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Lackluster IPO Market Flashes Warning

Pace for initial public offerings is slowest since first quarter of 2009, and analysts warn that second period may not bring much relief

Syndax Pharmaceuticals priced its March initial public offering below expectations. *PHOTO: NASDAQ*

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The U.S. stock market has taken off, but it has left behind an important passenger: the IPO.

Major stock indexes have gained about 13% in the past seven weeks and are now in positive territory after a swoon early in the year. The market for initial public offerings, however, is in its slowest period since the first quarter of 2009, both in terms of number of deals and total money raised, according to data provider Dealogic.

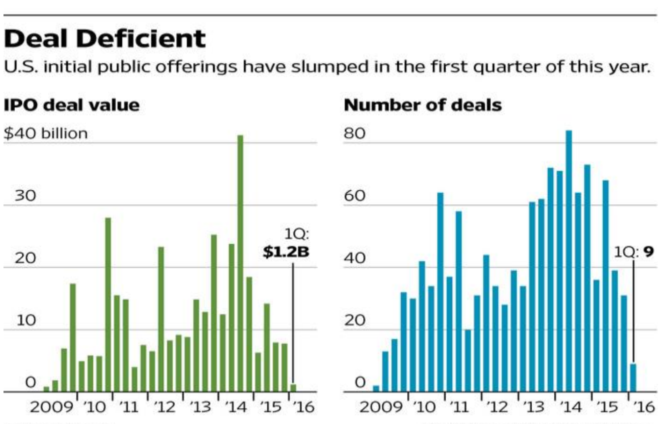
Analysts and traders warn that the second quarter may not bring much relief.

The sharp divergence is puzzling investors, who figure the two should move in the same direction. They said if the pace of IPOs doesn't accelerate, it could be a warning sign for the rally, a signal that investors haven't fully regained their appetite for risk.

"Either the IPO market is going to pick up, or the stock market is going to pull back, but it's hard to envision both conditions peacefully coexisting," said Jack Ablin, chief investment officer at BMO Private Bank.

Meanwhile, the market environment could portend more pain for investors in private technology companies who have bought in at valuations that likely can't be reached in the public markets in the near term. Nine deals raised a combined $1.2 billion in the quarter, the smallest amount since two IPOs pulled in $830 million in the first quarter of 2009.

Of the five companies that made their debuts after U.S. stocks hit their low for the year on Feb. 11, two ran into trouble. The other three were for blank-check, or shell, companies, which typically use IPO proceeds to acquire assets and aren't seen as a barometer of entrepreneurial risk.



Clinical stage cancer-treatment company Syndax PharmaceuticalsInc., priced its offering below expectations at $12 a share on March 2, raising just under $60 million, and fell below its offer price on its first day of trading, a sign of lackluster investor demand. Small biotechnology company Corvus Pharmaceuticals Inc. priced at the low end of its range on March 22 and closed below its offer price on its debut and has remained there. On Wednesday, Syndax closed above its offer price, while Corvus finished below.

Another sign of how bad the market has been: Issuers withdrew more than twice as many IPOs as they pulled off during the quarter, according to Dealogic. “It’s kind of unprecedented for the general stock market to be so close to record highs and yet so little IPO activity,” said Jay Ritter, professor of finance at the University of Florida.

Markets had opened the year with a rout amid concerns aboutweakening growth in China, the Federal Reserve’s decision to raise interest rates and a sharp drop in oil prices. Issuers want to sell into rising markets, and they and their bankers shy away from volatility that can make outcomes unpredictable.

Several big-name companies are waiting in the wings to go public, including Bats Global Markets Inc., US Foods Holding Corp. andAlbertsons Cos.

“There remains significant questions about the health of the economy and the equity market, and both are potential threats for the IPO market,” said Mary Ann Deignan, co-head of global equity capital markets at Bank of America Merrill Lynch.

What is needed to grease the skids for the IPO market, bankers said, is the successful debut of a stable, mature and profitable company.

“The companies that are likely to test the strength of the market in the near term will need to accept a slightly higher IPO discount than they otherwise would in a typical new-issue market,” said Paul Donahue, head of equity capital markets in the Americas at Morgan Stanley.

While companies typically debut at a price 10% to 15% below their publicly traded peers, the first companies out of the gate in this environment could be forced to take much steeper cuts of possibly 25% to 30% and would likely need to sell a smaller portion of their shares, some bankers said.

In the past 20 years, tech companies have accounted for about a fifth of the IPO market, according to Dealogic. Besides one small Chinese company, no other tech company has listed in the U.S. since AtlassianCorp.’s IPO in mid-December. It is trading 20% above its IPO price as of Thursday’s close. But Atlassian, which makes software-development tools, is one of the rare tech firms that funded its growth largely through its own profits. Some high-growth tech startups, including Etsy Inc. and Box Inc.,remain below their IPO prices.

The discount between the private-market valuations and what public investors might pay also has been weighing on tech firms. Some of the most high-profile IPOs that debuted in 2015, including Box and Square Inc., sold shares below the valuations used to price private fundraising rounds.

There have been some hopeful signs. Market volatility has eased significantly, which makes for a more attractive environment for public offerings. Ms. Deignan said she has seen an increase in investors asking the bank about the status of companies in the IPO pipeline.

In addition, this year’s IPOs now are trading on average 23% above their offer prices. One of the first IPOs of the year, Editas MedicineInc., has since more than doubled its stock price.

And there is scarcity value. Any company that isn’t a biotech firm or a blank-check vehicle would likely get significant attention from IPO investors, said James Palmer, head of equity capital markets for the Americas at UBS Group AG.

The return to a normal IPO market will be “evolutionary, not revolutionary,” said David Ludwig, co-head of equity capital markets in the Americas for Goldman Sachs Group Inc. “Both issuers and investors want confidence that deals will price and trade appropriately before we see a flood of companies testing the market,” he said.

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