

BUS 1003 - Literature Review

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By submitting this paper, I affirm that this work is my own except for where the words or ideas of others are specifically acknowledged. I also affirm that this work did not exist before the beginning of the course for which it is submitted.

Target Audience

This paper was written for my Rushmore MBA course advisor's review, and for viewing by other MBA students as an example to help them with their MBA program.

Purpose of this Paper

The purpose of this assignment was to develop my research and writing skills using the *Literature Review*¹ approach.

Executive Summary

The owners of the company I worked for wanted to triple its size through acquisitions with the ultimate goal of going public. The owners needed capital to accomplish the acquisitions, so they sold a majority interest in the company to an equity fund group. This occurred in 1998-1999 at the peak of our company's profitability. Acquisitions were made just before the decline of the automotive industry and a downturn in the economy. This put the company in a situation of declining profits and increasing debt. Divisions

¹ A literature review, according to Dena Taylor, Director, Health Sciences Writing Centre, and Margaret Procter, Coordinator, Writing Support, University of Toronto, is an account of what has been published on a topic by accredited scholars and researchers. It is for acquiring knowledge about a topic and for demonstrating the ability to scan literature efficiently and to critically analyze it instead of just summarizing the available material.

were sold and others were closed, and no IPO (Initial Public Offering) was realized. This experience gave me an interest in IPOs and venture capital.

The topic of this paper is Venture Capital Backed IPOs. My goal was to learn about venture capital; how the VC investment and IPO processes work. I also want to address two questions: how have the present economic conditions affected VC firms' exit strategy, and is there a solution to the problem of underpricing IPOs?

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Introduction

Whether you are starting a new business or wanting to grow an existing business, you need capital. Capital comes from various sources, including personal savings, bank loans, business profits, personal investors, and venture capital (VC). VC is a common source of funding fast-growing companies whose goal is to go public, a process referred to as an Initial Public Offering (IPO).

IPOs and VC-Backed IPOs have had a roller coaster ride of success from the past boom of .com companies to the present economic changes. The main goal of private companies, VC firms and investment banks remains the same – achieve the highest return possible on every investment. The path to getting there has changed, however. The present economy has

caused investors to perform more thorough due diligence before taking the leap into investments. Investors are requiring companies to show a higher level of proof of their profitability and probability of success before investing. David Furlong, Vice President and Research Director at GartnerG2 said, "Now you almost have to show revenue, clients and product..."²

Venture Capital Process

Venture capital firms differ from banks by investing from a long-term gain perspective rather than short-term interest return on their investment. Ashton Hudson emphasizes that, "They [venture capitalists] are entrepreneurs first and financiers second."³ Gary L. Moreau wrote an excellent article that explains how venture capital investing contrasts with traditional financing. Moreau states that venture capitalists are experts in valuing companies that are difficult to value by traditional methods. This is because companies that need venture capital funding are new startups or have developed a product and are ready to start production. In either case, the revenue stream and assets of the company are not established, which is what traditional lenders rely on to minimize their risk.⁴

Venture capital is higher risk compared to other types of investments because of the uncertainty associated with new startups or high growth companies. With higher risk comes the expectation of higher reward. "A common estimate is that they [venture capitalists] look for three to five times their investment in five or seven years. Of course venture capitalists don't realize capital gains on all their investments, and they certainly don't make capital gains of 300 percent to 500 percent except on a very limited portion of their total investments. But their intent is to find venture projects with this appreciation potential to make up for investments that aren't successful."⁵ A study performed by Ibbotson Associates, a Chicago asset allocation and consulting firm, has shown that between 1960 and 1999 venture capital funds have returned a 45% annual average return compared to that of the Standard & Poor 500 index of 13.34%, and Small Cap index of 17.16% for the same period. This report also shows that VC

² Grant, Elaine X. "What Shareholders Don't Know About High-Tech Venture Capital." 8 April 2002. 17 September 2002 <<http://www.ecommercetimes.com/perl/printer/17123>>

³ Hudson, Ashton. "A Venture Capital Primer." November 1999. 22 August 2002 <<http://www.law.wfu.edu/courses/secreg-Palmiter/handout/ashton-hudson/vc.html>>

