EXPERT insight

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ON GOING PUBLIC

To Sink or Swim When Floating Stock

By MIGUEL CANTILLO and NICHOLAS CORBISHLEY

It has become so common for investors to lose money in the months following an IPO that some have quipped that instead of standing for "initial public offering," a better interpretation of the IPO acronym would be "it's probably overrated."

Facebook's lackluster debut, in May 2012, has only reinforced this notion. Although many of the tech IPOs that preceded Facebook's have failed to disappoint – LinkedIn's IPO, for example, saw its shares more than double on their first day of issue – some companies' weaker performance post-IPO leaves much to be desired.

For almost as long as they've been around, concerns have been voiced that IPOs are primarily being used to enrich a select few within the investment banking community along with their most prized clients, often at the expense of the very companies that the banks are being paid to take public.

Still, the IPO, despite its flaws, is an essential financing mechanism that has played a pivotal role in supporting modern economic development. It provided large-scale finance to meet the capital-intensive needs of heavy industry in the late 19th century, and has helped bankroll the early-stage development of exciting new technologies, from television in the '30s to the Internet in the '90s. See **Exhibit 1.**

In this article, we will discuss the motivations behind IPOs, how they work in practice, what companies can hope to gain from going public, and, just as importantly, the risks they might face by doing so. We will also examine the current state of play in the IPO markets, as well

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The Benefits of Going Public

Going public is one of the biggest decisions an established company can ever expect to face. Not only is the IPO process itself costly and time-consuming, but it is also one of the most transformative experiences a firm can undergo. The publicly listed company that emerges from an IPO is profoundly different from its predecessor.

That said, taking your company public can help you to accomplish a number of strategic goals. Here are a few ways that companies can benefit from going public.

A MORE EXPANSIVE EQUITY BASE. For acquisitions, an issuing company can use the equity it raises to drive future growth, as well as repay debt or working capital. Take the example of UPS, whose IPO in 1999 was the largest ever in the United States. The company used much of the $5.47 billion it raised to embark on an acquisition spree that saw it buy up strategic companies such as Challenge Air Cargo, Mail Boxes Etc. and Fritz Companies. It was also able to fund an expansion of its operations in China.

MORE DIVERSIFIED EQUITY. When one's livelihood is tied to the performance of one asset – as is the case with most private companies – one is, by nature, much more risk averse. By going public, a company can diversify its equity base, making it easier to take the calculated risks necessary to help sustain further growth.

THE CHANCE TO CASH IN. Owners and investors of the firm going public can realize a substantial cash return on the investments they have plowed into the company. The company can also reward long-serving employees and service providers by offering them stock in the company. It's worth noting, however, that there are limits to how many shares can be liquidated in the initial offering, as well as blackout periods for selling shares.

RAISED MARKET PROFILE. Another potential boon of going public is the image boost it can bring. Google, for example, used its IPO to calm fears that it was losing its countercultural soul. The motto, "Don't be evil," was enshrined in its IPO prospectus, assuring users, customers and investors alike that a publicly listed Google would honor its culture and commitments: "In the long term, we will be better served – as shareholders and in all other ways – by a company that does good things for the world, even if we forgo some short-term gains."

ENHANCED LIQUIDITY. By going public, a company can acquire more liquidity, which, in turn, enhances its value and commands a certain premium. Studying firms at the start of the 20th century, the business academic Alfred D. Chandler noted that the market price of private equity could be two or three times its actual book value, whereas publicly traded companies had a multiple of six or seven times their book value.

Not Without Risks

Admittedly, all of these benefits have their limits, otherwise all companies would eventually become and remain public, when the reality is that very few actually do. The fact is, when

EXECUTIVE SUMMARY

While it's understandable why some companies, like Facebook, might choose to go public at this stage of their growth, the IPO process itself is costly and time-consuming, and can transform a firm beyond recognition. Facebook's lackluster debut, in May 2012, has only reinforced long-standing concerns that IPOs are primarily being used to enrich a select few within the investment banking community along with their most prized clients, often at the expense of the very companies that the banks are being paid to take public.

