PART I

IPO Fundamentals

CHAPTER 1

Getting IPO Shares

The most common question I get from investors is: How do I get shares in a hot initial public offering (IPO)? After all, many IPOs have strong gains on the first day of trading. During the dot-com boom of the late 1990s, there were many that more than doubled. The environment got so crazy that Barbra Streisand offered free concert tickets to get allocations of hot IPOs.

But even as things have calmed down, there are still IPOs that surge. And yes, they get lots of headlines.

Unfortunately, it is extremely difficult to get shares at the offering price. Instead, often individual investors have no choice but to buy the stock once it starts trading, which can be risky. If anything, it is usually a good idea to wait a few days until the trading activity subsides.

For the most part, the investors who get IPO shares at the offering price are large players—like wealthy investors, endowments, mutual funds, and hedge funds. They have the ability to buy large chunks of stock. Plus, these investors may be more willing to do heavy trading with other investments. In a way, IPOs are a nice reward for top clients.

Seems unfair? Perhaps so. But it is legal, and the Securities and Exchange Commission (SEC) actually encourages it. This is from the agency's website at www.sec.gov:

> By its nature, investing in an IPO is a risky and speculative investment. Brokerage firms must consider if the IPO is appropriate for you in light of your income and net worth, investment objectives, other securities holdings, risk tolerance, and other factors. A firm may not sell to you IPO shares unless it has determined the investment is suitable for you.

Interestingly, though, even some large investors fail to get allocations of hot deals. The process can be hit-or-miss. In fact, it is often the case that a big investor will get only a portion of the shares requested. This is actually a way for the underwriters to create a sense of scarcity. After all, if you got all the shares you wanted, might this indicate there is not much demand for the IPO?

Despite all this, there are still ways to get in on the action. Let's take a look.

Risk

Even if you can get shares in an IPO, this is no guarantee of getting profits. These types of deals are always risky. For example, on August 11, 2005, Refco went public, with the stock increasing 25 percent on its first day of trading. The company was a top broker for futures and options. It also had top-notch private equity investors, such as Thomas H. Lee Partners.

Unfortunately, Refco's CEO, Phillip R. Bennett, had been cooking the books for at least 10 years and failed to disclose as much as $430 million in debt. By October 17, the company was bankrupt and the stock was worthless.

True, this is an extreme case. But it does happen, although a more common event is a broken IPO. This is when the stock price falls on the first day of trading. This is often a bad sign and may mean further losses down the road as institutional investors try to bail out.

Yet there is still a lot of opportunity when getting shares in an IPO. So in the rest of the chapter, we'll look at some key strategies.

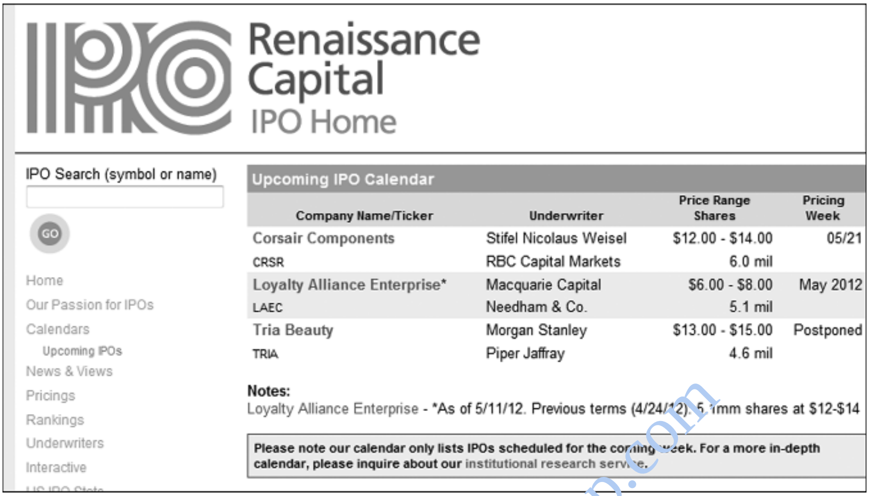
The Calendar

Before investing in IPOs, you need to track the calendar. This is a list of the upcoming IPOs. A good source is Renaissance Capital's IPO Home at www.renaissancecapital.com, shown in Figure 1.1. It will show the upcoming IPOs for the next month or so. This gives you time to check out who the underwriters are so as to perhaps get an allocation of shares, as well as to do research on the companies.

