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IPO Basics Tutorial

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Introduction

The term initial public offering (IPO) slipped into everyday speech during the tech bull market of the late 1990s. Back then, it seemed you couldn't go a day without hearing about a dozen new dotcom millionaires in Silicon Valley who were cashing in on their latest IPO. The phenomenon spawned the term siliconaire, which described the dotcom entrepreneurs in their early 20s and 30s who suddenly found themselves living large on the proceeds from their internet companies' IPOs.

So, what is an IPO anyway? How did everybody get so rich so fast? And, most importantly, is it possible for mere mortals like us to get in on an IPO? All these questions and more will be answered in this tutorial.

What Is An IPO?

Selling Stock
An IPO is the first sale of stock by a company to the public. A company can raise money by issuing either debt or equity. If the company has never issued equity to the public, it's known as an IPO.

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Companies fall into two broad categories: private and public.
A privately held company has fewer shareholders and its owners don't have to disclose much information about the company. Anybody can go out and incorporate a company: just put in some money, file the right legal documents and follow the reporting rules of your jurisdiction. Most small businesses are privately held. But large companies can be private too. Did you know that IKEA, Domino's Pizza and Hallmark Cards are all privately held?

It usually isn't possible to buy shares in a private company. You can approach the owners about investing, but they're not obligated to sell you anything. Public companies, on the other hand, have sold at least a portion of themselves to the public and trade on a stock exchange. This is why doing an IPO is also referred to as "going public."

Public companies have thousands of shareholders and are subject to strict rules and regulations. They must have a board of directors and they must report financial information every quarter. In the United States, public companies report to the Securities and Exchange Commission (SEC). In other countries, public companies are overseen by governing bodies similar to the SEC. From an investor's standpoint, the most exciting thing about a public company is that the stock is traded in the open market, like any other commodity. If you have the cash, you can invest. The CEO could hate your guts, but there's nothing he or she could do to stop you from buying stock.

Why Go Public?
Going public raises cash and usually a lot of it. Being publicly traded also opens many financial doors:

- Because of the increased scrutiny, public companies can usually get better rates when they issue debt.
- As long as there is market demand, a public company can always issue more stock. Thus, mergers and acquisitions are easier to do because stock can be issued as part of the deal.
- Trading in the open markets means liquidity. This makes it possible to implement things like employee stock ownership plans, which help to attract top talent.

Being on a major stock exchange carries a considerable amount of prestige. In the past, only private companies with strong fundamentals could qualify for an IPO and it wasn't easy to get listed.

The internet boom changed all this. Firms no longer needed strong financials and a solid history to go public. Instead, IPOs were done by smaller startups seeking

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to expand their businesses. There's nothing wrong with wanting to expand, but most of these firms had never made a profit and didn't plan on being profitable any time soon. Founded on venture capital funding, they spent like Texans trying to generate enough excitement to make it to the market before burning through all their cash. In cases like this, companies might be suspected of doing an IPO just to make the founders rich. This is known as an exit strategy, implying that there's no desire to stick around and create value for shareholders. The IPO then becomes the end of the road rather than the beginning.

How can this happen? Remember: an IPO is just selling stock. It's all about the sales job. If you can convince people to buy stock in your company, you can raise a lot of money

Getting In On An IPO

The Underwriting Process
Getting a piece of a hot IPO is very difficult, if not impossible. To understand why, we need to know how an IPO is done, a process known as underwriting.

When a company wants to go public, the first thing it does is hire an investment bank. A company could theoretically sell its shares on its own, but realistically, an investment bank is required - it's just the way Wall Street works. Underwriting is the process of raising money by either debt or equity (in this case we are referring to equity). You can think of underwriters as middlemen between companies and the investing public. The biggest underwriters are Goldman Sachs, Merrill Lynch, Credit Suisse First Boston, Lehman Brothers and Morgan Stanley.

The company and the investment bank will first meet to negotiate the deal. Items usually discussed include the amount of money a company will raise, the type of securities to be issued and all the details in the underwriting agreement. The deal can be structured in a variety of ways. For example, in a firm commitment, the underwriter guarantees that a certain amount will be raised by buying the entire offer and then reselling to the public. In a best efforts agreement, however, the underwriter sells securities for the company but doesn't guarantee the amount raised. Also, investment banks are hesitant to shoulder all the risk of an offering. Instead, they form a syndicate of underwriters. One underwriter leads the syndicate and the others sell a part of the issue.

Once all sides agree to a deal, the investment bank puts together a registration statement to be filed with the SEC. This document contains information about the offering as well as company info such as financial statements, management background, any legal problems, where the money is to be used and insider

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holdings. The SEC then requires a cooling off period, in which they investigate and make sure all material information has been disclosed. Once the SEC approves the offering, a date (the effective date) is set when the stock will be offered to the public.

During the cooling off period the underwriter puts together what is known as the red herring. This is an initial prospectus containing all the information about the company except for the offer price and the effective date, which aren't known at that time. With the red herring in hand, the underwriter and company attempt to hype and build up interest for the issue. They go on a road show - also known as the "dog and pony show" - where the big institutional investors are courted.

As the effective date approaches, the underwriter and company sit down and decide on the price. This isn't an easy decision: it depends on the company, the success of the road show and, most importantly, current market conditions. Of course, it's in both parties' interest to get as much as possible.

Finally, the securities are sold on the stock market and the money is collected from investors.