⁴ Moreau, Gary L. "Venture Capital: It's All About Valuation." May 2001. 29 September 2002 <http://www.viaventurecapital.com/all_about_valuation.htm>

⁵ Hosmer, LaRue Tone. "A Venture Capital Primer For Small Business." Date Unknown. 25 August 2002 <<http://www.sba.gov/library/pubs/FM-5>>

investments have a risk factor of approximately 115%. Therefore, returns can range 115% above and below the 45% average.⁶

The Fund

Venture capital firms create a *Fund* of a fixed amount of money (capital) obtained from wealthy individuals, corporations, pension funds, banks, and endowments. The major portion of the fund comes from these outside investors and the minor portion from the VC firm. The total capital of the fund is in the \$50-\$200 million range, and the fund is typically structured as a limited partnership. The fund invests its entire capital in 20-30 companies, and considers investments in the \$250,000 to \$9,000,000 range. Projects smaller than this are typically not considered because the investigation and administration costs would be too high a percentage of the project. Projects larger than this range includes acquisitions and leveraged buyouts. The average VC deal, according to the PricewaterhouseCoopers survey, has been approximately \$8 million in 2001 and the first two quarters of 2002.

Venture Investment By Quarter

Time Period	No. of Deals	Avg Per Deal (\$ mil)	Sum Inv. (\$mil)
1999-1	947	7.14	6759.16
1999-2	1382	8.41	11622.78
1999-3	1498	9.05	13550.35
1999-4	1979	12.28	24308.5
2000-1	2224	13.24	29451.46
2000-2	2245	13.09	29393.59
2000-3	2033	13.25	26930.34
2000-4	1876	12.13	22759.89
2001-1	1401	9.64	13503.91
2001-2	1363	8.74	11916.43
2001-3	1108	7.90	8753.67
2001-4	1039	8.15	8472.89
2002-1	832	7.74	6441.09
2002-2	857	7.02	6016.56

Source: PricewaterhouseCoopers/Venture Economics/National Venture Capital Association MoneyTree Survey

An established venture capital firm typically receives over 1,000 proposals a year. Most proposals are rejected because they don't fit the investment strategy of the firm. VC firms stay within specific geographical, technical,

⁶ EarlyBirdCapital Home Page. "Why Venture Capital." 17 September 2002
http://www.earlybirdcapital.com/Misc/VC_why_invest.asp

and market areas. Proposals that don't match these criteria and those that are poorly prepared are easily rejected.

The remaining proposals, approximately 10 percent of those received, are investigated thoroughly. These investigations are expensive because consultants may be hired to evaluate the company's product or service. The market size, competitive position of the company, production costs and present and potential customer base are assessed. An auditor confirms the financial condition of the company; most importantly, the character and competence of the management team is evaluated.⁷ VC firms look for an experienced management team that can execute the proposed business plan. If a complete management team is not in place, the VC firm can often help to build the team once the investment has been initiated.

Ownership

VC firms are equity partners in the company and do not typically take an active role in running the operations. They will provide financial and industry expertise, contacts, and recruiting help as needed. VC firms will demand some portion of control in the company by having a position on the board of directors, or by having a majority ownership.

The percentage of VC ownership in the company varies and depends upon the amount of VC money provided, the value of the business, and the anticipated investment return. Most VC firms target an ownership of less than 40%, which leaves at least 60% ownership with the company as an incentive to continue to build the business. "In the final analysis, however, the venture firm, regardless of its percentage of ownership, really wants to leave control in the hands of the company's managers, because it is really investing in that management team in the first place."⁸

Control

The VC funding firm has little interest in taking control of the day-to-day operations of the company. These firms typically do not have the technical expertise or the managerial personnel to run the 20-30 companies in which they have invested. They do, however, participate by taking an advisory role in the company's financial and strategic planning matters. VC firms will maintain continuous communication with company

⁷ Hosmer, LaRue Tone. "A Venture Capital Primer For Small Business." Date Unknown. 25 August 2002. <<http://www.sba.gov/library/pubs/FM-5>>

⁸ Ibid.

