THE WALL STREET JOURNAL. ONLINE

FORMAT FOR PRINTING sponsored by TOSHIBA Don't copy. Lead.

March 13, 2007

PAGE ONE

DOW JONES REPRINTS

This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit: www.djreprints.com.

• See a sample reprint in PDF format.
• Order a reprint of this article now.

Tech Companies Bleeding Red Ink Pursue IPO Gold

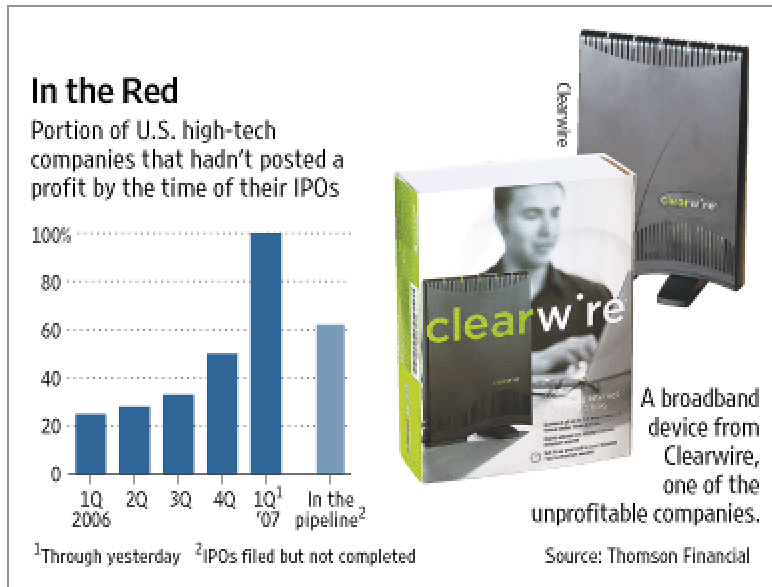
Hungry Investors Accept Growth Instead of Profit; A Bit More 'Speculative'

By PUI-WING TAM
March 13, 2007; Page A1

Technology companies that bleed red ink are once again lining up to go public -- and once again finding plenty of takers.

A number of unprofitable tech companies have launched initial public offerings in U.S. capital markets since the beginning of 2006, and more than half the tech companies now in the IPO pipeline are in the red. The trend recalls the dot-com boom of the late 1990s, when deeply unprofitable tech concerns -- often with no clear business models -- were snapped up by eager investors as soon as they hit the market.

Profits never materialized for many of those tech companies, an outcome that helped fuel the Nasdaq stock-market meltdown in 2000. In the aftermath, thousands of tech workers were laid off, and several Wall Street firms were accused of misleading investors by boosting the dot-coms, leading to a string of market



A broadband device from Clearwire, one of the unprofitable companies.

reforms.

In the years since, profits have been a stronger prerequisite for a tech company to go public. Overall, investors have demanded more maturity from companies -- showing longer track records, larger customer bases and bigger revenues -- in order to launch on the stock market. By the time Google Inc. went public in late 2004, for instance, the Internet search company had been profitable for three years, according to its public filings.

Now, as memories of the dot-com bust have faded, growth is again trumping profitability as a reason to buy into tech, especially as returns in sectors such as property and energy dry up. The pace of unprofitable tech IPOs is still far from the extremes of 1999, when 85% of tech companies that went public had no profits, according to Thomson Financial. And many of the current crop show promise of profits to come, unlike many businesses that cashed in before the dot-com bust.

Still, many investors appear willing to turn a blind eye to profits if a tech company displays soaring revenues. The recent IPOs of networking company Riverbed Technology Inc. and storage company Isilon Systems Inc. -- both unprofitable but boasting double- and triple-digit revenue growth -- were oversubscribed by investors. On its first day of trading in September, Riverbed's stock jumped more than 50%, while Isilon's soared 77% on its debut in December. Both stocks still trade well above their offering prices.

The trend has carried on despite recent broader market turbulence, which has featured jitters about overseas markets and U.S. subprime-mortgage providers. Clearwire Corp., a fast-growing wireless Internet service provider founded by cellphone pioneer Craig McCaw, went public on Thursday after investor demand pushed the IPO price to the top end of its range, though its shares have since fallen in trading. On Friday, security-software maker Sourcefire Inc., which is unprofitable but is doubling its revenues year over year, rose in its debut a day after pricing above its expected range.

