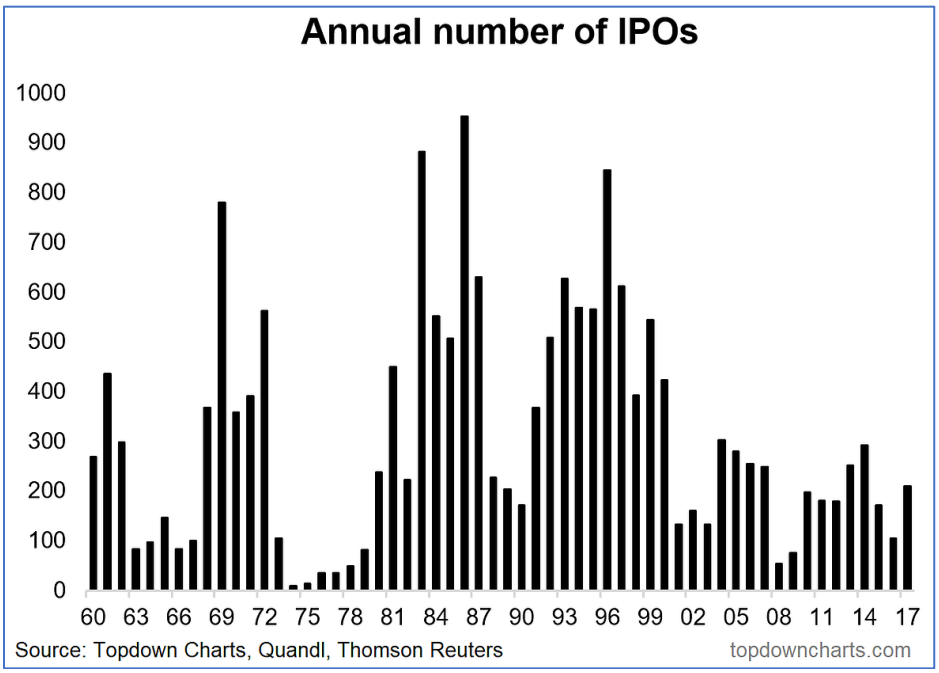
# GEEK-OUT TOPIC: Initial Public Offerings

As the name implies, an Initial Public Offering, or an IPO, is the process by which privately held companies offer their shares to the public for the first time. Privately held companies are those whose shares are typically owned by a small group of individuals or investment institutions. Most commonly, private companies are owned by founders, family members, venture capital firms, or angel investors. By taking a company public using an IPO, private investors are able to sell some of their private shares and capitalize on any growth in value, but more importantly, expanding into the public markets provides a growing company with an expanded capital base from which to raise money for future growth. Initial Public Offerings are very much top of mind these days with some very high profile private companies lining up to go public.

## The history of IPO's

The very first Initial Public Offering was made by the Dutch East India Company, which offered shares of stock and bonds to the public in 1602. Though public securities were offered before then, particularly during the Roman Republic, the Dutch East India Company was the first to be traded on an exchange. The Bank of North America was the first US company to sell shares to the public in 1782. A lot has changed since that time with the emergence of many public exchanges. The largest IPO in history was Alibaba, which raised $21.8 billion in September of 2014. To put that into perspective, the largest public company in the US by market capitalization, Microsoft (as of 3/31/19), raised just $61 million in March 1986. The number of companies that go public in any year reflects the state of the economy and the market. The following chart shows the number of IPO's annually from 1960 through 2017 and one can see the spikes that occurred in the 1980's and 1990's with a marked drop-off after the dot-com bubble burst in 2000, a year in which the amount of IPO proceeds peaked at $96 billion. Also evident is the sharp drop during the financial crisis and slow recovery in its wake.




## The Process

When a company decides to go public they assemble a team of experts which include:

- Company management and key investors
- Lawyers
- Certified Public Accountants
- Investment Bankers or Underwriters

