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Small-Cap IPOs Shun U.S.

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By Bill Snyder

An upstart stock exchange in London is giving the long-established Nasdaq a run for its money.

Since the beginning of the year, the Alternative Investment Market, or AIM, has been the venue for 150 initial public offerings that raised an aggregate $7.7 billion; the 48 companies that went public on the Nasdaq raised a collective $5.8 billion.

A large part of AIM's attraction is its significant cost advantage over U.S. exchanges. But perhaps even more important is the almost visceral distaste that Silicon Valley venture capitalists and entrepreneurs have for the Sarbanes-Oxley Act as well as regulations requiring companies to expense the cost of stock options.

"Sarbox has pulled a trillion dollars out of the U.S. market," says Timothy Draper, a well-connected venture capitalist and founder of Draper Fisher Jurvetson. "We're shooting ourselves in the foot." As to regulation-light AIM -- "I love it," he says.

That trillion-dollar figure may be something of an exaggeration, but for the relatively small companies that go public on AIM -- the average market cap on the newer exchange is just $80 million vs. about $1 billion on the Nasdaq -- lower compliance costs are deal makers.

To be sure, most AIM-traded companies are European-based, but as the cost of going public in the U.S. increases, and regulators here become more demanding, more companies are willing to take their business overseas.

As of June 30, 17 U.S.-based companies went public on AIM this year, compared with 19 in all of 2005, says Anne Moulier, AIM's business development manager for North America.

One company likely to take the plunge early next year is iTracs, a Chicago-based developer of network software.

"The cost and the hassle of complying with Sarbanes-Oxley isn't worth it," says CEO Tom Reedy.

But distaste for the regulatory environment in the U.S. is only part of the story.

"There's a lack of interest [here] in small-cap companies. If you look at what's out there [in the U.S.] , 80% of [the small-caps] are orphans, with only one or two market-makers and no research analysts," says Reedy.

Going public via AIM is also relatively cheap, costing about 9% or 10% of the cash raised via the IPO, including fees to bankers and lawyers, compared with about 12% to 14% on the Nasdaq, says Giles McNamee, a longtime Silicon Valley venture capitalist and managing director of McNamee Lawrence.

But the real advantage comes in lower annual costs.

"Ongoing compliance costs [for public companies in the U.S.] are going to run $2 million to $3 million a year," says McNamee. "That's an awful lot of net income to generate for a small company. It's essentially a tax on EPS [earnings per share] ."

One example: Public companies in the U.S. are required to report financial results four times a year, while their counterparts on AIM and other U.K. exchanges report just twice a year.

But McNamee says the real problem with U.S. financial regulations is that they don't distinguish between large and small companies.

"Most of the new regulations are designed to deal with companies on the scale of Enron, not with emerging growth companies," he says. "If I were running a growth company, I would not take it public in the U.S."

Founded in 1995, AIM is a unit of the London Stock Exchange, which views it as a vehicle to take smaller, venture-backed companies public.

To date, it has taken more than 2,400 companies public, raising more than $56 billion in the process.

Although it has grabbed some business from the Nasdaq, AIM is less a rival than a complement to the older exchange.

If iTracs, for example, does go public on AIM, it may well opt for a dual listing on Nasdaq when it's time to raise more capital, says Reedy. That strategy, explains Moulier, is fairly common.

AIM does have its critics in the U.S., particularly among mergers and acquisition (M&A) managers who profit by helping startups sell themselves to larger companies.

Eric Gebaide, managing director of New York's Innovation Advisers, was concerned enough about the potential threat of AIM that he conducted a rather elaborate study of the exchange.

He found that while AIM companies as a whole are performing a bit better than the Nasdaq this year (up 2.3% vs. down 3.2%), tech companies on AIM are underperforming similar companies on the Nasdaq.

As of late August, when Gebaide gathered his data, AIM tech companies were off 10%, while Nasdaq tech issues were down 2%.

Also affecting returns on AIM is the relatively small size of the listed technology companies.

While Nasdaq's Software and Services technology companies (excluding Microsoft (MSFT) and IBM (IBM)) produce a median revenue of $257 million, similar companies on AIM have a median top-line figure of just $32.8 million.

Moreover, tech companies on AIM don't age well, he says.

Two years after going public, the median return of tech IPOs on AIM is negative 57%, compared with a 7% return for tech companies of the same age on the Nasdaq, he says.

Gebaide's arguments resonate with the founders of tech companies who wonder about their exit strategy should the stock price go south after a few years.

Ashley Leonard, founder and CEO of NetworkD, an IT services provider in Newport Beach, Calif., spent much of the last year exploring ways to raise about $16 million.

Initially, Leonard says, AIM seemed ideal: "It's easier, quicker and cheaper for a small company."

But as Leonard studied the data on aftermarket performance, he became less interested.

"Going public on AIM is more an exit strategy for VCs; it's a good way for them to get liquid fairly quickly." But company founders risk losing at least some of their equity if the value of the stock declines by the end of the lockup period. "It's not nearly as attractive [for us] ," Leonard says.

For now, Leonard is exploring another round of venture funding.

AIM isn't likely to become a serious threat to the Nasdaq.

Small-cap companies, after all, don't rule the financial world, and the Nasdaq is more interested in going up-market as it challenges the New York Stock Exchange than in fighting over small fry.

But AIM and other new exchanges outside the U.S. are attracting the kind of fast-growing, innovative companies that made Silicon Valley the world capital of technology, says Michael Moe, CEO and chairman of ThinkEquity Partners, a growth-oriented investment bank.

And that's not likely to change. Investors, says Moe, don't really care what ticker a company trades under or where the exchange is located.

Indeed, one obstacle to offshore listing has been the relative difficulty U.S. investors face when buying or selling equities on AIM or certain other foreign exchanges.

But as interest grows, it's likely that the restrictions that make electronic trading difficult will ease, says Moe.

Until then, investors looking for hot growth prospects will have to work a bit harder.

But if Moe and many others in the venture capital and investment banking businesses are right, it will be well worth the effort.