management to take the pulse of company operations – it has more to do with involvement than control.⁹

Stages of Investment

“Some venture capital firms make their initial investment at the seed or early stage phase and then continue to participate in subsequent investment rounds right through to the Pre-IPO stage.”¹⁰ Not all VC funds, however, are invested in new, start-up companies – investments are also made in companies at various business stages of the company where capital is needed. Investing at a start-up or early stage, as opposed to making an investment in a growth stage for a mature company, means that it will take longer to bring the investment to the point of exit. Venture capital stages are:¹¹

Early Stage Financing (\$25,000-250,000)

Seed Capital: Provided to prove a concept and to qualify for start-up capital. Primarily for product development and market research.

Start-up Capital: Provided for completing product development and initial marketing. Company has completed business plan. Companies may be in the process of organizing or they may have been in business for one year or less, but have no commercial sales yet.

Expansion Stage Financing (\$500,000-5,000,000)

First-Stage Financing: Provided for full-scale manufacturing and sales.

Second-Stage Financing: Essential working capital for the initial expansions of a company. It is in production and shipping, and has growing receivables, inventories, and payables. The company may not yet be profitable.

Third-Stage or Mezzanine Financing: Provided for major expansion of a company that is breaking even or profitable, with increasing sales. Funds are used for working capital, new products development, and further plant expansion.

Fourth-Stage or Bridge Financing: Financing for a company that plans to go public within six months to a year. The financing can be repaid from the proceeds of the IPO. It can also involve restructuring or major stockholder positions through secondary transactions. Restructuring is

⁹ NewSpring Ventures Home Page. “About Venture Capital.” 17 September 2002
<http://www.newspringventures.com/venture_cap.html>

¹⁰ Global Finance Online Home Page. “Venture Capital Overview.” 16 September 2002
<<http://www.globalfinanceonline.com/venture-capital-overview.html>>

¹¹ Venture Planning Associates Home Page. “Venture Capital Process.” 2 October 2002
<<http://www.globalfinanceonline.com/about-venture-capital.html>>

undertaken if there are early investors who want to reduce or liquidate their positions.

Acquisition Financing (\$3,000,000-20,000,000)

Funds provided to finance the acquisition of another company. Also high interest 'junk' bonds may be used, or substantial debt from banks.

Exit Strategy

Venture capitalists look for 30-40% annual return on investment and for a total return of 5 to 10 times their investment over a 3 to 5 year investment period. They recoup their investment and profits at the end of the investment period, which is determined by the exit strategy. The most common forms of exit are: merger with another company; acquisition by another company; IPO; or management buyout.

Exit Problem 2002

The present downturn in the economy that began in 2001 has had a dramatic effect on the exit strategies of venture capital firms. At the height of IPOs from the dot.com boom, exit routes via IPOs and mergers were quick and easy. Public interest in buying IPO stock was at its peak. The problem now is that 20-30 investments made by a fund are tied up with fewer opportunities for exit. "The limited partners of VC funds are getting edgy. What's more, nobody is in the mood to tie up money for the five years of more it takes typically for high-risk venture to bear fruit."¹² Venture capital firms are under pressure from their investors to improve performance in a slow economy, which has led firms to reduce fees and return uncommitted funds.

Returning uncommitted funds does not mean sending a refund check, but means that VC firms are releasing partners from contractual agreements for money in the fund that was targeted for future investments. Through June 2002, these 'givebacks' have totaled approximately \$3 billion, and experts predict that this figure could reach \$50 billion in the next year.¹³ Ricki Fulman writes that limited partners are praising their VC firms for reducing fund sizes and management fees.¹⁴ However, VC firms are taking a hard line on the terms of new deals. This is particularly true with the newer, more distressed VC firms. For instance, the terms state that, in the

¹² Der Hovanesian, Mara. "The VCs Don't Want Your Money Anymore." Business Source Elite. EBSCO. 29 July 2002. 27 September 2002 <<http://www.epnet.com/>>

¹³ Der Hovanesian, Mara. "The VCs Don't Want Your Money Anymore." Business Source Elite. EBSCO. 29 July 2002. 27 September 2002 <<http://www.epnet.com/>>