This article discusses the motivations behind IPOs, how they work in practice, what companies can hope to gain from going public, and, just as importantly, the risks they might face by doing so. It also examines the current state of play in the IPO markets, as well as the possibility of another dot-com bubble taking shape.

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deciding to go public, companies face a number of considerable risks.

AGENCY PROBLEMS. After going public, a company's owners and/or investors no longer have a large enough stake to monitor the actions of management. These so-called "agency problems" worsen whenever it is difficult to convey information to outsiders, or when managers can easily divert value from a company in which they have no significant stakes.

COSTS. Operating a publicly listed company entails substantial legal, accounting and marketing costs. In addition, regulations require that company information be disseminated publicly. Suddenly, valuable information concerning your profit, your margins and your days of accounts payable and receivable is there for everyone, from clients to suppliers to competitors, to see. Such information can be of benefit to competitors, and strategically bad for your company.

CHANGE OF CULTURE. Arguably the biggest risk of going public is the damage it can do to the corporate culture. A recent article in *Wired* magazine observed: "Going public might be good for a company's investors and employees, but it is usually bad for the company itself. It forces CEOs to focus on short-term stock fluctuations at the expense of long-term growth."

This was the main gripe of Greg Smith, a Goldman Sachs executive who published an op-ed in *The New York Times* in March 2012 laying out the reasons behind his resignation from the investment bank. He complained of a "toxic environment" that, he claimed, had gripped the firm ever since it went public in the late '90s. Though his description of Goldman Sachs's pre-IPO past may be romanticized, his broadside does warrant honest discussion of how going public can impact a company's culture.

Tips When Going Public

To navigate the IPO minefield with success, here are some key areas that deserve close attention.

BUILD A STRONG TEAM OF UNDERWRITERS. Once a company has made the decision to go public, the first step is to file with the respective national regulatory authority, such as the Securities and Exchange Commission in the United States. As soon as the prospectus has been approved by the regulator, the focus turns to attracting investors.

This responsibility falls to a syndicate of underwriters. Typically, these are investment banks that use their established reputations to convince their clients of a company's value in exchange for a commission of the total capital raised. Usually, the lead underwriter takes the lion's share of the commissions, which may add up to 7 percent of the total value of the shares sold.

A company going public must choose its underwriters carefully. The strength of the relationship that the issuing company builds with the underwriting syndicate is likely to be one of the key factors in the success of its initial offering.

Most importantly, the lead underwriter must have enough prestige and influence on the international stage to convince retail and institutional investors of the issuer's potential for high performance and, with it, healthy returns.

During the period leading up to the IPO, no one involved with the company is allowed to talk publicly about anything that isn't in the prospectus. Meanwhile, the underwriter will be inviting potential investors to indicate the amount they are willing to buy, and the price they are willing to pay.

This approach, often referred to as bookmaking, enables underwriters to generate, capture and record investor demand for shares in an IPO in order to support efficient price discovery.

The issuing company must also choose how to dispose of its shares in the IPO, for which there are two generally accepted methods: the firm commitment and best effort methods. The difference between these two approaches is that, in the firm commitment model, the investment banker guarantees the issuing company that it will obtain the full capital, whereas in the best

IPOs' Evolving History

EXHIBIT 1

The IPO has enjoyed a surprisingly long life, dating back to the first ever company to issue stocks and bonds: the Dutch East India Company, founded in 1602. Since then, IPO activity has evolved through three key stages.

The first stage of IPO activity was during the 1700s, when British textile manufacturers began to offer the merchant and middle classes the chance to own a piece of their enterprises.