"There's now a tremendous willingness to pay for growth," says Vadim Zlotnikov, chief investment officer at Sanford C. Bernstein. "We've had four years of unbelievable capital discipline. Now we've entered a bit more of a speculative

environment again."

The proportion of unprofitable tech companies that went public grew during 2006. While one of the four that went public in the first quarter was unprofitable at the time, that was true for two of seven tech IPOs the second quarter, one of three tech IPOs in the third quarter and six of the 13 tech IPOs in the fourth quarter, according to an analysis by Thomson Financial.

So far this quarter, all three tech companies that have had IPOs are unprofitable, says Thomson. Some 62% of the 26 tech firms that have filed with the Securities and Exchange Commission for an IPO since January 2005 and are waiting to go public are also in the red.

More money-losing companies are going public in the tech sector now than in some others, says Thomson. Since the fourth quarter of 2006, for example, only 15% of energy IPOs involved unprofitable companies, and no financial companies new to the market were losing money.

The tech companies arriving on the stock market now are also smaller on average than in recent years. In 2005, tech companies that held IPOs generated average annual revenues of $115 million each. Last year, that dropped to an average $77 million a year, according to Revolution Partners, a boutique investment bank in Boston. And some recent tech IPOs were those of even smaller companies: Software company Salary.com Inc., which went public last month, posted revenues of $15.3 million in its fiscal 2006 that ended last March.

Some of these small firms are widening their net losses rather than closing the gap to profitability. Salary.com more than doubled its revenues to $15.3 million in its fiscal 2006 from its fiscal 2004. But its net loss more than doubled too: The Waltham, Mass., company, which provides software to help companies manage compensation information, had a $3.1 million loss in fiscal 2006 versus a $1.2 million loss in fiscal 2004.

"Profit isn't one of the key criteria" for a company like Salary.com to go public, says Ken Goldman, the company's chief financial officer. "We could've waited a year or two until we were larger before going IPO, but we might've missed the market opportunity because IPO windows open and close." He says Salary.com is committed to becoming profitable "within the next several years."

It is easier to take these smaller loss-making tech companies public now because of investor appetite for growth stories, say investment bankers, who reap fees from underwriting IPOs. Bill McLeod, director of capital markets at investment bank Thomas Weisel Partners, which helped underwrite Salary.com, says it was difficult to take a company public in 2004 if the firm had a market capitalization of less than $250 million. Now, smaller firms are making the cut because investors are willing to buy into companies with market capitalizations of $150 million as long as they

are growing fast, he says.

"Profitability is preferred, but we don't say that you have to be profitable to go public," Mr. McLeod says.

All of this is good news for financiers such as venture capitalists, who invest in private companies with the hope of a payout later if they go public or are sold at a profit. Venture capitalists have been unable to cash out of many investments in recent years because the IPO market has been largely moribund. Of 623 tech start-ups to which VCs gave initial financing in 2001, more than 50% remain closely held and independent, according to research firm VentureOne. (VentureOne is owned by Dow Jones & Co., which publishes this newspaper.) The huge backlog has crimped venture returns and caused hand-wringing across that industry.

"People weren't willing to trade off growth for profitability in 2004, but now the public markets are looking for growth again," says Kevin Fong, a partner at venture-capital firm Mayfield Fund in Menlo Park, Calif. "So things look pretty healthy" for venture capital.

Some of the newly public companies have clear paths toward profitability. Riverbed, which makes products that speed global networks, turned a profit 100 days after its IPO in September. The San Francisco company, which sells primarily to multinational corporations, gets recurring revenue when customers pay Riverbed to continue to service their technology. Earlier this month, Riverbed completed a secondary offering of five million shares at $32.50 a share, nearly three times the price at which the company went public.

Isilon, meanwhile, says it expects to be profitable in the second half of this year. The Seattle company, whose products help companies store digital content, says it is one of the few firms in the fast-growing digital-storage niche and is acquiring customers rapidly. Isilon projects revenues of $115 million this year, nearly double its $62 million in 2006. Steve Goldman, Isilon's chief executive, says the company could have been profitable by now but decided to invest aggressively in expanding its business instead.

Write to Pui-Wing Tam at pui-wing.tam@wsj.com[1]

URL for this article:
http://online.wsj.com/article/SB117375644557235120.html

Hyperlinks in this Article:
(1) mailto:pui-wing.tam@wsj.com

Copyright 2007 Dow Jones & Company, Inc. All Rights Reserved
This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our Subscriber Agreement and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com.