¹⁴ Fulman, Ricki. "Cuts in Venture Cap Fees, Fund Sizes Get High Marks From Limited Partners." Business Source Elite. EBSCO. 10 June 2002. 27 September 2002 <<http://www.epnet.com/>>

event of a sale, the VC firm is assured of up to five times its investment before anyone else is paid. In the past, VC firms would be paid their original investment amount before anyone else got paid, but not the profit portion. Funding that was handed out in a lump sum in the past is now apportioned. A company must now meet certain milestones, such as revenue and growth targets, before receiving the next round of funds. Some of the top VC firms have made adjustments in their terms to reflect present realities, but they have not taken the extreme positions the younger VC firms have.¹⁵

The IPO Process

Initial Public Offering (IPO) is also referred to as "going public," or "new issue." It is the first time a company sells stock to the public with the help of underwriters. Underwriters are investment banks that draft the prospectus, assist with filing, sell the stock, and set the offering price of an IPO. Pricing an IPO is an important and controversial topic that will be discussed later in this paper. For reference only, a Direct Public Offering (DPO) refers to a company that sells its shares to the public without the assistance of an underwriter, often over the Internet.

Why do owners of private companies want to take their companies public? There are several reasons:¹⁶

- Public companies can obtain better rates when they issue debt.
- More stock can be issued for mergers and acquisitions.
- Trading on the open market means liquidity, which makes it possible to initiate employee stock option plans for retention of talent and attracting new talent.
- The ability for existing stockholders to partially cash out their investments at a profit.
- Relative ease of raising capital for future expansion.

The most appealing reason for going public is that it creates a large amount of capital from the sale of stock. This capital gives the company the means to grow or to repay debt. Management of most companies consider going public as a milestone of success and accomplishment for its efforts. There is a certain sense of prestige in being a public company on the stock exchange. The rewards and advantages of going public,

¹⁵ Himelstein, Linda. "VCs Turn The Screws." *Business Source Elite*. EBSCO. 27 May 2002. 27 September 2002 <<http://www.epnet.com/>>

¹⁶ John Leslie Livingstone and Theodore Grossman, *The Portable MBA in Finance and Accounting*, 3^d ed. (New York: John Wiley & Sons, Inc., 2002), 463.

however, come with a price to pay. These disadvantages may or may not be detrimental to the goals and circumstances of a company, but need to be considered before going public:¹⁷

- The cost of an IPO is significant.
- Attention is diverted from operations to get through the IPO process.
- Disclosure of company business strategy, terms of contracts, and other details required in the prospectus.
- Transactions between the company and its officers, stockholders, and relatives are disclosed.
- Periodic (quarterly and annual) reporting to the SEC.
- Public (shareholder) pressure to achieve short-term growth and profitability to sustain and advance the stock price.

The costs incurred in getting to the initial offering include underwriter's fees, which can take 6 to 10 per cent of the gross proceeds, and other out-of-pocket expenses for filing fees, legal fees, printing fees, and accounting fees. Some of these costs continue after the IPO is done, which includes quarterly SEC filings, cost to maintain audited financial statements, and other reporting that adds to the company's costs of doing business.

Typical costs involved in an IPO are:

Expenses can vary widely, but these are typical.

Underwriting fee (negotiable, but doesn't vary much in practice)	7% of offering
SEC filing fee	\$92 for each \$1 million raised
Nasdaq initial listing fee (depending on the number of shares outstanding)	\$105,000 to \$155,000
National Association of Securities Dealers filing fee	\$0.0001 x the number of shares, plus \$500
Legal fees	\$300,000 to \$500,000
Accounting fees	\$300,000 to \$500,000
Printing expenses (for the prospectus, which sometimes must be printed and circulated several times)	\$200,000 to \$300,000
Transfer-agent fees (to an outside firm for keeping track of shareholders and transferring stock certificates)	\$10,000 to \$20,000
Blue-sky fees (if there are no state registration fees)	\$5,000
Miscellaneous (for the road show and other expenses)	\$100,000
Directors' and officers' insurance	\$500,000 to \$1 million

Source: inc.com¹⁸

Once a company is public, shareholders put pressure on the management to show continually improving performance, which puts the emphasis on short-term strategies. This leads to a lack of long range planning. "Failure

¹⁷ Livingstone, *The Portable MBA in Finance and Accounting*, 463-4.