As you follow the calendar, you'll notice some things. First, there is seasonality to the IPO market. Generally there are no more IPOs during mid-December, and the market does not get started again until mid-January. The IPO market is also closed in August and does not get going again until mid-September.

Moreover, there will usually be five to 10 deals in a normal week. But when there is lots of instability in the market, there may be none. Keep in mind that during the fourth quarter of 2008—when the world was ensnared in the financial crisis—there was only one IPO.

FIGURE 1.1 Renaissance Capital IPO Calendar



Source: Renaissance Capital, Greenwich, CT (www.renaissancecapital.com)

Some deals may be postponed. And yes, this is not a good sign. A company will usually blame "adverse market conditions," but the real reason is probably that investors are not interested in the deal. In many cases, a postponement will turn into a withdrawal of an offering.

Online Brokers

In the IPO market, there has been resistance to the changes in technology, and there are still many elements of the old boy network. However, the Internet has certainly made a huge impact.

A key was the emergence of Wit Capital.

In 1995, a beer company called Spring Street Brewery, a microbrewery that sells Belgian wheat beers, needed to raise money. Unfortunately, the company was too small to interest a Wall Street underwriter, and venture capitalists wanted to take too much control of the company.

So the founder of the company, Andrew Klein, decided to sell shares of the company directly to investors. One option was to sell directly to his growing base of customers—by putting a notice of the offering on the beer bottles.

Because Klein had considerable experience in finance (he was once a securities attorney at one of the most prestigious Wall Street firms, Cravath, Swaine & Moore), he decided to take another, more sophisticated, route. He organized the prospectus, made the necessary federal and blue-sky filings, and prepared to sell the offering over the Internet. He posted the prospectus online, and Spring Street raised $1.6 million from 3,500 investors. Overnight he became a celebrity, as the *Wall Street Journal*, the *New York Times*, CNBC, and many other media covered the pioneering IPO.

However, Klein did not stop with the Spring Street Brewery IPO. He recognized the need for a mechanism to buy and sell stock on the open market for companies such as Spring Street that are not on a regular stock exchange. So he created a trading system where buyers and sellers could make their transactions commission free.

The SEC stepped in and suspended trading, but to the surprise of many, within a few weeks, the SEC turned around and gave conditional approval of the online trading system. From there, Klein decided to build an online investment bank, called Wit Capital. It would be a place where individual investors had access to IPOs at the offering price and to venture capital investments. Before that, such services had been provided mostly to high-net-worth individuals and institutional investors.

But of course, a big driver for Wit Capital—as well as other IPO digital brokers—was the dot-com boom. Investors had a huge appetite for new issues, and the market exploded.

Yet after the market fell apart, so did many of the online brokerages. As a result, the main players in digital IPOs are the larger players, such as Fidelity, E*Trade, and Charles Schwab.

So it is worth checking out these firms and seeing what deals are available. But they all have eligibility requirements; take Fidelity (see Figure 1.2).

A customer must have a minimum of $100,000 in assets with the firm, or must have placed 36 or more stock, fixed-income, or option trades during the past 12 months. Also, there must be at least $2,000 in cash in the account.

Then there is the following process:

- *Alerts.* This is an e-mail system that will indicate when an IPO is available. There will also be e-mails for when offers are due, the effectiveness of the offering, the pricing, and the share allocation.
- *Q&A.* A customer must answer a variety of questions (which are based on securities regulations). Essentially, these are meant to flag a so-called restricted person, a customer who has some type of connection to the financial services industry that may forbid him or her from participating in the IPO.
- *Review the preliminary prospectus.* This is done by downloading the document.
- *Enter an indication of interest.* This is the maximum number of shares to buy in the offering. You will not be able to indicate a price since it

FIGURE 1.2 Fidelity.com IPOs

Fidelity.com Search Quotes Customer Service Open an Account Log In

Accounts & Trade | News & Insights | Research | Guidance & Retirement | Investment Products

Monday, April 23, 2012

Investment Products > Trading >

Initial Public Offerings (IPOs)

We are pleased to offer eligible brokerage customers the possibility of participating in Initial Public Offerings and other public equity offerings through Fidelity Brokerage Services LLC. We have established relationships with Deutsche Bank, Kohlberg Kravis Roberts & Co. (KKR) and multiple other underwriters to offer access to both new issue equity and fixed income offerings.