Underwriters and bankers will advise the company on the best way to approach the markets to ensure the most successful outcome. Often the same firms will end up leading the transaction in a larger group of underwriters, referred to as a syndicate. This expert team will compile all of the necessary information including its past financial performance along with its plans and prospects for future success. This critical information is compiled into a Prospectus, which is used to provide information to prospective investors. Once the company has determined its IPO strategy, it must file a Form S-1 with the Securities and Exchange Commission. A company's Form S-1 is publicly disclosed and you can look for these on the SEC website here: https://www.sec.gov/edgar/searchedgar/companysearch.html . The SEC will then investigate the validity of the claims and work with the company to set an IPO date. A syndicate will then be formed by the lead underwriters. The syndicate is a group of registered dealers who will be responsible to sell the company's shares. The syndicate members will technically purchase the shares directly from the company before selling them to the public and the difference between their purchase price and the IPO price is how the underwriters make money. The preliminary

prospectus, which does not include pricing information, is referred to as a Red Herring Prospectus (the front page is typically printed in red ink). The red herring is circulated and the underwriters along with the company will go on a road show to determine the demand by a broader group of institutions which include investment firms and institutional buyers. Once the underwriters have a feel for the public's demand they will set price targets and create a final prospectus. Underwriters will also finalize on an exchange and an IPO date. These are both selected to provide the best possible outcome of the offering. Shares are allocated across the syndicate with the largest allocations going to the lead underwriters. The underwriters will then sell the shares to their clients and based on the demand for those shares on the day of the IPO determines where the stock will actually begin trading on an exchange.

## Pros and cons of going public

As with all things in finance, there are many things a company must consider before selling shares to the public.

### Pros

1. Access to capital – Once public, a company can raise capital beyond its IPO by issuing more stock in a secondary offering. Access to capital is critical for a company's growth.
2. Mergers and Acquisitions – Companies will often use stock to acquire other companies. Though M&A with private shares can occur, public stock makes the process simpler.
3. Compensation – A good way to incent employees and executives is through the issuance of stock bonuses. Publicly traded stock can be more easily sold making incentives more attractive.
4. Diversified ownership – A larger group of owners ensures that no single investor or group of investors will have too much influence on the company. This can be both positive or negative.

### Cons

1. Reporting requirements – Public companies have more reporting requirements than private ones and undergo significantly more scrutiny. Public company filings are available for not only investors and regulators, but also for competitors who use public filings to conduct competitive analysis.
2. Corporate governance – Public companies have more rigid governance structures which is good for investors to ensure that management is performing on behalf of shareholders. Greater governance however, can often be a burden to management who might be more comfortable and creative in the less rigid structure of a private company. Think of Mark Zuckerberg before Facebook was public versus now.
3. Management focus on the wrong things – Management, which is typically heavily compensated in stock, may be too heavily focused on stock price. Management decisions that affect near term stock performance might be chosen over ones that may be best for the long term health of the company.

4. Increased operating costs – Many employees and professionals are involved in the required ongoing filing and communications with shareholders adding to the expense burden of a company. Additionally, professionals such as accountants and lawyers must be on constant retainer adding additional costs.

## Things to consider when buying an IPO

Many smaller retail investors are unable to get a stock allocation at the IPO price and are forced to purchase stock in the open market once the shares start trading. In a hot IPO, a stock's price will often exceed its offering price, significantly adding risk to the investor. When considering an IPO, investors should consider the following:

- The financial viability of the company – based on the available financial data, can a company achieve its stated goals with available capital? Additionally, are the company's sales and financial objectives achievable given the market and economy?
- Strength and diversity of management – a great plan is only good for investors if execution is flawless. Investors should be confident that the management team has the necessary experience and seasoning to ensure success in reaching strategic goals.
- Expected return – This is a big one. Many investors decide to invest in newly public stocks based on hype from friends, colleagues, and the media without considering the risk of financial loss. History shows that IPO shares have a greater chance of going down than up in the period after the IPO. Once the hype dies down shares ultimately trade down. Investors need to consider investment objectives. How long does an investor plan to hold an investment? Can the stock feasibly trade up in that timeframe? As newly public stock does not typically pay dividends, will a long period of no return be risky for the investor?

Clearly there are many more factors that need to be considered when deciding whether to invest in an IPO. In addition to aforementioned considerations, investors should consult a financial advisor who would have access to more information and would be able to determine if the risks associated with the investment are appropriate.

## Conclusion

Initial Public Offerings are popular way for private companies to access capital markets through the sale of publicly traded stock. For the offering companies there are pros and cons that come with the public offering. Some positives include access to new capital and ease of M&A transactions. Some of the negatives include increased costs, strict management structures, and increased reporting requirements. While IPOs often attract retail investors due to media hype, strict investment analysis should be conducted with the help of professionals to minimize risk and loss of capital.

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DISCLOSURE