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UNH Center For Venture Research: Angel Investors, VCs Look At IPOs Differently

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July 22, 2009

EDITORS AND REPORTERS: Jeffrey Sohl, director of the UNH Center for Venture Research, can be reached at 603-862-3373 and jesohl@christa.unh.edu. ï¿½Initial Public Offerings and Pre-IPO Shareholders: Angels Versus Venture Capitalistï¿½ is available at http://wsbe.unh.edu/files/Initial_Public_Offerings_and_Pre-IPO_Shareholders-_Working_Paper.pdf.


Jeffrey Sohl

DURHAM, N.H. - New research from the Center for Venture Research at the University of New Hampshire shows substantial differences in how angel investors and venture capitalists approach initial public offerings, a finding that entrepreneurs should consider when selecting early investors.

The research is presented in the working paper "Initial Public Offerings and Pre-IPO Shareholders: Angels Versus Venture Capitalists." The research was conducted by Jeffrey Sohl, director of the UNH Center for Venture Research and professor of entrepreneurship and decisions sciences at the Whittemore School of Business and Economics, and William Johnson, assistant professor of finance at the Whittemore School.

"Our results suggest that prior to making a decision about obtaining angel versus venture financing, private firm management should also consider the consequences of such early investors on IPO firm proceeds raised in an eventual IPO," Sohl said.

Researchers studied all firms that went public (Initial Public Offering) from 2001 to 2007. Firms were categorized at the time of IPO as follows: no angel or venture capitalists invested in the firm, only angel investors invested, only venture capitalists invested, or angels and venture capitalists invested. Researchers then examine the effect of pre-IPO ownership on IPO underpricing. Thirteen percent of IPO firms had angel investors as their only outside shareholders, 16 percent had angel and venture capital backing, 33 percent had only venture capital backing, and 38 percent did not have angel or venture capital backing.

VCs More Likely to Underprice
According to the researchers, venture capitalists are prone to underprice IPO firms, thus reducing the proceeds to the firm from the offering, and angel investors have incentives more aligned with non-venture capital pre-IPO shareholders. Underpricing occurs when the offering price at IPO is low and the closing price is high.

One of the largest costs faced by the firm in the going-public process is the implicit costs of underpricing. In the IPOs from 2001-2007, underpricing averaged 12.1 percent and the proceeds of the offerings averaged $179.4 million. As such, the average firm leaves $21.7 million "on the table," or 12.1 percent of the offering proceeds.

"If the offering price is low and the closing price is high, this benefits those who plan to hold their shares after the offering, which the venture capitalists do since they do not sell their shares but rather they distribute shares to their limited partners. This allows the venture capitalists to point to a high return to their fund investors (the limited partners) and high returns help venture capitalists as higher returns enhance their reputation to potential future limited partners," Sohl said. "In converse, a high offering price brings more money to the firm and to the angels, the individuals that plan to sell their shares at the IPO."

"This result is particularly important in that it implies that it matters where entrepreneurs get their financing: from venture capitalists or from angels. If our conjecture is correct, then an entrepreneur may be better off avoiding a venture capitalist altogether and going to an angel to obtain their financing," he said.

Angel/ VC IPOs Quickest to Go Public
Researchers also found that IPO firms backed by both angels and venture capitalists are taken public sooner after founding, compared with non-backed firms. At the time of IPO, the age of firms with angel and venture capital backing was 10.9 years and 14.4 years for venture capital-only firms. The age of IPO firms backed with only angel funding averaged 21.4 years and 27.7 years for firms without angel or venture capital.

"Angels and venture capitalists may select firms with the highest quality management and the best business plans. Thus, firms may be able to go public sooner because the firms are of higher quality even before the angel or venture capitalist invests in the IPO. This implies that both venture investors and angel investors have some skill in picking good quality private firms to invest in," Johnson said.

The researchers also said that angels and venture capitalists may be better at nurturing firms and getting them ready for an IPO sooner, suggesting that angel and venture investors are extremely valuable in the process of assisting a firm in the going-public process.

"These investors may provide many things that the pre-IPO firm requires including industry expertise, contacts with potential customers, and general business knowledge, in addition to the capital needed by the firm," Johnson said.

Finally, angel and venture investors may simply pressure the firm to go public earlier and thus, provide liquidity to their portfolio, which could mean that there is some cost to having these early stage investors, the researchers said.

The Center for Venture Research has been conducting research on the angel market since 1980. The center's mission is to provide an understanding of the angel market and the critical role of angels in the early stage equity financing of high growth entrepreneurial ventures. Through the tenet of academic research in an applied area of study, the center is dedicated to providing reliable and timely information on the angel market to entrepreneurs, private investors and public policymakers. For more information visit http://wsbe.unh.edu/cvr or contact the center at 603-862-3341.

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Jeff Sohl, director of the UNH Center for Venture Research
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