Renaissance Capital
The IPO Expert

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Committee on Banking, Housing, and Urban Affairs
U.S. Senate

Hearing on

Spurring Job Growth Through Capital Formation
While Protecting Investors

Testimony by

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Chairman Johnson, Ranking Member Shelby, and members of the Committee:

I want to thank you for inviting me to testify today. Capital formation, when accomplished through a transparent IPO market open to all investors, plays an important role in allocating capital to our best entrepreneurial companies, spurring significant and sustainable job growth. We are all concerned about economic growth and job creation, so it is no surprise that our eyes would turn to the IPO market – America's most admired system for funding entrepreneurs.

The issue we address today is access to capital by entrepreneurial companies. When America's job-creating smaller companies are unable to access the IPO market, we need to understnd why and what we can do about it. Measures to ease costly regulatory burdens that weigh most heavily on small firms may be helpful. At the same time, care must be taken in waiving certain disclosure and stock promotion rules that could result in misallocating capital to weak or fraudulent companies. Weak companies that ultimately fail cause job losses, not job creation, and result in serious stock market losses to investors who abandon the IPO market, as was the case after the internet bubble burst.

Renaissance Capital's IPO Expertise

We share the concerns of lawmakers about the IPO market and are honored to be asked for our thoughts on this important policy making process. For over twenty years, Renaissance Capital has had a singular focus on the IPO market. We are involved in IPOs in three ways:

1. We are an independent research firm. We provide institutional investors with research on IPOs. We analyze every IPO in the U.S. and we cover the international IPO market.
2. We are an indexing firm. We create and license IPO indexes that measure the investment returns of newly public companies. These indices are used by IPO investors as a benchmark of performance.
3. We are an IPO investor. We invest in newly public companies through a mutual fund and separately managed institutional accounts.

Regulators around the world often reach out to us about our views on IPO issuance, valuation and research. These regulators are studying the best practices of the U.S. IPO market. They know that a well-functioning IPO market can be the most efficient way for them to allocate capital to their growing enterprises. A well-functioning IPO market is based upon full and honest disclosure of company information made available evenly to all public investors.

I will start by examining the condition of our IPO market, including where we stand in global IPO market share, what is working and what is not, and the importance of investor returns in the equation. I will then make suggestions on the specific bills under consideration.

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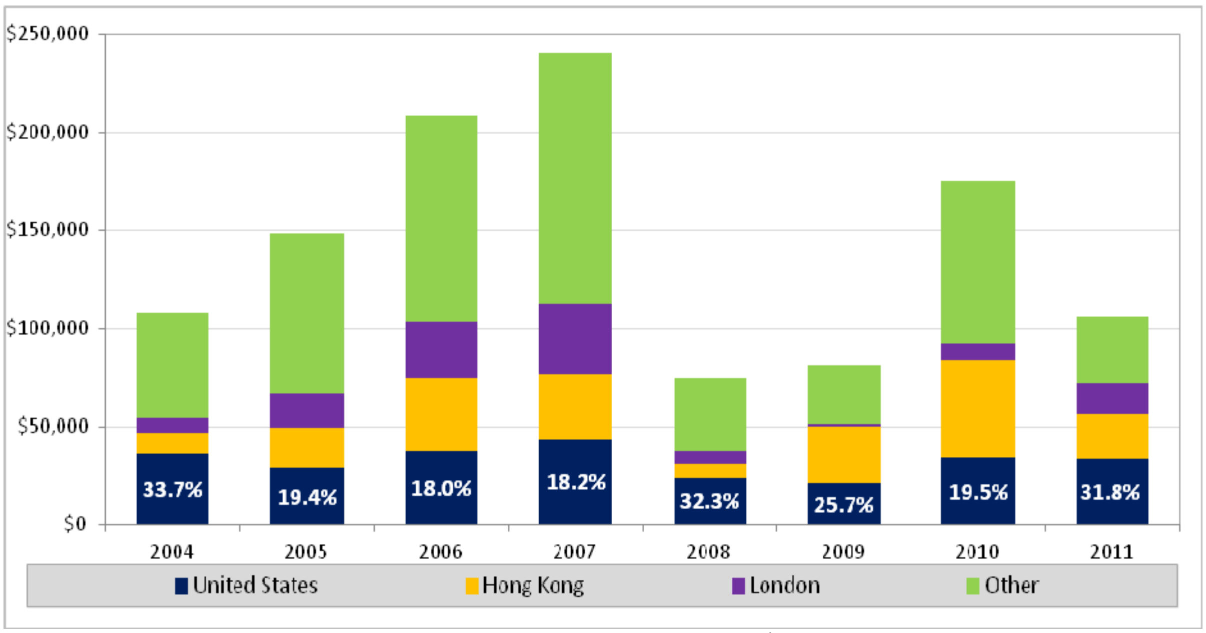
The U.S. IPO Market is Doing Well Relative to IPO Markets Around the World