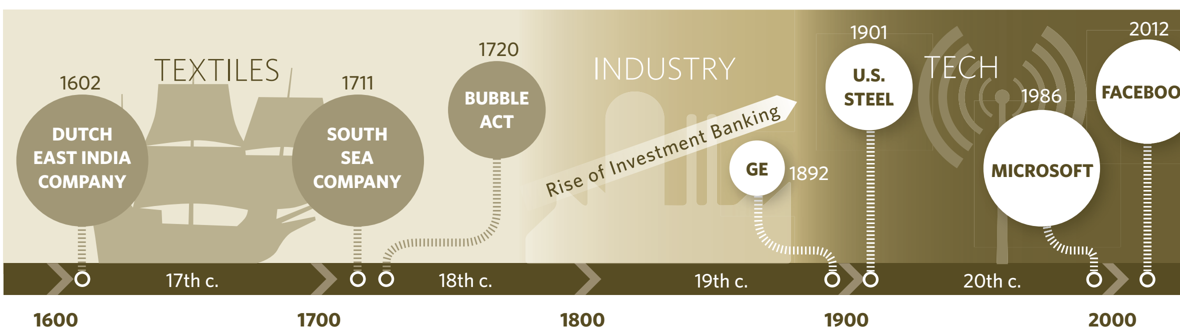
One of the largest IPOs of this period was the South Sea Company, which had a monopoly on trade in Spain's South American colonies. In a short space of time, the company's stock price jumped 10-fold, and the first stock-market "bubble" was born. When it burst, thousands of investors were wiped out, leading the British Parliament to pass the Bubble Act.

By the late 1800s, the second wave of IPO activity had shifted to the United States and Germany, where large-scale finance was required to build factories and lay railroad tracks.

This period also saw the rise of the investment bank, which would come to play a major role in helping firms set the value of their shares, as well as find buyers for them, prior to their IPOs. J.P. Morgan's underwriting of many corporations in the early 1900s, including merging Andrew Carnegie's many business interests to form U.S. Steel, epitomized this era.

A look at the Dow Jones 30 today reflects the third shift in the IPO mix: Of the industrial stocks that dominated the index when the Dow was formed, hardly any remain today. The rest date to the middle and later decades of the 20th century, when new technology sectors, such as Microsoft, began issuing stock.

This more or less defines IPOs today: more telecom and computer technology, as well as more retail and consumer goods.



effort model, the bank does not guarantee it will do so. A significant majority – around two-thirds of IPOs – are executed through the firm commitment method, which is perhaps unsurprising given the firmer guarantees it offers issuers.

PRESERVE THE BEST OF YOUR CORPORATE CULTURE. To minimize the risk of damage to their corporate culture, companies should pay particular attention to market timing and assembling the right management team.

According to Ernst & Young's *Guide to Going Public*, rather than trying to time the market, companies should make sure they enter the IPO arena only when *they* are truly ready.

To do this, a firm's top managers must have the experience and skills necessary not only to manage the IPO transaction but to operate the public company that emerges.

This requires that the people at the top set the right tone. Take the issue of the wealth generated by going public, which can open up fissures and drive wedges between managers and employees. Envy and resentment may fester as some staff cash in their shares and flaunt their newfound wealth. Newly minted millionaires may lose their motivation to work, or simply abandon ship, leaving less rewarded colleagues to pick up the slack.

Recognizing that bad blood can easily develop, Google cofounders Sergey Brin and Larry Page made it clear to their employees that if they wanted to buy a fancy car, they weren't to bring it into the company parking lot. Lise Buyer, a former investment banker who guided Google through its IPO, has stated that if the top mana-

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gers "handle it graciously," then the rest of the organization "tends to handle it graciously."

GET A "FAIR" LAUNCH PRICE. In recent years, IPOs have been heavily criticized for the widespread practice of underpricing – that is, deliberately pricing an IPO below its market value.

On the face of it, there may be legitimate grounds for doing so: No one can be 100 percent sure beforehand at which level the stock will eventually trade; companies need some way to encourage investors to take up their offer; regulations may require it; and frankly, no one wants to burn clients with wildly overvalued stock that loses value early in the game, as recently happened with the Facebook IPO, which at the time of writing was trading well below its issue price.

In a recent interview at IESE Business School, John Reed, former Chairman of the New York Stock Exchange and prior to that CEO of Citigroup, said that underpricing was understandable: "Remember, the people who are pricing are the people who are selling. They're interested in having customers who are loyal to them, and if you give them a good deal, they're going to be more loyal to you. The worst thing that could happen to you if you are a bank is to misprice something so badly that you will get investors who pay too much: to put something out at $25 and have it worth $15 in two weeks. That destroys confidence. Everybody you sold it to says, 'I'll never buy from you again!' So, the motivation of sellers is always to underprice, because they're trying to make sure that the next time they have something to sell, they're able to sell it."

