MV Capital Management Thought Leadership

The Anatomy of an IPO

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Note to our clients and friends: this piece is somewhat longer than our usual commentary. We are taking the extra space because we think the issue of IPOs and their role in today's securities markets is extremely important and of great concern to anyone invested in the markets. We hope you will take the extra time to read our thoughts.

The Holy Grail

Those three letters have a magical effect. I-P-O, the Holy Grail that impels impassioned entrepreneurs to pursue their dreams and create the next great thing that will revolutionize the world, joining the storied pantheon of stars gone public from Gordon Moore to Steve Jobs, Bill Gates, Jeff Bezos, the Sergei Brin/Larry Page duo and, most recently, Mark Zuckerberg. But the problems and controversy surrounding the recent Facebook IPO are a stark reminder that all is not well in the world of the public offering nor, for that matter, of the publicly traded company itself. Facebook may or may not live up to the sky-high expectations baked into the valuation at which it went public. But the process that led to the valuation and launch lays bare flaws that have always been part and parcel of the IPO, but are now considerably more endemic and severe.

Conflicts Galore

Like just about everything else in modern finance, the IPO process is fraught with conflicts between interested parties. Here are the principal *dramatis personae* of this play: (a) the early shareholders, typically the founders, venture capitalists and angel investors; (b) the company itself and its capital needs for continued growth; (c) the offering underwriters, usually led by bulge bracket investment banks; (d) investors allocated a slice of shares in the primary offering; (e) the investing public who will come in to participate in secondary market trading; (e) the stock exchanges; and (f) the securities regulators. Just looking at that list of interested parties should make it clear that someone, somewhere is not going to be happy with the results. Let's see what went right, and what went wrong, for Facebook.

One important way the Facebook IPO deviated from historical norms is in the split between shares sold to fund the company's next stage of growth and those sold by insiders to cash out of their investment. Historically, companies going public via an IPO have kept a large chunk of the funds raised to bankroll their next initiatives. That was the case in the last great era for tech stocks, during the Internet salad days of the late 1990s. Consider that two of the darlings of that era – Yahoo! and Amazon – went public with IPOs in 1996 and 1997 respectively. Of the money raised in these two IPOs exactly none of it represented exits by selling shareholders, and 100% of the proceeds raised went directly into the companies' coffers. VCs and other early shareholders typically had lockup periods after the IPO and had to wait until the expiration of these periods before they could sell their shares.

By contrast, a whopping 57% of the Facebook offering consisted of insider shares. This has been one of the flashpoints of controversy, with pundits and casual observers opining that insider pressure drove Morgan Stanley, the lead underwriter, to raise the offering price to the top end of its range. But that is too simplistic a picture to draw. It's worth taking a few moments talking about the mechanics of this process to understand the delicate dance between all the forces and interests at play.

The Mechanics of an IPO

Let's start with the underwriting syndicate, a team of 33 investment banks led in this case by Morgan Stanley. Whose side were they on? Tough question! Like most investment banks Morgan Stanley has what the industry calls a buy side and a sell side. The sell side – the investment bankers – were hired by Facebook. Their job is to fetch the highest market-bearing price possible – to raise as much money for Facebook as they can while still ensuring a successful, fully subscribed underwriting. Whether “Facebook” means Zuckerberg, VCs *et al* or the corporate entity makes no difference – the underwriter’s job is highest possible price they can get, period.

So the underwriters go out to the market in an exercise called book building. They prepare a prospectus and other offering documents, go on an investor road show to get indications of demand, and establish a likely range of offering prices based on these indications (this is that famous “range” with $38 at the upper end). But now it gets complicated. Who are these investors coming to the breakfasts and luncheons that are part and parcel of the IPO road show? Could it be that they are also Morgan Stanley clients – for example users of Morgan’s asset management services or institutional brokerage clients? Why, yes! Here’s how it works. The investment bankers – the hired guns for Facebook – are sitting on one side of the table with their pitch for how their client is the greatest thing since sliced bread. On the other side of the table are investors who were invited by Morgan Stanley brokers and advisors – in other words buy side clients of Morgan Stanley. So Morgan is selling the goods of one of its clients, who wants to fetch the highest price possible, to many other of its clients, who would like to pay the lowest price they have to. And all of this is fully within the letter of our securities laws.