While there is legitimate concern that recent issuance in the U.S. IPO market has been below long-term trends, the U.S. market is not alone. IPO markets globally have been hurt by the 2008 U.S. financial crisis and the 2011 European Sovereign debt crisis. However, in the context of weak global IPO markets, the U.S. has actually gained market share, accounting for 32% of global IPO proceeds in 2008 and again in 2011. In 2011, when international IPO issuance fell 50%, U.S. IPO issuance fell only 6%. This tells us that when put to the test of a financial crisis, investors trust the disclosure, transparency and depth of the U.S. IPO market more than any other IPO market in the world. So, despite the low IPO issuance levels, much of the U.S. IPO market is functioning as well as can be expected under challenging conditions.

U.S. IPO Market Maintains Share in Weak Global IPO Market



Source: Renaissance Capital. Global statistics include IPOs with a deal size of at least US$100 million and exclude closed-end funds and SPACs. Excludes the China-A shares market.

Larger Issuers Continue to Access the IPO Market

The IPO Task Force provided helpful data about IPO issuance since 1991. This data shows that while smaller IPOs have effectively disappeared, larger companies raising over $50 million in IPO proceeds continue to access the IPO market. From 2000 to date, investors have experienced the weakest period of stock market returns in decades. As the chart shows, during this period, the larger issuers have dominated the IPO market. In weak markets, investors gravitate to the perceived safety of larger, more liquid IPOs.

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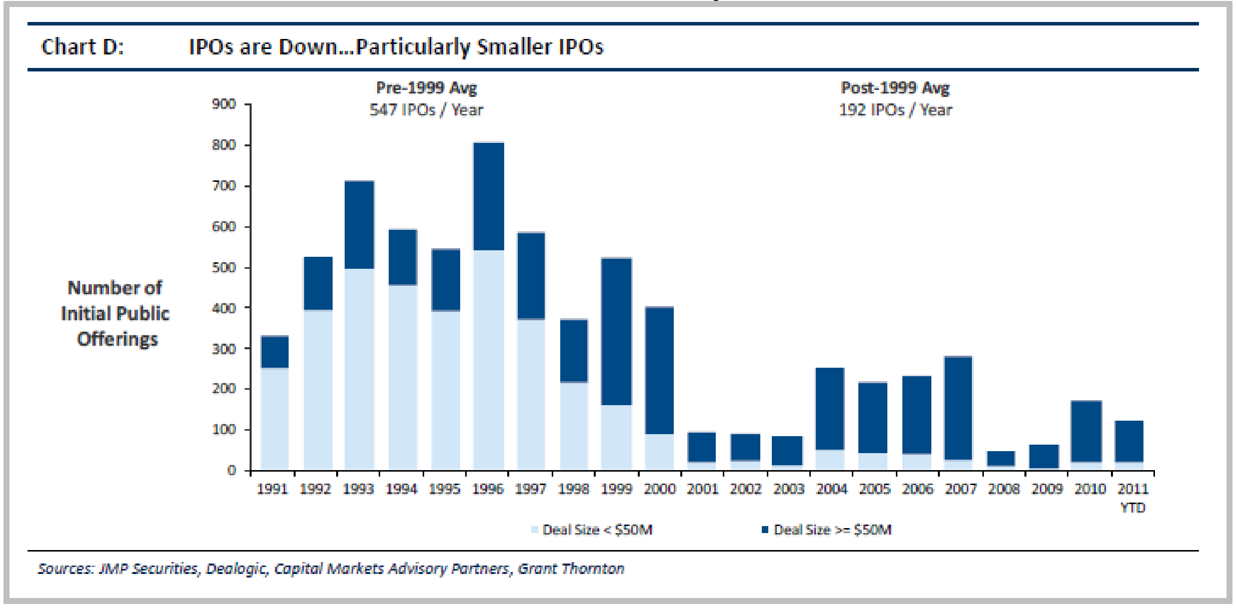
IPO Task Force: "IPOs are Down…Particularly Smaller IPOs" under $50 million



Source: IPO Task Force, October 20, 2011

Furthermore, despite our current regulatory regime, we find little evidence that these larger issuers have been deterred from tapping the IPO market. Today, we count over 200 companies in the U.S. IPO pipeline seeking to raise over $52 billion in aggregate proceeds who have undergone financial audits, implemented Sarbanes Oxley policies and filed full disclosure documents with the SEC. This is the largest backlog of companies lined up to go public that we have seen in over a decade. Over 92% of these companies are larger issuers seeking to raise over $50 million in IPO proceeds.