Sign up with Fidelity Alerts to receive New Issue offering alerts via pagers, e-mail, and personal data assistants.

Enter IPO indication of interest online

Eligible brokerage customers can now enter IPO indications of interest.

Participate in an Offering

Current Offerings Calendar

Issuer Name	Offering Type	Expected Pricing Date	Expected Price Range	Fidelity Indication of Interest Period	Distribution By	Offering Size	Industry	Lead Managers	
ARES COMMERCIAL	Initial Public Offering	04/26/2012	$19.00-$20.00	04/17/2012 - 04/25/2012	ISSUER	7,700,000 shares	REAL ESTATE - REITS	WFS, CITI, BAML, JPM	Participate Prospectus
THE CARLYLE GROUP	Initial Public Offering	05/02/2012	$23.00-$25.00	04/16/2012 - 05/01/2012	ISSUER	30,500,000 shares	FINANCIALS - DIVERSIFIED FINANCIALS	JPM, CITI, CS, BAML, BARC, DB,	Participate Prospectus
ENVIVIO INC	Initial Public Offering	04/24/2012	$10.00-$12.00	04/11/2012 - 04/23/2012	ISSUER_SELLINGSHAREHOLDERS	7,755,000 shares	HIGH TECHNOLOGY - OTHER HIGH TECHNOLOGY	GS, DB, STIFEL	Participate Prospectus
FIBRIA CELULOSE S A	Follow On	04/24/2012	$0.00-$0.00	03/30/2012 - 04/23/2012	ISSUER	[illegible] shares	MATERIALS - PAPER & FOREST PRODUCTS	BAML, ITAU BBA	Participate Prospectus
PETROLOGISTICS LP	Initial Public Offering	05/02/2012	$19.00-$21.00	04/23/2012 - 05/02/2012	ISSUER_SELLINGSHAREHOLDERS	35,000,000 shares	MATERIALS - CHEMICALS	MS, CITI, UBS	Participate Prospectus

has yet to be determined. Instead, the deal will have a price range, such as $12 to $14.

Keep in mind that you may not get the amount of shares requested—or any shares. The offer is not binding.

- *Effectiveness.* On the day the deal is declared effective, you will get an e-mail to confirm your indication of interest. You can also withdraw the offer before the transaction is priced, which usually happens within 24 hours.
- *Allocation.* You will receive an e-mail showing the number of shares you have purchased. In the case of Fidelity, the allocation is based on a propriety system that evaluates a customer's relationship, such as the level of trading and other activities with the firm. According to the website at www.fidelity.com:

> The allocation methodology is done as fairly and equitably as possible. The size of a customer's indication of interest is not considered during allocation other than the fact that we will not allocate more than the customer requested. Therefore, you should only enter an indication of interest for the amount of shares you are interested in purchasing as entering a larger number will not help you receive additional shares and there is always the possibility that you could be allocated everything you ask for.

- *Check your account.* Make sure you received the allocation. Mistakes do happen. There will also be a link to the final prospectus.
- *Trading.* You can sell the shares at any time. But again, you may be penalized for flipping them. According to Fidelity:

> If customers sell within the first 15 calendar days from the start of trading in the secondary market, it will affect their ability to participate in new issue equity public offerings through Fidelity for a defined period of time.

Build Relationships with the Syndicate Firms

A company will usually have two or more underwriters. They manage the offering. But they also form a syndicate of many other brokerage firms to sell the deal. You'll find these firms in the prospectus. Interestingly, you will often see many boutique operators.