¹⁸ Fraser, Jill Andresky, and Barker, Emily. "The Road To Wall Street." 01 June 2002. 8 October 2002 <<http://www.inc.com/magazine/20020601/24259-3.html>>

to meet these shareholder expectations can cause the market value of the company's stock to decline, making it more expensive for the company to raise money or acquire other companies using its stock."¹⁹

The Managing Underwriter

It is important for the company to choose a good managing underwriter as a first step toward going public. Management should consider several factors in choosing an underwriter:²⁰

- The value the underwriter is willing to place on the company.
- The discount the underwriter proposes in making the shares attractive for public purchase.
- The underwriter's recent track record and reputation.
- The underwriter's past success in structuring IPOs for sufficient "aftermarket" for the shares so that the price does not drop.
- Experience other companies have had with the underwriter.
- Ability of the underwriter to place some shares with larger institutions for stability in the stockholdings of the company.
- Ability of the underwriter to distribute the stock on a broad geographical basis.
- The underwriter employs securities analysts who are known within the investment community.

The top underwriters, based on raised amounts (\$ millions) for 2002:

Underwriter	No. of IPOs	Amount Raised
1. Salomon Smith Barney	8	\$6,525.7
2. Goldman, Sachs & Co.	6	\$5,353.4
3. Lehman Brothers	6	\$5,347.4
4. Merrill Lynch & Co.	12	\$5,022.2
5. Credit Suisse First Boston	12	\$4,300.7
6. Morgan Stanley	7	\$3,426.0

Source: IPO.com ²¹

There are two types of agreements between a company and an underwriter. The first is the "Firm Commitment," in which the underwriter agrees to purchase the entire stock issue from the company. The underwriter then offers this stock to the public. The company is guaranteed a certain amount of money with this type of agreement, and

¹⁹ Richardson, Clinton D. "Going Public." September 2002. 30 September 2002

<<http://www.ipo.com/venture/vc-glossary.asp>>

²⁰ Livingstone, *The Portable MBA in Finance and Accounting*, 465-6.

²¹ IPO.com Home Page. 2 October 2002 <<http://www.ipo.com/ipoinfo/stats.asp?p=IPO>>

the risk lies entirely with the underwriter. The second type is called a “Best Effort” agreement. The underwriter agrees to sell the stock for the company, but does not guarantee a certain amount of money for the sale.²²

All Hands

The IPO process officially begins once the underwriter is chosen, and a meeting takes place that is called an “all-hands” meeting. All of the members of the IPO team attend this important meeting: company management, company lawyers, underwriter, underwriter lawyers, and accounting representatives. Responsibilities are assigned and a timetable is established. Usually, the time from this meeting until the closing of the IPO is 16 weeks. The company is charged with preparing the draft of the *registration statement*, which will take 6-8 weeks to finalize and submit to the SEC – when submitted, this is the official *filing date* for the IPO. A draft of the prospectus is submitted with the registration statement for SEC review.

Prospectus

The development of the prospectus is one of the most difficult and time consuming tasks for the IPO team, but it is one of the most important documents it prepares. The SEC’s strict rules relating to the prospectus make it complicated for the attorneys. Since 1998, the SEC has required that the prospectus be written in “plain English,” which is clear, concise and understandable.²³ The prospectus includes company financial information for the previous five years, a description of its business, and detailed information about management – managers’ backgrounds and their percentage of shares in the company. Any existing or pending legal issues must be divulged, and an explanation of the intended use of the proceeds from the offering is included.

Road Show

At the same time as the SEC is reviewing the preliminary prospectus, the IPO team begins the “road show.” This refers to marketing of the IPO before the offering to generate interest in the stock. Visits are made across the country to other underwriters, securities analysts, brokers, and other potential investors to present, and answer questions about, the preliminary

²² Kaplan, Charles J. “Initial Public Offerings (IPO) of Securities.” 24 September 2002
<<http://www.e-analytics.com/fs3.htm>>

²³ Livingstone, *The Portable MBA in Finance and Accounting*, 468.

prospectus. Today, road show presentations are allowed over the Internet, but ground rules and SEC regulations for doing this are in the development stage.

