IPOs Dirty Secret

Broadview's Paul Deninger tells how venture capital made the bed it's lying in.

Paul Deninger [**Broadview**] | POSTED: 03.30.06 @07:17


Tomie NEWS

In a recent interview with AlwaysOn, Paul Deninger, Chairman of Jefferies Broadview, explained why VCs are making good short-term decisions that are bad for the long haul.

Deninger: VCs have become brand bigots—you can quote me.

AlwaysOn: I can?

Deninger: Yes. The venture capital firms have become brand bigots. They made all their money in the late 80s and early 90s when Wall Street didn't know how to spell technology and where the firms taking them public were the Alex Browns and the Robertson Stephens of the world and the H&Qs of the world and now they're believing what Wall Street—and it was all because these firms could do something that Wall Street couldn't. They could take a $50 million or $25 million or $30 million revenue company and get it public, and they would trade it and they would support it. So they did something that Wall Street couldn't do and wouldn't do and so they gave their business to those firms and that's how they got built.

They won't do it today. Every VC complains about the fact that there is no IPO market yet no VC will give a lead on a deal to anybody other than Goldman, Morgan, CSFB, et cetera. They all believe what they're being told by the big bracket firms, which is you have to $80 to $100 million in revenue to go public and if you don't have one of us running the books, you're not going to have a successful public offering. And they've become Gucci buyers and they've forgotten what got them there.

Alex Brown wasn't selling their IPOs to the largest traders on Wall Street. They were selling it to firms who wanted to buy a $400 million market cap company and ride it to $800 million. That is not where Goldman Sachs is taking typical IPOs today. As a consequence, the IPOs are more volatile and buyers are flipping out of the stocks. They have a bigger—because the bracket firms have a bigger obligation to the institutional investor than they do the company. Only 15 percent of Goldman Sachs's revenue comes from investment banking today. You think of Goldman Sachs as an investment bank. It's really a hedge fund.

AlwaysOn: They're also buying companies.

Deninger: Absolutely, and it's an asset management firm. Eighty five percent of the revenue comes from outside investment banking. Investment banking is not the priority. So you sit around a board room, and you've got a 15 percent investment. How much attention does it get in the boardroom? The 85 percent gets the attention. So the point is that the structure of the investment banking industry and the venture capital firms reaction to it is a bigger problem than Sarbanes-Oxley.

Fifty percent of the NASDAQ stocks had a market cap of $250 million or less and Wall Street tells us you can't go public with a $250 million market cap. It doesn't make sense. Those firms, those companies with $200, $300, $400 million market caps are owned by institutional investors, not by widows and orphans. They are not owned by the institutional investors but Goldman and Morgan are going to take their IPO to and that's the issue.

AlwaysOn: Who are they taking the IPOs to again?

Deninger: They are taking them to the funds who they do the most sales trading revenue with. That is the dirty secret of IPOs today. It's not about matching the right buyer to the right seller.

We're on the tail of two IPOs this year. The reason I want to tell you is because it's a $50 million company. Goldman and Morgan, these guys don't know where to take a $50 million IPO. They can't take it where it needs to go because they—and because they are beholden to these big cap funds. Robertson Stephens knew where to do it and could do it, H&Q knew how to do it and could do it, Alex Brown knew when to do it and could do it. I tell every venture capital firm when they want to know what the problem is with the IPO market, I tell them, 'You're the problem. *You* are the problem.'

AlwaysOn: They're not going to the smaller firms to go public with their companies because they're star fucked, is that what you're saying?

Deninger: Yes.

AlwaysOn: But isn't it in their interest to try to get some of their . . .

Deninger: Absolutely, but they are going to have to hold them. Here is the prisoner's dilemma. Hold it longer than they want to to get to $100 to $200 million revenue, which is a real race. You've only got to get to $100 to $200 million to be a sure Goldman IPO. How many venture firms do you know that can hold a company long enough to get it to $200 million?

AlwaysOn: None.

Deninger: Or they can try to convince Goldman to take it earlier in which case they're screwing themselves because Goldman will take the money. They'll take the $4 million fee and they'll place the stock with their customers which are the wrong guys. Newstar was at $250 million in revenue, growing and profitable. Perfect Morgan Stanley IPO.

AlwaysOn: Is this a commentary on, for the lack of a better expression, entrepreneurial investment bankers?

Deninger: I don't think it is a lack of entrepreneurship, I think it's a lack of . . . Like I said, part of what you don't understand is how much the economics in investment banking have changed. In an IPO of a couple hundred million with $10 million—let's say a $50 million IPO which is $3 million in fees, if Think Equity is the fourth guy to the right or the fifth guy to the right? The fee is like $500,000. They can't make money on $500 grand. I mean $500,000 is a $30 million M&A deal, so this is why Perseus is going after the M&A business. They can make more money working on a $40 million M&A deal than they can being a co-manager of a $50 million IPO for a $300 million market cap company. All the economics have shifted to the book manager and the book manager's job in today's market, the big bracket firms are the only ones to get books.

It is a very complicated story and you probably can only touch on it in this one. At some point it will probably make sense and talk more about it. I'm starting to piece together what we would need to do as a firm in order to pull together a group of firms to take over that part of the market because no one firm can do it alone.

AlwaysOn: That's a cool idea.

Deninger: Yes, it's needed. I mean what I tell the VCs is if you think you're having trouble getting returns in this fund wait til the next one—because if you don't get companies public and nobody does, the buying public is going to continue to shrink and the times are going to get even more tough. So the venture capitalists are making a short-term decision to sell their best companies because they can't get it big enough to be an IPO for Goldman? They're killing themselves. Because if you'd never taken Cascade public, if you had never taken Cisco public, where would you be? Where would the industry be right now if Juniper hadn't gone public but sold instead?

AlwaysOn: We could do an open letter to the venture capital community.

Deninger: That's an interesting idea.

AlwaysOn: Would you want to put your name on it?

Deninger: I might. I want to think about it but I might.

AlwaysOn: I could get that published very dramatically. It would be a lot of fun. With my editor hat on it's like when we launched an open letter to Trip Hawkins and said don't take 3DO public.

Deninger: I think if you could get a hold of—right now, a lot of my analysis is anecdotal. I need to do some analyst work and I'm working on it right now, to back up all my claims. So my suggestion is when I do that, we talk again.