The U.S. IPO Market is Closed to Small Issuers

On the other hand, as the IPO Task Force concluded, smaller IPOs of $50 million proceeds or less have become a reduced presence in the IPO market. Prior to 1999, smaller IPOs represented 50% or more of the IPO market, currently they represent less than 15%. Helping these smaller job-creating companies lower the cost of accessing the IPO market, while protecting investors, may help somewhat in boosting the presence of smaller IPOs in the market.

However, opening the path for easier issuance by smaller companies only works if investors are interested in buying these IPOs. Thus, it is even more critical to address the investor side of the equation. At present, the trading market for IPOs is highly volatile with average IPO trading turnover on the first day often equal to the number of shares offered. This suggests that IPO

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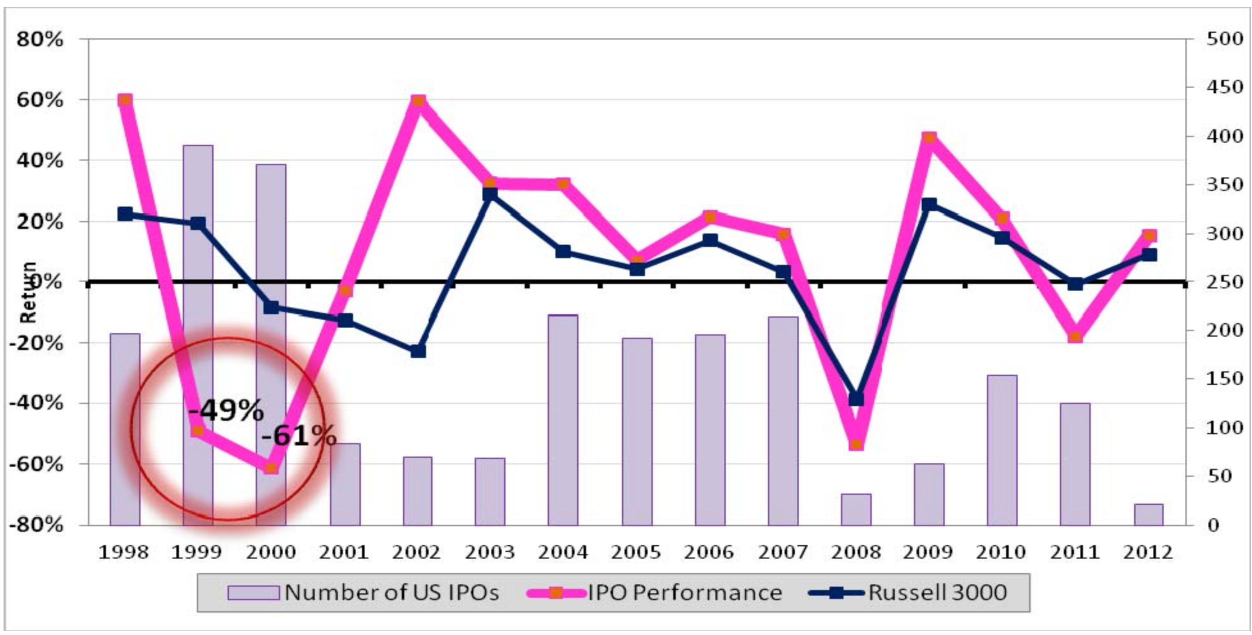
shares are being placed with short-term trading clients of the IPO Underwriters. IPO shares placed with a broader base of fundamentally-oriented investors would go a long way to help open the IPO market to smaller issuers. We urge policy makers to study ways to encourage IPO Underwriters to allocate IPOs to a broader base of long-term investors.

Ultimately the IPO Market Opens Up when IPO Investors Earn Positive Returns

While policy to ease the way for more small issuers to accomplish an IPO may be helpful, the most powerful fix for the IPO market would be to improve returns for IPO investors. Unfortunately, there is little policy makers can do on this front, short of creating a government fund that purchases shares in every small IPO – which we would not recommend. Returns to IPO investors matter because good returns for IPO investors drive future IPO activity. IPO issuance grows when returns are positive. The IPO market closes when returns are negative.

Weak IPO Returns Explain Low IPO Issuance for Smaller IPOs



Source: Renaissance Capital. Statistics include all IPOs except closed-end funds and SPACs. IPO Performance reflects average two-year aftermarket returns from 1998-2002 and returns from the FTSE Renaissance US IPO Capped Index from 2003 through February 29, 2012.