The road show is one of the most critical parts of the process that contributes to the success of the IPO. The underwriter has the responsibility to orchestrate the road show, contacting and bringing together key investors to scheduled meetings. Even though the prospectus is the only *written* information that is allowed during the 'cooling off' period, verbal responses to questions about the prospectus, that the general public does not hear, are allowed at these meetings. The 'cooling off' period is from the *filing date* to the date when the stock is offered. The offering price and date are not contained in the preliminary prospectus. Once the SEC gives approval for the IPO to proceed, the final prospectus is created and the underwriter sets the offering price. The level of interest shown during the road show influences the pricing decision of the underwriter.²⁴

Lockup Period

Part of the agreement between the company and the underwriter is a lockup period. This binding contract requires that existing stockholders not sell any of their shares for a specified period of time after the initial offering. Usually, this period of time is 180 days. The purpose of this is to prevent insiders (company officials and employees) from selling their shares soon after the offering, causing loss of public confidence and a consequent stock price decrease. The lockup agreement can, however, stipulate that insiders be allowed to sell a very limited number of shares within the lockup period.

Initial Public Offering

The "effective date" is the day that the stock is publicly traded for the first time. But does the general public have the opportunity to buy the stock on the effective date? "The IPO is declared effective at least two days after potential investors receive the final prospectus and the offering price is set. This happens after the market closes for the day with trading commencing the following morning."²⁵ The potential investors that promised, during the road show, to buy the stock receive the final prospectus that contains updated financial, and insider shares information and the offering price. The underwriter allocates the majority of the stock offering to these

²⁴ Kaplan, Charles J. "Initial Public Offerings (IPO) of Securities." 24 September 2002

<<http://www.e-analytics.com/fs3.htm>>

²⁵ Kautz, Judith A. "Managing an IPO." 1999. 20 September 2002

<<http://entrepreneurs.about.com/library/weekly/1999/aa081399c.htm>>

investors, which leaves a small portion of the stock for the average investor. All of this commitment occurs before the stock starts trading, so by the time the average investor considers buying, the stock price has changed. "After all, Wall Street's IPO community is essentially a restricted club; only individuals who hold accounts with the firms underwriting the offerings can hope to get a few shares, and even then the stock is reserved for VIP customers."²⁶

There is a business advantage for underwriters to provide pre-IPO stock to their institutional investor friends. The investors will certainly return the good IPO deal rewards they receive by doing future business with the underwriter. Underwriters justify this practice by saying that these institutional investors are less prone to "flipping," which is immediately selling the stock for a quick profit, which results in a more stable stock offering. They also argue that this practice protects most smaller, individual investors from risky investments. However, this also places the underwriter in a middleman position of trying to please both the company going public and the institutional investors in its pricing of the stock.

The Problem of Flipping and Underpricing

The price per share and the total number of shares determine the amount that the company will receive from the IPO, less the 7% underwriter's cut. The company wants the highest offering price for its shares, and the investors want to buy at the lowest possible price. If the price is set too high the result could be poor aftermarket performance and a lot of upset investors. If the underwriter sets the price too low the resulting upswing in trading price means that the company has "left something [money] on the table." The stock should have been priced higher and, in turn, the company should have received a higher payoff. "The evidence of underpricing is clear. There has always been a bump in the price of IPOs on the first day of trading. But the average 7.4% gain in the 1980s exploded to 65% in 1999 and 2000..."²⁷

In a typical underpriced IPO, the price tends to have a big first day increase, called a "run-up." The run-up generates positive publicity for the issuer and attracts uninformed retail [individual] investors, who think that the run-up implies a special investment opportunity. This results in the public buying the shares at the highest price.²⁸

²⁶ Prince, C.J. "Flipping Over IPOs." March 1999. 25 September 2002
<http://www.findarticles.com/cf_0/m3514/3_46/53996907/p1/article.jhtml>