This might explain the last-ditch efforts of lead underwiter Morgan Stanley to prop up Facebook's flagging offering on the first day of trading. As understandable as this may be, Reed also acknowledged that the existing arrangement represented "a bad combination of forces."

Jay R. Ritter, a finance professor at the University of Florida's Warrington College of Business Administration and a leading expert on IPOs, has found that underpriced share allocations are sometimes used by underwriters to "enrich buy-side clients in return for quid pro quos ... to curry favor with the executives of other prospective IPO issuers ... or even to influence politicians."

In effect, underwriters are intentionally leaving more money on the table than necessary in order to allocate shares to their most favored clients. Then, when the stock jumps in price on its first day of trading, hundreds of millions of additional dollars can be made by investors virtually overnight.

This was commonplace during the heady dot-com boom years. Research by finance professors Alexander Ljungqvist and William J. Wilhelm shows that average first-day returns on IPOs increased from about 17 percent in 1996 to 73 percent in 1999, and Internet IPOs averaged a "stunning" 89 percent during 1999 and 2000. The experience of LinkedIn's IPO in 2011, which saw prices more than double on the first day of trading, suggests that underpricing is still with us.

Given this state of affairs, for a company to maximize the value of its IPO proceeds, its management must play a central role in the price discovery process.

"The people who have to fight back are the management," said Reed. "They have to say, 'Hey, it's not fair for us to get a bad price'."

Reed cited an example from when he sat on the board of Monsanto and was preparing for its

ABOUT THE AUTHORS

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IPO. As the company was a spin-out from Pharmacia, "We had a fair idea of what the company was worth because it wasn't a start-up. So, we were able to insist (on a fair share price)."

Unfortunately, as Reed noted, most companies "are at a disadvantage because they don't understand what the market is going to be worth."

This is especially difficult "if you are 28 years old and they say your company is worth $4 billion but it's really worth $6 billion. You don't know. You can't even imagine what $4 billion is worth, so who cares if you underprice it? That's the phenomenon we are now witnessing."

CONSIDER HOW YOU WANT TO ISSUE SHARES. Despite all the effort to avoid overpricing, so that share prices don't take a nosedive on the first day of trading, most public offerings tend to see their prices beginning to flounder over the ensuing months. This suggests that while economic fundamentals may have little bearing on the first day's trade, they certainly come into play during the medium to long term, being manifested in weaker share-price performance over time.

For example, of the four big tech IPOs in 2011 – LinkedIn, Pandora, Zynga and Groupon – shares in Zynga are down around 40 percent from their original IPO price, while Groupon shares have lost close to 50 percent of their IPO value.

There are exceptions. Google, for instance, was trading around $600 per share in April 2012, compared with its initial 2004 IPO price of $85 per share. It has achieved this despite opting to issue its shares via a so-called Dutch auction, designed to both democratize IPO share allocation and afford companies and early investors the best price for their shares.

This system of share allocation was used, for instance, by Jim Koch, founder of Boston Beer Company, and William R. Hambrecht, a prominent Silicon Valley venture capitalist.

When Koch decided to take his brewery public in 1995, he was determined to do it in such a way that it primarily served the interests of the business and its customers, instead of rewarding the banks and their favored institutional investors. The model Koch and Hambrecht devised, which has come to be known as Open IPO, is based on price auctions.

In the case of Boston Beer Company, the company sold its shares at two different prices. Customers were offered $15 a share, while those who bought at the opening price in a public offering run by Goldman Sachs had to pony up $20.

Although they have encountered stiff resistance from some quarters of the investment banking community, Open IPOs are a viable alternative, as they allow for equal access to the allocation of shares and eliminate the behind-the-scenes dealings of shares often found in conventional IPOs.