What About Me?
As you can see, the road to an IPO is a long and complicated one. You may have noticed that individual investors aren't involved until the very end. This is because small investors aren't the target market. They don't have the cash and, therefore, hold little interest for the underwriters.
If underwriters think an IPO will be successful, they'll usually pad the pockets of their favorite institutional client with shares at the IPO price. The only way for you to get shares (known as an IPO allocation) is to have an account with one of the investment banks that is part of the underwriting syndicate. But don't expect to open an account with $1,000 and be showered with an allocation. You need to be a frequently trading client with a large account to get in on a hot IPO.

Bottom line, your chances of getting early shares in an IPO are slim to none unless you're on the inside. If you do get shares, it's probably because nobody else wants them. Granted, there are exceptions to every rule and it would be incorrect for us to say that it's impossible. Just keep in mind that the probability isn't high if you are a small investor.

Don't Just Jump In

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Let's say you do get in on an IPO. Here are a few things to look out for.

No History
It's hard enough to analyze the stock of an established company. An IPO company is even trickier to analyze since there won't be a lot of historical information. Your main source of data is the red herring, so make sure you examine this document carefully. Look for the usual information, but also pay special attention to the management team and how they plan to use the funds generated from the IPO.

And what about the underwriters? Successful IPOs are typically supported by bigger brokerages that have the ability to promote a new issue well. Be more wary of smaller investment banks because they may be willing to underwrite any company.

The Lock-Up Period
If you look at the charts following many IPOs, you'll notice that after a few months the stock takes a steep downturn. This is often because of the lock-up period.

When a company goes public, the underwriters make company officials and employees sign a lock-up agreement. Lock-up agreements are legally binding contracts between the underwriters and insiders of the company, prohibiting them from selling any shares of stock for a specified period of time. The period can range anywhere from three to 24 months. Ninety days is the minimum period stated under Rule 144 (SEC law) but the lock-up specified by the underwriters can last much longer. The problem is, when lockups expire all the insiders are permitted to sell their stock. The result is a rush of people trying to sell their stock to realize their profit. This excess supply can put severe downward pressure on the stock price.

Flipping
Flipping is reselling a hot IPO stock in the first few days to earn a quick profit. This isn't easy to do, and you'll be strongly discouraged by your brokerage. The reason behind this is that companies want long-term investors who hold their stock, not traders. There are no laws that prevent flipping, but your broker may blacklist you from future offerings - or just smile less when you shake hands.

Of course, institutional investors flip stocks all the time and make big money. The double standard exists and there is nothing we can do about it because they have the buying power. Because of flipping, it's a good rule not to buy shares of an IPO if you don't get in on the initial offering. Many IPOs that have big gains on the first day will come back to earth as the institutions take their profits.

Avoid the Hype
It's important to understand that underwriters are salesmen. The whole

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underwriting process is intentionally hyped up to get as much attention as possible. Since IPOs only happen once for each company, they are often presented as "once in a lifetime" opportunities. Of course, some IPOs soar high and keep soaring. But many end up selling below their offering prices within the year. Don't buy a stock only because it's an IPO - do it because it's a good investment.

Tracking Stocks

Tracking stocks appear when a large company spins off one of its divisions into a separate entity. The rationale behind the creation of tracking stocks is that individual divisions of a company will be worth more separately than as part of the company as a whole.

From the company's perspective, there are many advantages to issuing a tracking stock. The company gets to retain control over the subsidiary but all revenues and expenses of the division are separated from the parent company's financial statements and attributed to the tracking stock. This is often done to separate a high-growth division with large losses from the financial statements of the parent company. Most importantly, if the tracking stock rockets up, the parent company can make acquisitions with the subsidiary's stock instead of cash.

While a tracking stock may be spun off in an IPO, it's not the same as the IPO of a private company going public. This is because tracking stocks usually have no voting rights, and often there is no separate board of directors looking after the rights of the tracking stock. It's like you're a second-class shareholder! This doesn't mean that a tracking stock can't be a good investment. Just keep in mind that a tracking stock isn't a normal IPO.

Conclusion

Let's review the basics of an IPO:

- An initial public offering (IPO) is the first sale of stock by a company to the public.
- Broadly speaking, companies are either private or public. Going public means a company is switching from private ownership to public ownership.
- Going public raises cash and provides many benefits for a company.
- The dotcom boom lowered the bar for companies to do an IPO. Many startups went public without any profits and little more than a business plan.

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- Getting in on a hot IPO is very difficult, if not impossible.
- The process of underwriting involves raising money from investors by issuing new securities.
- Companies hire investment banks to underwrite an IPO.
- The road to an IPO consists mainly of putting together the formal documents for the Securities and Exchange Commission (SEC) and selling the issue to institutional clients.
- The only way for you to get shares in an IPO is to have a frequently traded account with one of the investment banks in the underwriting syndicate.
- An IPO company is difficult to analyze because there isn't a lot of historical info.
- Lock-up periods prevent insiders from selling their shares for a certain period of time. The end of the lockup period can put strong downward pressure on a stock.
- Flipping may get you blacklisted from future offerings.
- Road shows and red herrings are marketing events meant to get as much attention as possible. Don't get sucked in by the hype.
- A tracking stock is created when a company spins off one of its divisions into a separate entity through an IPO.
- Don't consider tracking stocks to be the same as a normal IPO, as you are essentially a second-class shareholder

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