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Initial Public Offerings – Considerations for Investors

Initial Public Offerings (IPO) can be an attractive investment full of potential and risks. Many of us would love to go back in time and get in on the ground floor of Mastercard, Alphabet (Google), and Facebook. Unfortunately, we could have just as easily gone under with eToys, Pets.com, and Groupon. IPOs are highly volatile by their nature. How can we find the diamonds in the rough?

WHAT IS AN IPO?

An IPO is a means of transferring a company's ownership from private to public. The private owners are selling the company to unknown investors. The process is often referred to as "going public."

New business ventures or current industry leaders may make the choice to go public to raise capital to pay off debts, fund growth initiatives, raise their public profile, or to allow existing owners to diversify their holdings.

The Triangle is a hot bed for IPOs in bio/pharm, medical devices and high tech among other industries because of spin-offs from local universities and existing companies. You've probably heard about specific IPOs in the N&O, TBJ, on social media and at backyard BBQ's.

HOW DOES IT WORK?

The first step in going public is for the company to choose a lead underwriter to help with securities registration and public distribution of shares. The lead underwriter then assembles a group of investment banks and broker-dealers (known as a syndicate) to sell the shares to investors.

AVOID THE HYPE

Most of the information circulating around an IPO is produced by the syndicate seeking to sell the shares—it's their job to attract a market. Do your own due diligence. Consider the risks. This can be challenging because there is a lack of readily available public information on a company issuing shares for the first time. Spend time in the preliminary prospectus (the "red herring") to learn about the company's management team, target market, competitive landscape, financials, current shareholders, expected price range, potential risks, and the number of shares to be issued.

PARTICIPATION

Investors can find companies about to go public. by searching S-1 forms filed with the Securities and Exchange Commission (SEC). To participate, the investor must register with a brokerage firm. When companies issue IPOs, they notify brokerage firms which then notify investors. Most brokerage firms qualify participants by requiring a specified amount of funds in the brokerage account or limiting sales to those with a qualifying number of transactions at the firm. Most large brokerages will not allow an investor's first transaction to be an IPO.

STRONG BROKERS TEND TO BRING QUALITY COMPANIES

Although not a surety, look for companies teamed with a strong underwriter. There can be some misfires, but in general, quality brokerages bring quality companies public. Smaller brokerages may be willing to underwrite a broader quality range of companies to keep their pipeline filled.

SMALL BROKERAGES DO HAVE AN ADVANTAGE

One advantage the smaller brokerages have when underwriting is that their smaller client base makes it easier for their clients to purchase IPO shares. Large brokerages will limit participation more strictly to efficiently allocate shares among sophisticated investors.

READ THE PROSPECTUS

I mentioned the red herring above… do your homework. It isn't entertaining reading, but it lays out risks and opportunities. What is the purpose of the money raised by the IPO? If the money is going to repay loans or buy the private owner's equity, that could be a bad sign. Beware of companies that can't afford to repay debt without issuing stock. Money going to research, marketing, or expanding new markets is usually more promising.

BE SKEPTICAL

If a broker recommends an IPO to his clients, this may be cause for caution. This is a good indication that institutions and money managers have already passed on the underwriter's attempts to sell them stock. In this situation, individual investors are essentially getting the leftovers that the "big money" didn't want. An IPO position should hold a place in a portfolio equal to other positions. If the position grows to be overweighted over time, don't be afraid to rebalance.

BE PATIENT

There is a "lock-up" period of about three to 24 months during which the underwriters and insiders of the company are contractually prohibited from selling any shares of stock. If they are relying on IPO marketing to bump of the share price for sale, they will have to wait—and that could spoil the strategy. If, at the end of the lock-up period, they continue to hold the shares, that could be an indication to market investors that the company has a promising future.

Although many companies experience an initial bump due to syndicate's marketing, timing a flash in the pan is difficult as an individual investor. Getting early shares of long-term ventures is usually more lucrative.

Some investors who have bought stock at the IPO price have been rewarded handsomely for their foresight. Those who remain skeptical of the hype and inform themselves with available information are likely to perform better than those who do not.

Patrick Yanke is a Raleigh-based financial advisor. Opinions expressed here are mine and not necessarily those of RJFS. The information is not a complete summary or statement of all available data necessary for making an investment decision and does not constitute a recommendation. Investing involves risk and you may incur a profit or loss regardless of strategy selected. www.yankefinancial.com.