²⁷ McNamee, Mike. "IPOs: Getting The Price Right." *Business Source Elite*. EBSCO. 9 September 2002. 27 September 2002 <<http://www.epnet.com/>>

²⁸ Hambrecht, Bill. "Fixing the IPO Process." September 2002. 16 September 2002

Underpricing promotes “flipping” because of the large profits that are realized when the stock is sold. During the height of IPOs from 1998 to 2000 the demand for IPO shares outweighed the supply. Underwriters turned their heads as investors flipped stock. Institutional investors defend this as being one of the perks for being good customers of the underwriter. Individual investors complain, however, that the institutional investors’ flipping hurts them. Purchase of the stock may have been based on knowledge of favorable institutional investors’ participation in the stock, but without the knowledge that they would flip the stock.²⁹

Individual investors are discouraged from flipping stock and are penalized if they do. IPOs want long-term investors, and brokers may blacklist individuals who want to flip IPO stock, thereby preventing them from participating in future IPOs. The underwriter or larger broker that brought the broker into the IPO scrutinizes the broker for flipping by its clients and may impose penalties on the broker in the same manner.

A recent survey of online brokers shows that most restrict aftermarket trading:³⁰

<u>Online Broker</u>	<u>Selling Restrictions</u>
DLJ Direct	None
E-Trade	May refuse future allocations if investors sell within 30 days
Fidelity	Barred from future IPOs if investors sell within 15 business days
Schwab	Ineligible for IPOs for 6 months if investors sell within 30 days
Wit Capital	May refuse IPOs to investors selling within 60 days

These restrictions and constraints imposed on individual investors do not apply to the institutional investors. It is accepted practice for institutional investors to flip IPO stock because they “... have many ways to dispose of stock quickly and discreetly. In fact, the underwriters of IPOs that rocket on

²⁹ <http://www.wrhambrecht.com/ind/strategy/bill_pov/200209/index.html>
Moskowitz, Eric. “Flipping Made Easy: The In-N-Out IPO.” 4 May 2001. 30 September 2002
<<http://www.redherring.com/ipo/2001/0504/450019245.html>>

³⁰ Renaissance Capital Home Page. “How To Have IPO Intelligence.” 2001. 12 October 2002
<<http://www.ipohome.com/newcomer/guide.asp>>

the first day of trading are happy to have stock put back to them. They can turn around and sell the shares to another investor.”³¹

Changing the System

Shawn Tully called the underpricing of IPOs and associated profits that are reaped by institutional investors “...the ultimate kickback business: Wall Street firms set offering prices for startups far below their real value, then offer the cheap shares to their best customers...”³² Bill Hambrecht, one of the best-known and most-cited investment bankers, believes that the system for going public needs changing. Since 1998, his company, W.R. Hambrecht, has auctioned IPOs on the Internet in an attempt to level the playing field to include the average investor. Hambrecht says, “Any time you create a guaranteed profit for a select few, it’s just going to corrupt things.”³³ He has specific ideas as to what changes should be made in the IPO process.

The first suggestion that Mr. Hambrecht presents is to disseminate information to everyone, not just to certain investors. The road show should be accessible to everyone, via open Internet or public notice of meetings. He believes that this would lessen the need to use analysts to support the stock. The information at road show meetings would be available to anyone who attended them. Making information more available would include changes to the preliminary prospectus guidelines to allow price estimates to be included.

Next, the allocation of IPO stock is typically 80% to institutional investors and 20% to retail [individual] investors. The practice of not making all stock available to all investors raises a question of legitimacy as public securities are withheld from qualified, public buyers. The underwriters’ control over who has access to the stock raises the question of ethics, given the fact that with control comes the opportunity for abuse. Selective access also contributes to the underwriter pricing the new issue based on a limited market, which results in a price that does not reflect the aftermarket demand. If IPOs were available to all investors, allowing them to bid on pre-IPO stock would create an offering price based on true market interest, which would minimize the possibility of underpricing.