So a good idea is to contact them and learn about these firms. How do they allocate IPOs? Do they like to have a certain level of assets in your account? By building a relationship, you are likely to get allocations in IPOs. You may also get some deals for secondary offerings.

Dutch Auction

More and more, auctions are becoming a popular way for people and companies to do business on the web. It was the Nobel Prize–winning economist William Vickrey who developed the ingenious auction system. It's the same system that the U.S. Treasury uses to auction Treasury bills, notes, and bonds. Why not use it for IPOs?

Actually, a firm called WR Hambrecht + Co does have an auction system set up for IPOs. It is called, appropriately enough, OpenIPO. The founder of the firm is William R. Hambrecht, who is also the founder of the traditional investment bank Hambrecht & Quist. He started the firm because he wanted to "balance the interests of companies and investors." OpenIPO allocates IPOs to the highest bidders. However, the auction is private, and all winning bidders get the same price. Consider that top companies such as Google, Morningstar, and NetSuite have used the system.

Here's how it works: Suppose that XYZ wants to go public and has offered to sell one million shares. Its investment bankers have performed the necessary due diligence and have established a price range of $10 to $14.

Anyone can go to OpenIPO—rich or poor, individuals or institutions—to place a bid on the shares.

Let's say you want to bid for 1,000 shares of XYZ at a price of $14 a share. Before you can make the bid, you must first establish an online OpenIPO brokerage account for a minimum of $2,000. Keep in mind, though, that when bidding on an IPO you will need to have enough cash to cover the maximum IPO bid price. It is important also to take note of the fee schedule listed on the website. What's more, you cannot buy IPO shares on margin, and the minimum bid is for 100 shares, although there is no maximum. You can submit multiple bids, say 2,000 shares at $13 and 1,000 shares at $11, and so on. If you have second thoughts, you can withdraw any of the bids.

Let's say there is a lot of action for the XYZ IPO, and many bids come in (the auctions typically last between three and five weeks before an IPO is declared effective). The OpenIPO proprietary software processes these bids. It determines that at a price of $13 per share, 1.1 million shares will be purchased. This is known as the clearing price.

Since there are more shares demanded than have been offered for sale, XYZ has two choices. First, it can have the IPO at $13 per share, in which case you will get 91 percent of your bid. (This is calculated as 1.0 million divided by 1.1 million, or 0.91. As a result, you will get 910 shares, which is 91 percent of 1,000.) Or second, XYZ can decide to lower the price below the clearing price. Suppose it lowers the price to $12. At that price, there is demand for 1.3 million shares, which means a 77 percent ratio. Thus, you will get 770 shares (77 percent of 1,000).

There are certainly successful Dutch auction IPOs. Perhaps the most notable was the offering of Google, which was on August 19, 2004.

Actually, the company used a modified Dutch auction. That is, Google reserved the right to set the final price, not a computer.

So for the IPO, the company priced its shares at $85, which was at the bottom of the range of $85 to $95. But on the first day of trading, the stock closed at $100.34.

In a true Dutch auction, this first-day pop would probably not have happened since the demand would have equaled the supply of shares. But perhaps Google wanted to provide a nice return for its shareholders.

However, it would not have been smart for shareholders to take this quick profit. By October 2007, the shares would go over $700.

Despite the success, Dutch auction IPOs are fairly rare. The reason is likely that Wall Street investment banks prefer the traditional approach, which gives them more power over the process and often results in higher fees.

Buy on Secondary Markets

Secondary markets in IPOs have seen tremendous growth over the past few years. Two of the top operators are SharesPost and SecondMarket.

These firms have platforms that allow investors to purchase pre-IPO shares. This is done by purchasing stock from employees and venture capitalists. No doubt the hottest trading to date was in the shares of Facebook.

But there are some drawbacks. First, the fees can be high and it can easily take several months to pull off a transaction. Besides, the companies may never go public, making it difficult to get a return on the investment. In Chapter 22 we'll go into much more detail on secondary markets.

Private Placements

A secondary market involves buying shares from existing shareholders. In a private placement, you buy shares directly from the company. For the most part, the buyers tend to be venture capitalists and private equity investors.

But this is starting to change. Over the past few years, there have emerged some marketplaces for private placements. One is actually SharesPost.