Facebook's pre-launch road show raised some concerns along these lines. According to Reuters, the lead underwriters disclosed lowered forecasts to preferred investors only, instead of to all investors. Given the perceived lack of transparency, democratizing the allocation of shares and providing more equal access to vital market information can only be a move in the right direction.

CHOOSE THE RIGHT MARKET FOR YOUR LAUNCH. While American IPO activity has dropped off somewhat over the past decade, global IPOs are playing a greater role in the public launch of non-U.S. firms. According to Ernst & Young's Global IPO Trends 2011, global IPOs made up 31 percent of total capital market activity, much of it centered on Asia. This means that more and more companies are launching operations beyond their domestic markets.

According to Reed, this reflects the fact that "the world is seeing a globalization of wealth. The wealth is accumulating around the world, and as it accumulates, you will see a dispersion of market activities. A market is simply a place that brings investors together with people who need the money. So, if the investors are in Asia, then there are going to be many people who go to Asia."

Asian issuers, particularly Singapore and Hong Kong, have led IPO activity since 2006, says Ernst & Young, generating up to 65 percent of global proceeds. Hong Kong has attracted the

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most public offerings in the world since 2009, raising roughly twice as much as New York's stock exchanges. See **Exhibit 2**.

Stock exchanges in Asia have even begun to attract prestigious Western names, including Glencore and Manchester United. With companies such as Prada choosing to launch in Hong Kong instead of the traditional Western markets, Asia is fast becoming an important launch pad for many luxury goods companies.

As the *Financial Times* reported in August 2011, "The surge in interest is both a reflection of Western equity market woes, and Asia's rising viability as a flotation venue. Europe in particular has proven inhospitable recently. Many companies have had to shelve IPO plans due to lackluster demand, and the poor performance of many newly listed companies has led investors to demand lower prices."

Yet one mustn't be too quick to write off the Western markets. One survey predicted that the United States was on its way to becoming the star of the global IPO market for 2012, having accounted for a significant percentage of the global proceeds raised as of March. The IPO pendulum may be swinging Stateside again.

Latest Moves to Jump-Start IPOs

The companies going public today tend to be large and well-established. With bank lending all but drying up in the wake of the 2007-08 financial crisis, concerns are growing that smaller firms – by far, the most important generators of new private-sector jobs – may be facing a funding drought.

Certainly, small firms are going public far less than they used to. According to the University of Florida's Ritter, during the 2000s decade, the number of small firms launching IPOs fell by more than 80 percent with respect to the previous two decades.

In an attempt to address this issue, the U.S. Congress recently passed the Jumpstart Our Business Start-ups (JOBS) Act, which has attracted equal measures of praise and opprobrium.

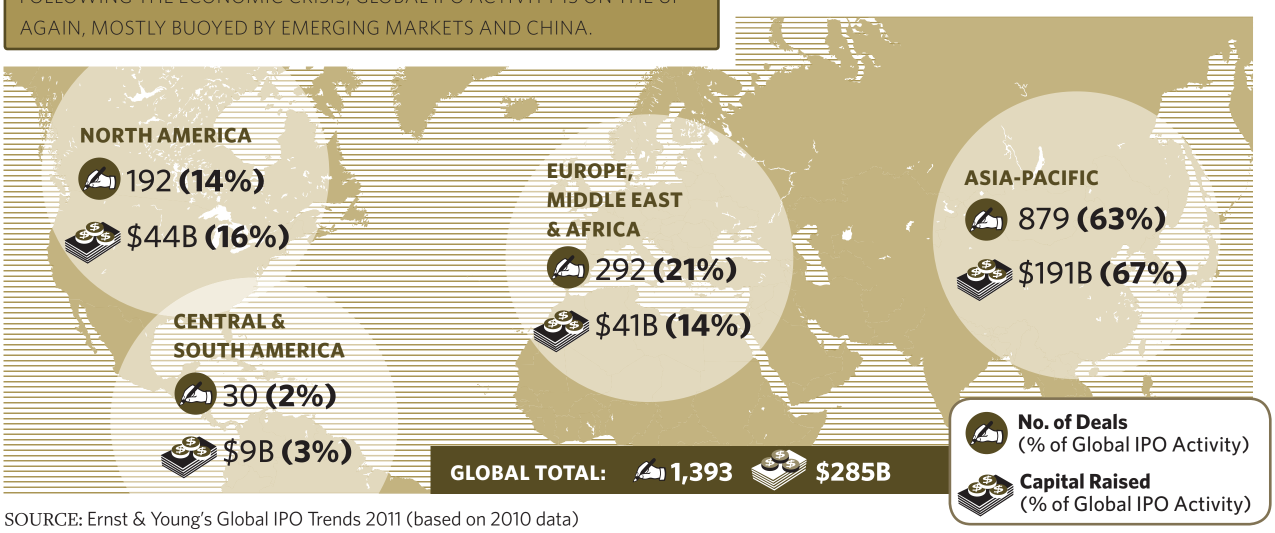
Supporters say the JOBS Act will make it cheaper to go public by exempting start-ups from independent accounting requirements in their first five years after an IPO.