After a long run through the 1990s of positive equity returns for all investors, the bursting of the internet bubble devastated IPO investors, causing losses of -49% and -61% in 1999 and 2000, respectively, far worse than the rest of the equity market. No wonder in the years following that disaster, investors were cautious about smaller IPOs, shutting off IPO issuance for these important job-creating small companies. Over 70% of the IPOs during that period were unprofitable companies whose offerings were promoted by the IPO Underwriters' research

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analysts. We caution lawmakers to avoid new policies that would pave the way for IPO Underwriters to engage in these types of promotional activities again.

We are encouraged that following the poor returns of 2008 and 2011, returns for IPO investors have turned strongly positive so far in 2012. These positive returns will start up the IPO issuance engine again. We believe that an extended period of positive returns for IPO investors is the most powerful solution to increasing IPO market activity leading to a greater presence of smaller sub-$50 million issuers. In the meantime, policies that assist these smaller IPOs to lower the cost of accessing the IPO market and improve IPO allocation to attract a broader base of long-term investors could provide some helpful relief.

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Renaissance Capital's Recommended Improvements to the Proposed Legislation

1. Focus on the companies seeking to raise under $50 million that are currently shut out of the IPO market by properly defining Emerging Growth Company as smaller issuers seeking to raise up to $50 million.

2. Strike the proposed informational rules in S.1933 Section 6 that permit IPO Underwriters and issuing companies to promote offerings and provide special information to selected clients during the IPO process to avoid re-creating the internet bubble.

3. Encourage larger private companies (e.g. Facebook) to file public disclosure (i.e. go public) when active trading markets develop in its shares, by adding a public float requirement to the proposed private company legislation.

Recommendation #1: Refine the definition of "Emerging Growth Company" to focus on the small companies seeking to raise up to $50 million, replacing the proposed $1 billion revenue rule

The S. 1933 legislation defines Emerging Growth Company as a firm with $1 billion in revenue. By this definition, we would be giving relief to over 90% of the companies going public, effectively the entire IPO market, and would include companies with very large market capitalizations. The real Emerging Growth Companies that need to be targeted are smaller issuers seeking to raise under $50 million in capital. Based upon our analysis, an Emerging Growth Company should be redefined as one seeking to raise up to $50 million with an implied market capitalization under $200 million. This would target the part of the market that needs attention.

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Recommendation #2: Strike the proposed rules that permit IPO Underwriters and issuing companies to promote offerings and provide special information to select clients during the IPO process

We agree that more research on companies would be favorable for stock trading, but Section 6 in the S. 1933 legislation, as written, would allow IPO Underwriters to engage in promotional activities. After the internet bubble burst, investors suffered devastating losses of -49% and -61% in 1999 and 2000, respectively, from purchasing overvalued IPOs pumped up by underwriter research. Over 70% of the IPOs during that period were unprofitable companies, many of which went out of business. As we know from bitter experience, research by broker dealers and their affiliates that underwrite the IPO is inherently biased, used as a marketing tool to sell shares in the IPO and, without some restrictions, provides an informational advantage to the IPO Underwriters' research analysts and proprietary clients, contrary to Regulation FD.

Recommendation #3: Improve legislation expanding the size and dollar thresholds of the private placement market by adding another threshold that would encourage private companies, whose shares are actively trading, to go public

The various bills seeking to expand the size of the unregistered ("no-doc") private market from $5 million to $50 million and the number of accredited investors from 500 to 1,000, may help to open up more capital raising opportunities for smaller issuers. However, these changes may have the unintended consequence of creating a shadow IPO market of larger private companies. These private IPO-ready companies would reap the benefit of being public without taking on disclosure responsibilities. For example, even under the existing 500-shareholder limit, active private transactions in Facebook shares have occurred prior to its IPO filing at large cap valuations of $100 billion, the size of McDonald's. We recommend adding a provision to these new rules that encourage private companies (e.g. Facebook), who meet certain thresholds of transactional activity, to go public, providing full disclosure to all investors. We support the market capitalization limit proposed by Columbia University Professor John Coffee of $500 million or less. This would help the IPO market.

Summary

A well-functioning IPO market is based upon the principal of full and honest disclosure of company information made available evenly to all public investors. The U.S. IPO market is functioning amazingly well under the stressful conditions of a global financial crisis. While there may be initiatives that can help improve the functioning of the IPO market, especially as it pertains to the most vulnerable smaller companies, the IPO market will heal itself starting with the larger, more established private companies. Waiving certain disclosure and stock promotion rules that could result in misallocating capital to weak or fraudulent companies will only endanger the recovery of the IPO market. It is the positive returns that investors earn from these larger issuers that will lead to more issuance for smaller IPOs.

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