Are Venture-Backed Companies Keeping Pace With a Changing World?

By Adam J. Epstein

As the economy continues to sputter along in an extended recovery, lackluster job growth remains a focal point. In years past, the economy depended mightily upon newly public companies to top up the national supply of well-paying jobs. But with the number of IPOs in 2012 standing at only 60 percent of pre-2008 figures, anemic employment figures are getting little help from Silicon Valley and elsewhere. For those companies that are fortunate to complete IPOs, the broader economy is more dependent upon them to succeed than at any time in recent memory, in light of the persistent malaise.

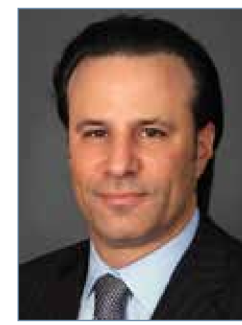
These companies face uphill battles once public. In addition to the global competitive forces that conspire to either fuel or impede newly public companies, the past five years have spawned myriad corporate governance challenges to further complicate matters. A 2012 FTI consulting study showed that for 1 in 2 corporate directors, cybersecurity was their top concern. Eighty percent of directors at the 2012 KPMG Annual Audit Committee Issues Conference said company regulatory filings were too long and complex. Other highly nuanced, time-consuming governance issues to be faced include, but are not limited to, FCPA/U.K. Bribery compliance, SEC whistleblower bounties, the implications of social media, the proliferation of information technology risks, increasing governance and shareholder activism, conflict minerals, and say on pay.

In addition to these complex governance issues, the small-cap marketplace into which the average venture-backed IPO company now emerges is virtually unrecognizable from years past:

- The median IPO size has dropped 20 percent below where it was in 2008, according to Renaissance Capital's 2012 review of the U.S. IPO market.
- Because of the smaller IPO sizes, the average amount of time between an IPO and a company's first follow-on equity financing has dropped to under 300 days from 600 days in 2007, according to the National Venture Capital Association.
- The annual cost of being a public company (about $2.5 million a year) is high, and rising.
- The decimalization of trading and associated decrease in "tick" sizes have decimated the capital markets infrastructure for small caps, resulting in decreased trading volume and increased volatility.
- As of Dec. 31, 2012, 29 percent of all exchange-listed U.S. companies have *no sell-side research coverage*, according to a white paper published recently by Keating Capital, which also reports that 40 percent of exchange-listed U.S. companies now have market capitalizations of less than $250 million.

Put differently, the small-cap ecosystem has become increasingly inhospitable, with the penalties for poor performance oftentimes exceeding the rewards for excellence. Considering that the median market capitalization of all venture-backed IPO companies in 2012 was approximately $400 million, according to various industry sources, these companies have small margins of error.

In 2012, the headlines were filled with stories about the inability of numerous companies to artfully navigate the IPO process; that is, poor underwriting selection/management, excessive road show exuberance leading to unrealistic expectations, and deficient deal pricing. But it's often what happens after the IPO spotlights have long since been redirected to other companies that has a greater impact on a newly public company's success or underperformance. For example, how the company manages its relationships with sell-side equity research analysts, how the company communicates to the broader Street, how and to what extent the company interacts with its principal stakeholders, and how it undertakes further financings.



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When one considers that the average annual aftermarket performance of IPOs (i.e., the percentage annual gain achieved starting after the customary first-day price spike) during the period 2009–2012 was 2.58 percent, based on Renaissance Capital's statistics, and the average annual performance of the Russell 3000 for the same period was 13.35 percent, it's clear that there are many newly public companies that are struggling to adjust to public company life. Reasonable people will differ, but it's certainly arguable that at least a portion of the disconnect is attributable to the fact that while the continuum of risks and corporate governance challenges has changed dramatically in recent years, pre-IPO board composition practices appear to have remained predominantly the same.

While there is little question that founders, venture capitalists, and industry CEOs often make perfectly good choices for the boards of pre-IPO companies, perhaps the venture community's historic pattern and practice of substantially limiting board composition from within those confines is ripe for some recalibration. For example:

- Intelligence, sophistication, and industry bona fides notwithstanding, there are many founders, CEOs, and venture capitalists that lack recent material experience governing public companies, and that don't have appreciable backgrounds in small-cap capital markets and corporate finance.
- The average public company board member now spends 40 percent more time on governance work than he or she did 10 years ago, according to 2012 NACD data (i.e., governance is very nearly a full-time job now). Yet on 3 of the boards of prominent venture-backed IPO companies in 2012, for example, there were a total of 8 investors between them who *averaged* 7 board memberships each, in addition to being full-time venture capitalists (2 of the directors had more than 10 board memberships each).
- Particularly with respect to venture-backed technology companies, gender diversity on pre-IPO boards is virtually a fact not in evidence.

An Oct. 14, 2010 article on Directorship.com titled *Building the Right Board* probably said it best: "It's no longer about finding the perfect CPA for the audit committee, a savvy CEO from a peer industry, or a sharp academic who's a tennis whiz at the club." In the same article, NACD Managing Director and CFO Peter Gleason added: "This requires a variety of new approaches to board composition, such as recruiting skill sets versus recruiting names."

Given the irrefutable changes to the environment in which newly public companies now operate, it's likely that pre-IPO board composition practices need to similarly evolve in order to include more diverse skills. D