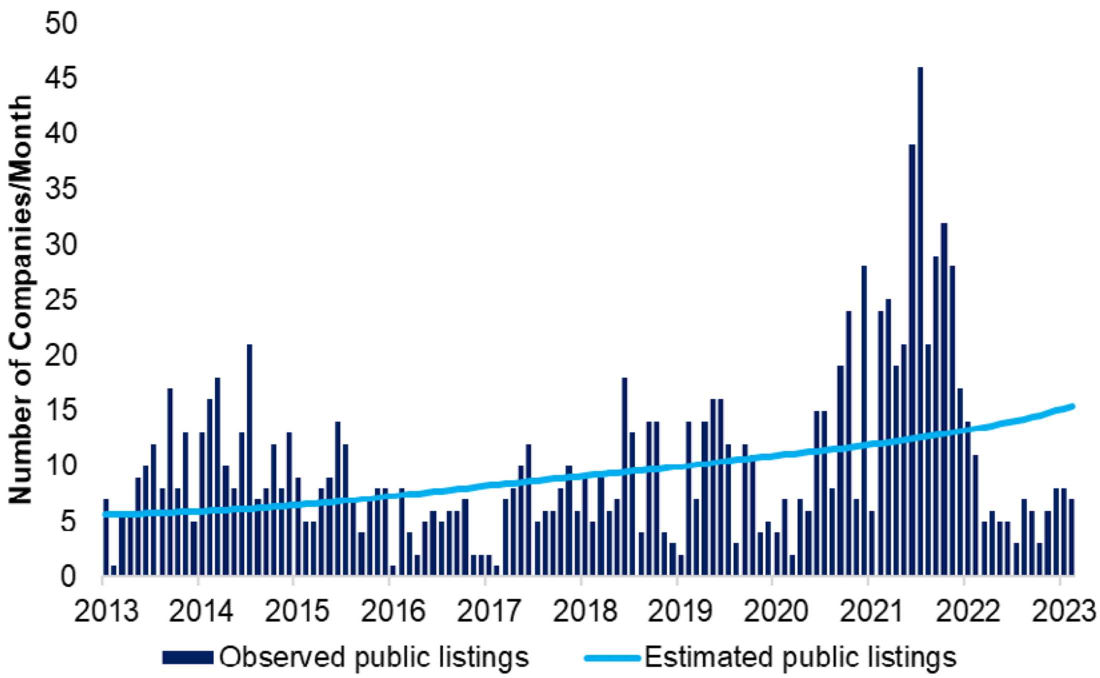
The shutdown of the IPO market over the past 18 months reflects the pressures faced by venture capital and private equity firms. And while Q2 2023 saw some relief from three straight quarters of declines in exit activity for private equity funds in the US, dollar exit volumes were still 57% below Q4 2021 levels.

Buyout funds may be able to lean on corporate acquisitions, General partner-led secondaries and sponsor-to-sponsor transactions to exit portfolio companies, but the fortune of the venture capital sector is much more closely tied to public markets. From 2013 to 2021, approximately 69% of the exit value realized from VC-backed companies was through IPOs and SPACs. In 2021, this peaked at 85%, according to Pitchbook.

When a VC-backed restaurant company successfully completed an IPO in June 2023 and saw its share price soar for several weeks thereafter, there was noticeable relief, especially given this was not a tech company.

As of July 28, there were an estimated 726 “unicorn” companies in the US. These represents all of the privately-held startup companies that achieve a $1 billion post-money valuation in a private round of financing. And of these, Pitchbook estimates that the current backlog of companies that would have exited via IPO under normal conditions is over 200. Among these late-stage IPO hopefuls are firms engaged in fintech and payments infrastructure, cyber security, aerospace, artificial intelligence, internet retail, logistics, marketing and education technology.

Figure 9: Monthly observed public listings versus expected public listings of U.S. VC-backed companies



Source: Pitchbook as of September 15, 2023

Limitations of an IPO Recovery

The reopening of the IPO market may provide some new data to tech investors relatively starved of good news. But it will also serve as a reminder that the valuations of 2021 are not coming back.

As an illustrative example, the valuation for a food delivery app company who recently filed to go public has been reported to be priced at approximately 3.1x trailing sales, or $9 billion. This valuation is below the company's best public competitor, trading at 4.2x trailing sales. The target valuation is also down 77% from the company's most recent round of private financing in 2021 which valued the company at $39 billion, or 22x reported revenues according to the Wall Street Journal[2].

[2] “Instacart is an expensive lesson for Venture Firms” Wall Street Journal, September 16, 2023

Realistic re-valuations of later stage venture backed companies is a necessity for the return of a healthy IPO market. The average unicorn last raised capital 17 months ago, at the height of the free-money mania. Many of these companies are running through their cash reserves and will either need to go public in order to generate liquidity or raise another private round of financing at major discounts to peak values. Therefore, while the pipeline of potential tech IPOs is quite deep, the willingness of those companies to accept current public market valuations is still unknown.

As of this week, only two US unicorns have filed an S-1 to go public. Many late-stage private company CEOs and investors will be watching these debuts in the coming weeks.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
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