Critics, on the other hand, say the JOBS Act repeals many of the existing rules designed to protect investors from the conflicts of interest that damaged the IPO market during the late '90s, including the division that was erected between analysts and investment bankers. They fear that the JOBS Act may diminish some of the

EXHIBIT 2

Global IPOs by Region

FOLLOWING THE ECONOMIC CRISIS, GLOBAL IPO ACTIVITY IS ON THE UP AGAIN, MOSTLY BUOYED BY EMERGING MARKETS AND CHINA.



SOURCE: Ernst & Young's Global IPO Trends 2011 (based on 2010 data)

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deterrent effect of the 2002 Sarbanes-Oxley Act, which was enacted specifically to deal with the lax accounting standards that led to several high-profile corporate frauds.

According to Reed, "These arguments always get exaggerated: Businessmen always think the world would be much easier if they didn't have to obey all these 'stupid' rules, and the market insists that there be some discipline."

"I think history makes very clear that rules help. Ask a person why a car has brakes. Most people say a car has brakes so that it can stop, but that's not true. A car has brakes so that it can go fast." In the same way, rules are needed in financial markets so that businesses can operate "with confidence and energy."

Reed takes a pragmatic approach to these revived debates over whether more or less regulation would be best for IPO activity: "I do think it's in everybody's interest to have confident markets, and to make sure that you know what you're buying."

One Bubble Too Many?

One question arising for investors is whether the latest wave of IPOs, as epitomized by Facebook, may signal another dot-com bubble in the making. More to the point, given the below-par performance of some of the latest market entrants, are we on a collision course for another dot-com bubble to be burst? Are today's IPO valuations growing completely unhinged from market fundamentals?

Probably not, say most observers. For one thing, today's tech firms have much more revenue and cash flow than those of the previous era. Also, markets are facing much greater pressures than they were in the mid to late '90s, when macroeconomic conditions were rather more favorable. Today, most countries in the West are grappling with an ever-worsening debt spiral. Despite concerted efforts by central banks to reinvigorate their markets, credit remains tight.

So, while some may long for the boom years of the '90s, there doesn't appear to be enough investor appetite to fuel another bubble. Quite simply, most retail investors do not have the disposable cash they used to.

With twice-bitten investors still nursing wounds, not only from the dot-com bust, but also from the more recent real-estate crash, they are unlikely to flock en masse to embrace every IPO that might come down the pike.

The Facebook flop has only reinforced this market wariness, rather than serving as "the spark that would rev up the market," as many had anticipated, according to *The New York Times*. Quoting market analysts as saying, "The current market is on hold," "It's pretty ugly out there" and "It's going to be a slow summer," the article noted that would-be issuers are taking "a second look at what they're getting into."

Given the acceleration of boom/bust cycles and the damaging aftershocks they triggered throughout the world economy, perhaps this is not such a bad thing. □

TO KNOW MORE

- Watch "The Ins and Outs of IPOs," an exclusive podcast with John Reed, former Chairman of the New York Stock Exchange and previously CEO of Citigroup, at www.ieseinsight.com

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