In late 2011, the firm helped with the private placement of TrueCar, an online service to buy cars. The company raised $200 million in debt and equity.

In the process, investors received a document called a private placement memorandum (PPM). It is like an IPO prospectus but is usually not as in-depth. In the case of TrueCar, there was an online video of a presentation from the CEO.

A private placement will also usually involve one or more investment bankers. They will perform due diligence as well as put together the investor materials.

But to participate in private placements, an investor must be accredited. This means he or she must have made over $200,000 for the past two years (or more than $300,000 for married couples).

Even if you meet the criteria, you still may not get shares in a private placement. Keep in mind that the company will often want certain types of investors in its company—that is, those who have demonstrated a long-term focus.

IPO Mutual Funds

There are a variety of mutual funds, closed-end funds, and exchange-traded funds (ETFs) that focus on IPOs. Examples include the Global IPO Fund, Direxion Long/Short Global IPO Fund, First Trust U.S. IPO Index Fund, and GSV Capital Corp.

Because of their scale, they can get shares at the offering price. In fact, some even purchase shares in the secondary market. For example, GSV Capital has invested in pre-IPO shares of companies like Groupon, Twitter, and Facebook.

These funds also have the advantage of professional management. In Chapter 19, we'll take a closer look at IPO funds.

Directed Share Program

A directed share program (DSP) is when a company sets aside a certain number of shares for friends and family. These usually account for about 5 percent of the offering. So yes, if you know someone at a company that's going public, it's worth asking if there are shares available. A DSP must be disclosed in an IPO prospectus.

In many cases, DSP shares are not subject to the lockup (this forbids an investor from selling shares for a period of time, which is usually a six-month period after the offering). But companies are starting to change this.

In some situations, a company may have a DSP for employees, customers, and suppliers. This was the case for the General Motors IPO. Actually, with the Dunkin' Donuts offering, the company had a DSP for its franchisees.

But this type of program is not without its risks. For example, when Vonage had its IPO in 2006, it set up a DSP for customers to purchase at the offering price of $17.

Unfortunately, the stock price plunged, hitting $6 within a couple of months. As a result, many of the DSP investors failed to pay for the shares!

Follow-On Offerings

After a company has an IPO, it may have other offerings of stock. These are known as follow-on offerings, but many investors also call them "secondaries."

A follow-on offering is similar to the process of an IPO in many ways, such as with disclosures. In other words, there will be a new prospectus filing, and management will have a road show.

It is fairly common for a company to have a follow-on offering within six months to a year after the IPO. In many cases, it is a way for executives, venture capitalists, and private equity firms to sell off shares. It tends to be better to have a follow-on offering than for them to start dumping stock. Interestingly, though, a follow-on offering may require these holders to extend the lockup on the rest of their shares.

To generate demand in a follow-on offering, a company will price the shares below the market price—say by a few percentage points. Thus, buying follow-on shares can mean a nice short-term profit. But like getting an IPO, you need to establish a relationship with an underwriter. Or you might want to check out some top online brokers. Consider that Fidelity provides access to follow-on offerings.

Direct Public Offerings

A company using a direct public offering (DPO) does not use an underwriter. Instead, the company offers stock directly to the public. In many cases, these investors are customers or friends of the company. The company, in a sense, is leveraging its goodwill to do an IPO and avoiding the costs of hiring an underwriter.

Small companies seeking less than $5 million in capital usually pursue DPOs. Often, companies going the DPO route have had trouble getting financing from venture capitalists or underwriters.

Until 1995, DPOs were quite rare. In most cases, when a company did a DPO it sold its stock only to its established customers, known as an affinity group. Perhaps the best-known DPO was Ben & Jerry's selling its IPO stock at its ice cream stores. The offering was announced on the bowls of ice cream.

But not all companies have such loyal affinity groups. As a result, DPOs were scarce. Then the Internet arrived and offered companies a huge, cost-effective distribution channel to sell stock directly to investors.

The simplicity and low costs of putting up a web page make it enticing for companies to engage in securities fraud. And yes, there have already been numerous cases of DPO fraud.

