Why Aren't VCs Happy?

Broadview's Paul Deninger does the math that explains the Wal-Marting of investment banking.

In a recent interview with AlwaysOn, Paul Deninger, Chairman of Jefferies Broadview, gave his take on the forces that are shaping the market now and to come.

Paul Deninger: A lot is going on. If you look at actual real activity we've sort of recovered to pre-bubble levels, so the M&A market is actually pretty good. We're seeing companies with strong EBITDA profitability at reasonable multiples. We're seeing best in class companies being acquired at 10, 15 times revenue, so we're back. So why isn't everyone feeling great? I think there are several reasons.

Number one, because of the constraints on the IPO market and that we are in a fifth straight year of the present decline in the number of public companies, completely unprecedented, historically.

The number of buyers is shrinking in virtually every market except the Internet—that is digital conference, e-media kind of companies. So any market other than that, the number of public companies is shrinking. As a consequence, whereas you might have gotten five or six deals done in a market segment, two or three of which are huge wins, you can now look forward to one, maybe two huge wins in three or four deals. In other words, there are fewer high-multiple deals happening in aggregate because of the propensity of buyers. That is compounded by the fact that there is an over supply of companies. Because of the large number of venture capitalists, there are too many companies in virtually every space. So if you build a winner, you're going to be thrilled. But your probability of being saved from mediocrity, your probability of being saved from failure, is zero. Your probability of turning a mediocre company into a double or a triple is very low.

Number two, the other compounding factor, is the amount of money you get in these deals. What VCs are saying today—it used to be that your fund was made by a 10 bagger. Now your fund is probably made by a 6 bagger or a 5 bagger or a 20 bagger. A great M&A deal was a 10 bagger and a great IPO deal was a 20 bagger. Now a great M&A deal is a 5 or 6 bagger and a great IPO deal is a 6 to 10 bagger. That's the bad news from a multiple standpoint.
The reason why the VC's who are doing well aren't complaining more is because—do the math. Ten times ten is 100, six times 10—six times 20 is 120. See what I'm saying? In other words, the rates of return in the industry are dropping but the VCs and the LPs are not complaining as much because the absolute dollar returns are good.

AlwaysOn: What would you say is the average percentage range?

Deninger: I don't know, I'm not sure if I'm in a position to comment on that. It's down.

AlwaysOn: Because I'm thinking that in the old days, it would average 23 percent.

Deninger: That's the long-term rate. I mean like over many, many years, every single fund.

AlwaysOn: Of course, but I was just saying that in the old days most VC's made money and I'm kind of feeling that most aren't now, right?

Deninger: It's a huge overhang. It's hard to know because I think it is going to be another two or three years before we know for sure. I mean really, that's the truth.

Let's talk about the IPO market for a second. I for one don't believe that Sarbanes-Oxley is the only problem. In fact, I don't even believe it's the biggest problem, although it is a big problem. I'm not in any way saying it's not. It is a problem and we should be in Washington, D.C., trying to fix it. There is no way of saying scrutiny should be on IBM with thousands of offices as some company with one office, so I'm there.

Having said that, I personally believe that the structure of the investment banking industry has changed and that is the number one problem. You're not going to hear it from anybody else. Have you seen Tom Weisel's numbers? Do you know Tom Weisel has filed to go public?

AlwaysOn: No, I didn't know that.

Deninger: You will understand what I'm about to tell you. There is a reason why Perseus Group [now Savvian] is focusing exclusively on M&A—because they can't get any other business and that's got nothing to do necessarily with their capability.

So now, you've got analysts who can only take by sales and trading—and sales and trading revenue has gone from 10 cents a share to two cents a share or from 20 cents a share to three cents a share. It's basic economics. In a narrow-margin market only scale competitors can make money. You can only make money through massive economies of scale. You can't have a little tiny oil refiner. You can't have a little tiny dishwasher detergent maker. Razor-thin markets require massive economies of scale. It's the Wal-Marting of the investment banking group now.

As a consequence, small firms like Perseus can't make money in sales and trading. If they can't make money in sales and trading, they can't do research and if they can't do research they can't take companies public. So then what happens? You have all these small firms, whether it's Needham or Perseus or Thomas Weisel Partners, none of them can make money in sales and trading. All of them can't pay for research and are struggling.

AlwaysOn: How does that impact Broadview?

Deninger: It's not affecting our M&A business at all, they're kicking butt. Here's the problem. If you average any five-year period from the late 80s to 1997, you'll come up with somewhere around 150 to 170 IPOs per year. That was a period of time when the boutique firms were driving the IPO market for tech. Today, both firms are driving markets for tech and we're averaging 25 IPOs in the last five year period. I do not think those are unrelated facts. And the reason for that is that people at the firm really don't care about the company. They really care about the institutions they support and the institutions they support are the biggest financial institutions in the world: the Wellingtons, the Putnams, the Fidelitys.

This is the first of three excerpts from an AlwaysOn interview with Mr. Deninger.
Part Two: Financial brand-awareness
Part Three: Information totalitarianism