Pop Goes the IPO (Or Not)

The way this conflict has been finessed in the past is that the investors who get invited to the IPO expect to cash in their shares by the end of the first trading day. It’s called the 10% pop, and it is all part of the art and science of pricing the deal. The idea is that the shares will open at their offering price and then “pop” to close out 10% or so higher. In other words, the typical institutional brokerage client subscribing to an IPO doesn’t care much what happens to Facebook in the long run. They want to book a 10% gain on a one day trade and be done with it – nice work if you can get it.

In any event, the “pop” didn’t happen with Facebook, and the fingers have pointed furiously. Who was to blame? A flurry of lawsuits allege that the underwriters did not uniformly make information available that came to light shortly before the offering, calling into question earlier financial assumptions underlying the valuation. Morgan Stanley says that was not the case, and to further complicate matters there was the technical malfunction on NASDAQ at the opening bell that caused confusion and possibly resulted in more than 30 million shares being improperly priced and executed, possibly causing or at least exacerbating the price sag.

Confusion, Not Crimes

Other accusations have pointed to evidence of Morgan covering short positions several days after the open, at significantly lower prices to book a profit. That is true – but that is also a perfectly legal and normal underwriting procedure called a “green shoe”, where the issuing company permits the underwriters to overallot – in effect to sell up to 15% more shares than those listed in the offering – to satisfy additional demand. The underwriters do this by selling shares they don’t own – essentially a short – and then covering the short position either by exercising an option to buy the shares from the company or simply buying them in the secondary market. It is highly unlikely that Morgan would have orchestrated some kind of a price fizzle on the stock just so they could go and make a comparatively modest profit on their green shoe cover.

The point of all of this is that IPOs are incredibly complex and filled with conflicting objectives. We think it is likelier than not that the Facebook flop was not the result of unfettered malfeasance, but that a combination of hype, confusion, lack of attention to detail, bad luck and timing (given the already fragile mood on Wall Street and ongoing fears over Europe’s pickle) led to a shoddy performance. Remember that even though the company insiders cashed out of billions there are still plenty of unexercised insider shares. Only 15% of the company’s stock is public float, with the remainder locked up pending further opportunities. So it wasn’t just unbridled greed on their part – these investors still have substantial skin in the game. For its part Morgan Stanley was left with highly unsatisfied institutional clients – they certainly didn't orchestrate the pricing and initial trading to work to their benefit. As for NASDAQ – well, in our age of supertechnology glitches happen.

Quo Vadis Publicly Traded Company?

The real victim of the whole affair is the publicly traded company. IPOs are just not an optimal way to realize a company's value in the market, and that presents a problem for the very idea of publicly traded securities. Look at it this way – and this is true not just of Facebook but of just about any IPO. The insiders – the ones who have been with the venture since its early stages – know the most about what the company is truly worth. They will presumably cash out nicely regardless of whether they exit via an IPO or via a trade sale, where the company is sold in a private deal to an acquirer. The vast majority of companies go this route as opposed to an IPO. Next come the institutional investors. They don't know much about the company but – as we noted above – they also don't care, because they intend to be out with the first-day pop. That leaves the rest of us. Even the most dedicated Facebook fan has no real knowledge about the company's business model or the ability of its management team to navigate over different business cycles and successfully steward a public company. It's a wing and a prayer, and the other players have already booked their profits by the time the secondary shares show up on our quarterly Fidelity statements. The odds against that wing and prayer are sharper when the process is as flawed and shoddy as it was for Facebook, and likely to dampen investor enthusiasm still further.

A vibrant securities market depends on a fresh supply of IPOs to maintain stability. Companies buy back stock, they go private, they go bankrupt, they delist for whatever reason, and all of that reduces the supply of shares available to trade. IPOs bring a new supply to make up for the losses – it's like the net population change according to the ratio of births versus deaths. These days we are seeing a very unfavorable fertility ratio – more shares exiting the public exchanges than coming onto them. The Facebook IPO is an important data point for why this is so. What this all means for the future health and growth of an ownership society is a very serious issue, one that is very much clear and present.

With warm regards,

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