One such case involved Interactive Products and Services, of Santa Cruz, California. The company raised $190,000 over the Internet from 150 investors. Unfortunately for those investors, the company was a complete sham, and the investors lost everything. Netcaller, the company's only product, was a figment of the founder's imagination, based on a rejected patent application. Interactive Products made false statements in its web prospectus, and the founder spent the money it raised on personal items such as clothing, stereo equipment, and groceries.

Interactive Products' Netcaller was described in its prospectus as a "handheld cordless Internet appliance which enables the user to browse the World Wide Web, send and receive e-mail messages, have real-time communication through the Internet, and two-way voice communications using Internet telephone software."

Interactive Products actually placed extensive web banner ads, many of which stated: "The next Microsoft is offering its stock to the public over the Internet." When you hear such inflated claims for a product that is seemingly too good to be true, stay far away.

There are other concerns with DPOs, including lack of liquidity. There is usually no market for buying and selling shares in a DPO. One company, Real Goods Trading, did a DPO and allowed its investors to trade their Real Goods stock from its website. In such cases, the transaction is then cleared through an escrow agent. But even this approach does not guarantee a good price for your stock. According to the Real Goods website, there was very little trading activity.

To get more liquidity, a DPO will often try to list on a national exchange like the New York Stock Exchange or NASDAQ. No doubt this will create much more liquidity and exposure for the stock.

In some cases, it has happened. But as an investor, it is not a good idea to count on it. DPO companies tend to be niche operators that do not have the growth ramp required for a national listing.

Another chief concern with DPOs is the absence of an underwriter to chaperone the deal. This means that vital tasks such as due diligence, research, and deal structuring, which ordinarily fall to underwriters, are left largely unmonitored and without expert assistance.

IPOs to Avoid

Sometimes you will get offers for IPOs that may seem too good to be true. It's probably best to avoid these.

Here's a look.

- *Spam.* It has become a huge business, primarily because it is so easy and cost-effective to send simultaneous messages to millions of people. Some look very personalized, and others look as if they were sent to you accidentally. But keep in mind that spam is never accidental. It's a marketing tool, not objective information. Some spam will offer you the "opportunity" to buy into IPOs or investments. It's a good idea to stay away. It is common to see these kinds of messages, like "Get the next Facebook." Unfortunately, they are scams. Keep in mind that a Wall Street firm would never use spam to sell a deal. It would be illegal.
- *Unsolicited mail.* If you sign up for magazines or online journals, you are likely to be put on a variety of mailing lists. In order to promote their IPOs,

small companies will purchase these lists and send out very professional-looking, glossy marketing materials. In most cases, a company has hired a public relations (PR) firm that knows how to hide the negatives and hype the positives. These may actually be pump-and-dump offerings—when a company's officers issue large amounts of stock to brokers, creating the illusion that the stock has done a successful offering as the price soars. The brokers, in turn, will dump the stock on clients.

- *Cold calls.* Cold calls are a key part of the brokerage business. It's called "dialing for dollars." These brokers are playing a numbers game. The more calls they make, the more people they reach who may put their money into the supposedly hot investments they are selling. Cold calling is by far the most cost-effective means of marketing. To be successful, there needs to be only a 1 to 2 percent closure rate.

  In most instances, you simply don't want to buy what cold callers are selling. Remember this: If it were such a hot investment, they wouldn't be selling it unsolicited over the telephone.

  But cold callers can be very convincing. They spend hours every day making the same calls, using the same script. If you want to reduce the number of calls you receive, ask the broker to put you on the Do Not Call list, or write a letter to the compliance officer of the firm.
- *Crowd funding.* In 2012, the U.S. government passed legislation that made crowd funding legal. Essentially, this allows small companies to issue shares using the Internet. But keep in mind that these investments will likely not reach the IPO market for many years, if ever. In Chapter 22, we'll take a closer look at crowd funding.

Conclusion

While it may seem tempting to get IPO shares for the opening day, it can be risky. Even Facebook fell over 20 percent within a few days of its offering. A better approach—at least for long-term investors—is to wait a quarter or two before jumping in. The hype will subside and the stock will get seasoned in the market.