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PUBLIC COMPANIES
SPECIAL REPORT

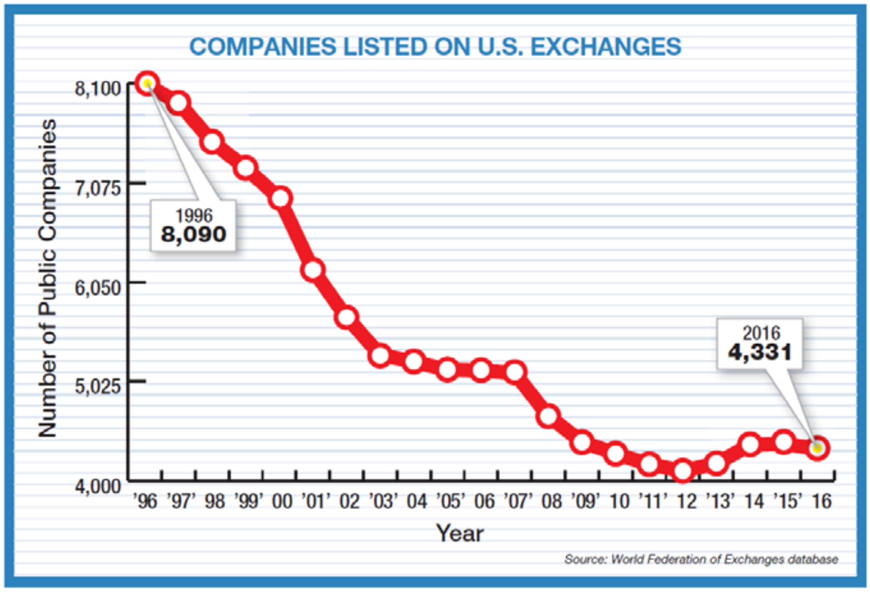
PAIN OF GOING PUBLIC

Despite regulatory costs, some Valley small-caps still trade publicly.

By IRIS LEE *Staff Reporter*

Running a public company – once the Holy Grail of entrepreneurial success and prestige – has become a fading star with the diminishing light especially apparent in markets such as the Valley region, where 60 percent of the names on the Business Journal's Public Companies list are small to micro-cap.

According to the experts, two factors have motivated entrepreneurs to avoid going public: a growing private equity market, and the stringent regulations applied to public companies that require time and money for compliance. The number of public companies in the United States has been on the decline since the mid-1990s, and, in 2016, the number of public companies listed on the U.S. stock market dropped to 46% of what it was two decades ago (see graph).



Trend: In the last 20 years, the number of public companies has tumbled as entrepreneurs look to private equity for growth funding.

"In the last few years there has been a much more vibrant private market, with endless sources of institutional capital available for companies looking to grow," said Lloyd Greif, chief executive of Greif & Co., an investment bank in downtown Los Angeles.

Greif

Since the 2008 Great Recession, there has been a lot of wealth created while the economy recovered, but that hasn't translated into a crop of new public companies because it has become increasingly fashionable for investment funds to invest in private companies, Greif said.

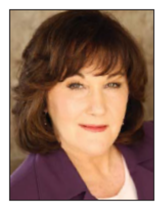
While the public market is still a great option for some companies looking to raise capital, public companies are constantly scrutinized under regulations and audits.

"Most public companies live and die by the requirement to report your financial results every quarter," said Greif. "But when you are private you can be much more long-term focused. Why go through being a highly visible public company that has some research analyst decide your value?"

However, this is not to take away from the benefits of being public. Greif stressed that, because public companies are perceived as lower risk, it makes it easier to raise equity capital and get approved for loans from financial institutions.

B. Riley case

If a company is looking to create an image of reliability and gain easy access to capital, becoming a publicly traded company may be worth it. For example, Woodland Hills finan-



Gurney

NUMBER OF IPOs

Year	Number
2006	265
2007	273
2008	85
2009	80
2010	161
2011	199
2012	303
2013	332
2014	356
2015	210
2016	101

Source: Zephyr Database

cial services company B. Riley Financial Inc. decided to go public in 2014 through a reverse merger with Great American Group Inc., a publicly traded liquidation company.

"There are a lot of benefits (of being public) as a people-based business," said Ryan Bernath, head of investment banking at B. Riley, which ranks 22 on the Largest Public Companies list with a market cap of $361 million. "We can spread the equity to motivate our professionals. Our company grows through mergers and acquisitions, so having that equity capital to grow via acquisition was pretty attractive."

Additionally, B. Riley benefited from going public through a non-traditional way, a reverse merger. In a reverse merger, a private company acquires a public company, which allows it to forgo the complicated and often costly process of registering with the Securities and Exchange Commission for an initial public offering.

