In this issue

Is There A Way In?

The media loves to report on Initial Public Offerings (IPOs) because the opportunity for fast money generates a lot of buzz. How can investors get in on the next big IPO?

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The Hot IPO

An investment bank is different from a traditional bank that accepts deposits, pools those deposits together, and then sells loans at a higher interest rate. These banks assist companies in raising funds in the capital markets, advise on mergers & acquisitions, and complete other complex financial transactions.

One of these is selling shares of private companies through an Initial Public Offering (IPO). This process is often referred to as "taking a company public."

The media loves IPOs because the opportunity for fast money generates a lot of buzz. For example, when Alibaba went public in 2014, the deal size was the largest in the history of the New York Stock Exchange. Demand for stock in this fast-growing internet giant was so high that for every share available, there were more than ten willing buyers[1].

Despite COVID-19 and the current state of the economy, this year has been one of the most hospitable for IPOs in years. According to Dealogic, U.S.-listed IPOs have raised more than $60 billion so far in 2020 and are on track for the highest level since the tech boom in 2000. On average, these IPOs have risen 23% in their first day of trading, which is the biggest first-day pop since 2000[2].

The big news this week is that Airbnb could be next. The Wall Street Journal reported that their listing is imminent[2]. This is one of the most anticipated IPOs over the last decade, and if it were to be successful, it could add even more fuel to the IPO fire.

But that doesn't mean individual investors will be invited to the party. In fact, getting in on "hot IPOs" is often next to impossible. Although this may frustrate some, let's explain how the IPO process works to see why this may not be such a bad thing.

The Process

The first step usually involves hiring an investment bank to facilitate the sale of their stock to the public.

Think of investment bankers as the middlemen between the company and big investors. These banks have deep relationships with money managers, and many sellers would rather pay a bank than try to sell the stock on their own.

This is no different than using a real estate agent to sell a house. An agent is not required, but they can make the process smoother and offer advice on how to get the best price.

Bankers initially target large investors because they can buy big blocks of stock and tend to be long-term holders. They also bring these opportunities to their best relationships, irrespective of size, because good customers of an investment bank expect exclusive access to deals like these.

Over the span of several weeks, the bankers travel with the management team to meet prospective buyers. This process is called the "roadshow," and its goal is to educate investors on the company and future growth prospects and gauge demand for the stock.

A few days before the sale, bankers solicit orders. If a money manager is interested, they tell the bank how much stock they want and the price they are willing to pay. The bank then compiles the orders to see how the overall demand compares to the amount of stock being sold.

This process helps the bankers determine where to price the stock. Since the company's stock has never traded on a public exchange before, determining the right price can be more an art than a science, and the bankers will often adjust the price more than once before it begins trading as they get a better sense of the overall demand.

Bankers walk a fine line because they were hired by the seller to get the best price for their stock. But they cannot price too high and risk damaging relationships with buyers who may feel that they got a bad deal.

A good rule of thumb for bankers is to price the stock at a level where it will open roughly 10% higher. Meaning, if a bank priced an IPO at $20, the bankers aim for the stock to open around $22.

Therefore, management does not feel like they are leaving money on the table, and investors now own a stock that they paid $20 but could sell immediately for $22. However, this rarely happens because pricing newly issued stock is extremely difficult. For example, Alibaba was priced in the mid $60s but opened in the low $90s[1].

Simply put, most retail investors and smaller institutions rarely get an allocation because the bankers prefer to put stock in the hands of those with the most money to spend.

Caveat Emptor

Let's assume that after a bank completes a roadshow, they realize that demand is lower than expected. This scenario happens occasionally due to a less sanguine view of the company's prospects or because the initial price range for the stock is too high.

Bankers are hired to sell this stock, and since the big buyers are not biting, they must resort to other channels to fill the demand. This is pretty much the only time when smaller investors get a look.

For example, the Facebook roadshow did not garner enough interest from large institutional investors. The bankers filled the gap by offering stock to smaller institutions, high net worth individuals, and the mass affluent through financial advisors and brokers at the banks involved in the IPO[3].

But when bankers opened the offering to smaller investors, they most likely didn't pitch it as a failure on their part to fill the demand from tier one clients. They probably marketed it as exclusive access to one of the biggest IPOs in U.S. history.

Furthermore, these investors did not get the chance to sit down with Mark Zuckerberg and Sheryl Sandberg. Nor did they have trained analysts create financial models and comb through SEC filings to assess risk in the offering.

Most likely, the only analyses made available to them were the research reports published by the banks hired to take Facebook public, which are little more than glorified sales brochures.

The Bottom Line

Stocks can be quite volatile for months after an IPO. The mix of emotions and uncertainty of whether management will deliver on their projections often make for too wild of a ride for some. In fact, many professional investors will wait a year or longer before buying to watch how a stock trades while they conduct extensive due diligence.

Therefore, if you miss out on a hot IPO but still want to get in, just remember that the professionals take their time to do the job right, so it's best to do the same.

If you just cannot resist the temptation to buy closer to the debut, a good rule of thumb is to only allocate what you are comfortable losing. This strategy will likely preserve your sanity if a stock were to fall flat on its face, which is often the case in the world of IPOs.

The bottom line is that most investors will never get the chance to participate in a hot IPO. For those who are offered, keep in mind that you are only getting the opportunity because some of the larger, more sophisticated investors did not like the deal and chose to pass.

Sincerely,

Mike Sorrentino, CFA

Chief Investment Officer

Sources

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