³¹ *ibid.*

³² Tully, Shawn. “Put The ‘Public’ Back In IPO.” *Business Source Elite*. EBSCO. 24 June 2002. 22 August 2002 <<http://www.epnet.com/>>

³³ Tarsala, Mike. “The IPO Market Is As Sleazy As Ever.” 18 September 2002. 19 September 2002 <<http://cbs.marketwatch.com/news>>

Underpricing and preferred allocation of stock produces guaranteed profit for the select few, as stated previously. One way to do this, Hambrecht suggests, is to use an open auction for determining the non-preferred allocation demand for the stock. The underwriter would then price the IPO based on truer demand information that would include preferred and non-preferred investor input. He also suggests that, to deter allocation abuse, strong legal penalties should be imposed. Allocation abuse can include 'laddering,' which requires investors to buy stock in the aftermarket. It can also include commission incentives, and 'spinning' shares – placing shares with the underwriter's best clients for future business.³⁴

Hambrecht predicts that issuers, the companies going public, will make demands of the underwriters to do IPO auctions. He and his company have experienced modest success in their Internet IPO auctions with seven deals so far. How successful will this be, though, in leveling the playing field for the public? Discount brokers, such as Charles Schwab, Fidelity, and E*Trade, teamed up with institutional investors, like Salomon Smith Barney, to distribute IPO shares. They were previously out of the IPO loop and established these alliances with the underwriters in hopes of cashing in on the IPO profits. Fidelity's agreement with Salomon Smith Barney was for their customers to have access to 10% of IPO stock where Salomon was the underwriter. The result, however, is that brokers still allocate shares on a preferential basis, meaning the average investor is still locked out of IPO offerings. Only the best, most active online customers receive the coveted shares. For instance, qualifying as an investor with Schwab requires 24 trades per year and an account balance of \$125,000.³⁵

Real change in how IPO stock is allocated may have to come from the SEC. Examples of impropriety, such as Enron or WorldCom, could make it more important and urgent that Harvey Pitt, SEC chairman, do something. "...Chairman Harvey Pitt has asked securities regulators to review the process for initial public offerings, as abuses in the system have been uncovered in the wake of the dot-com bust. Pitt, who is under fire as being too lenient on Wall Street because of his past experience as a securities lawyer, has asked the National Association of Securities Dealers and the New York Stock Exchange to review the process. Specifically, he wants them to look at how shares of IPOs are allocated and how investment banks set the offering prices. As a result, serious questions

³⁴ Hambrecht, Bill. "Fixing the IPO Process." September 2002. 16 September 2002
<http://www.wrhambrecht.com/ind/strategy/bill_pov/200209/index.html>

³⁵ Renaissance Capital Home Page. "How To Have IPO Intelligence." 2001. 12 October 2002
<<http://www.ipohome.com/newcomer/guide.asp>>

arose about the price setting process and the allocation processes of the underwriters of some of these offerings.”³⁶

Conclusion

Venture capitalists invest in projects offering high risks and high returns on investments. In today's economy, it has become harder for venture capital firms to exit and realize the profit level they have come to expect in the past few years. VC firms are evaluating their portfolios to determine where to cut their losses, and they are doing more thorough due diligence for new investment projects.

For VC firms that exit via an IPO, the potential of underpricing by the underwriter can greatly affect their profit. The underwriter wants to please the VC firm and its partners, but there are indications that they want to please their institutional investor friends more. So in a very short time, the underwriters can undermine the 3-5 years of time, energy and capital that the VC firm invested in a company. The offering price is based on an 8-week road show, which gathers information on level of interest in the stock from preferred clients only.

So, who benefits most by the existing IPO pricing practices of underwriters? The institutional investors reap huge profits from 'flipping' the stock. The underwriters pull in a fast 7% fee for orchestrating the deal in a relatively short period of time.

Can the average investor get a piece of the IPO action at the initial offering price? The push for auctioning a portion of the preferred stock and opening up the road show to the average investor has merit. Auctioning has even had some mild level of success, but the IPO good-old-boy system will continue unless the SEC makes changes as a result of its investigation.

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³⁶ IPO.com Home Page. "SEC's Pitt Asks Regulators To Review IPO Process." 22 August 2002. 27 September 2002 <<http://www.ipo.com/ipoinfo/news.asp?p=IPO&pg=37402>>

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