The company's founder Bryant Riley leveraged his long-term relationship with Great American in the merger. He had served on the board at Great American for five years.

"IPOs can be pretty costly, so it was cost effective for us," said Bernath. "We also thought they were in various business lines that had a lot of cross-sell opportunity. It was a financial and a strategic decision."

While a reverse merger may be an attractive option for a small company strapped for cash, it can be tricky. Bernath said it is far easier to reverse merge into a shell company, which has no ongoing business and whose sole asset to sell is its public structure.

However, Bernath noted that even if a company becomes public through a reverse merger, there are ongoing compliance costs of being public because of regulations.

"If you are not going to utilize the benefits of being public, it's not worthwhile to be public," he said.

Public toll

The cost of public status represents an insignificant sum for large-cap corporations, such as Walt Disney Co. in Burbank and Amgen Inc. in Thousand Oaks, the two biggest players on the Largest Public Companies list.

But the costs prove burdensome for a micro-cap company such as Mission Valley Bancorp, which has a market cap of $35 million and ranks 36 on the list. The bank currently trades on the over-the-counter market, and it intends to stay there. It has no plans to uplist to the Nasdaq because it would have to start reporting to the SEC.

"It would be a challenge for us to meet that requirement," said Tamara Gurney, chief executive of Mission Valley. "The amount of reporting doesn't provide much more benefit to our investing public."

Gurney's company is already meeting new regulations created under the Dodd-Frank Act. Since the law's enactment in 2010, the Sun Valley bank's compliance costs have increased 35%.

"It's particularly difficult for small banks like us," said Gurney. "When regulators are coming in, they will consider it best practices for the bank to follow regulations that are specific to a larger bank."

Earlier this year, lawmakers introduced a bill in Congress to roll back some of the regulations put in place by Dodd-Frank. However, the bill drew criticism because some legislators worry that it may pave a way for another financial crisis.

Gurney said she has travelled to Washington to speak with lawmakers. "Individually, they will tell you 99% of the time they are in favor of passing that kind of (reform) legislation," she said. "But in the Senate, they get so caught up in the partisanship that they can't even vote on what they agreed on."

Despite the onerous regulatory requirements, Gurney has no plans to delist her company. After all, the OTC listing has created a stable market and liquidity for the company's shareholders, who are mostly an aging population that value liquidity.

"It has made it easier to get the information out about the bank," said Gurney. "More and more people are aware that we exist."

Future potential

So, what does the future hold for Valley companies looking for public growth capital?

According to Brent Reinke, a partner at the law firm Musick Peeler & Garrett in Westlake Village who specializes in startup financing, the economic cycle looks promising for upcoming IPOs.

Obtaining venture capital funding has traditionally been the first step in going public. Venture capitalists provide seed money for a promising company with a great idea, but the VC fund's ultimate goal is to generate a return on investment through an initial public offering or sale of the company. However, during the Great Recession, that company maturation timeline was prolonged in the Valley.

"Unfortunately, it used to be that the 101 Biotech Corridor had a lot more companies receiving funding and developing a reputation," said Reinke. "But the amount of VC money being put in the region has really dropped off. When you have that occurring, you are going to see fewer IPOs."

Reinke said during the 2007-2008 recession, venture capitalists had to strategically allocate their funds to save a few portfolio companies, rather than invest in new projects (see table).

"You have fewer companies being funded by VC, so we have a time lag where in a period of two to three years, companies were not getting VC funding," Reinke explained. "Couple that with the stock market not doing well, and companies looked at the mergers and acquisitions route rather than IPOs."

But the market is picking up and venture capital investment is increasing, so hopefully there will be more IPOs in the future, Reinke said.

For investors, the demise of public companies represents lost opportunities. Last month, in remarks to the SEC Investor Advisory Committee, SEC Chairman Jay Clayton said the decline in the number of IPOs and publicly listed companies in recent years was a "great concern."

"Some companies have shifted capital-raising activities to the private markets, where many main street Americans have limited access," said Clayton. "This ultimately results in fewer opportunities for main street Americans to share in our economy's growth, at a time when we are asking them to do more on their own to save and invest for their future and their children's futures."

Greif from Greif & Co. agreed, reiterating that the regulatory burden of Sarbanes-Oxley – a national law passed in 2002 that required senior management of public companies to certify financial statements – can add additional accounting and administrative costs. However, given the recent growth of private equity, Greif is hoping it will help private companies in Los Angeles to expand.

"L.A. has a far more diversified economy than our neighbor to the north. L.A. has everything but a robust local venture capital network *a la* Silicon Valley," said Greif. "That being said, we are moving farther down the continuum every year to where, one day soon, early-stage companies in Southern California will enjoy the same ready access to capital as up-and-coming companies in Northern California."