The paradox of IPOs

By Iain McCormick

An initial public offering or IPO is a company's "coming out party" – it involves private companies offering their shares to the public for the first time. Recently we have seen with the Mighty River Power IPO that even the invitation to the coming out party, the pre-registration, has caused great investor excitement.

The first public share offering called the pubicani occurred in the Roman Republic, around 509 BC. Here public investors bought and traded shares in an over-the-counter market in the economic centre of Rome.

The first modern company to issue public shares was the Dutch East India Company in March 1602. This IPO set the trend with very large sums of money being raised by offering shares to the general public.

IPOs have many benefits as they can provide cheap access to ready capital, generate increased market exposure, diversify the shareholding base, help to retain better directors, management and staff through share options, and make acquisitions easier.

However they have a number of disadvantages, like the company having to disclose business information that may be used by competitors, large legal, accounting and marketing bills, the time and effort that must be put in by senior management and then there is a risk that the funding may not be raised.

Professor Jay Ritter of the University of Florida has collected a large amount of IPO data including companies' subsequent sharemarket performances. His research indicates that the IPO share price typically jumps from the offering price in the first day of public trading. First day gains for US IPOs averaged 18 percent between 1960 to 2005. Recently we saw a spectacular local example of this with the 438 percent raise of Snakk Media by mid-afternoon on day one of its IPO.

Ritter not only tracked first-day gains, he also followed the new companies for the next five years. He found that the five-year average annual gains for US IPOs, after the first day of trading, came in at 11 percent from 1970 to 2003. This may seem impressive but actually IPOs trailed far behind other similar stocks. Over the five years, stocks of a similar size outperformed the IPOs by an average of four percent each year.

So history would suggest that investors should buy IPO stocks on the first day or avoid them. This suggestion does not apply to all IPOs so investors need to be wary of the lofty words and expectations at the time of initial offering and look for real businesses with decent fundamentals1.

Why might it be that IPOs do not perform as well as similar stocks after their initial day of offering? Shai Bernstein, assistant finance professor at the Stanford Graduate School of Business may have part of the answer. Bernstein analysed the patent data of over 1500 public and private US technology firms between 1983 and 2006 including those of companies like Microsoft and Google. He found that the quality of internal innovation declined following the IPO and that firms experienced not only the loss of skilled inventors but also a decline in productivity from the inventors who remained.

Bernstein speculates that going public may produce career concerns and takeover threats that pressure managers to select more conventional, less risky and innovative projects which can be more easily communicated to shareholders.

This sentiment is illustrated by Mark Zuckerberg, founder and CEO of Facebook, who in the pre-IPO stage claimed that "being private is better for us right now because of some of the big risks we want to take in developing new products... Managing the company through launching controversial services is tricky, but I can only imagine it would be even more difficult if we had a public stock price bouncing around." (Facebook Blog, September 2010).

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Interestingly, though, these newly public firms were able to recruit new innovators and also to buy-in new external innovations.

Related studies similar to those of Bernstein have found that market analysts inhibit innovation in the US because they put pressure on managers to meet short-term, typically quarterly, targets. This makes it easier to buy in new innovations rather than grow them in-house.

IPOs may not only affect management's incentives but also those of the inventors. It may be that the dilution of ownership that occurs at this time may lead inventors to pursue less ambitious projects or to leave the company to use their ideas in another start up where they can harness more of the gain from their ideas. Also after the IPO the inventor may have cashed out his or her stock options and this money may make the individual more willing to take on new bigger risks. In addition any cash incentives offered by the company may now seem of less importance to the inventor.

Potentially the NZX has a whole swath of IPOs coming up in 2013 and as both investors and directors we need to think carefully about these. We need to make sure that the IPO coming out party does not lead to a nasty hangover!

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