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FEE-ONLY WEALTH MANAGERS

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IPO Winners and Losers

The past year will be remembered for two remarkable social media initial public offerings: LinkedIn on May 19, 2011 and Facebook on May 19, 2012. Although the dates were the same, the two offerings went very differently. LinkedIn's share price roughly doubled immediately after the shares were purchased, from the $45 IPO price to $94.25 when the market closed that day. The offering was widely described in the papers as a great success.

Facebook's shares, meanwhile, were priced at $38 and finished that frenetic first trading day at roughly the IPO price--at $38.23. You've seen the headlines ad-nauseum: news reports have declared it an epic failure.

So here's the question: which IPO was actually successful, and which was a failure?

The media has had no trouble answering that question. But if you look at the situation from the standpoint of the company bringing shares to the public (and what other standpoint really matters?) then you come to exactly the opposite conclusion. The LinkedIn IPO would have to be judged a spectacular failure, while Facebook's IPO represents a rare example of a success.

To see why, just look at the numbers. In all, LinkedIn raised $352.8 million on its 7.84 million shares. Based on what investors were willing to pay on that first day of trading, the company actually had the opportunity to sell those shares to willing buyers at closer to $95, and raised a total of $700 million. That extra $350 million could have been used to fuel its growth, develop new technologies, reach into new markets, purchase competing organizations or a million other uses.

Where did that extra $350 million go instead? To friends of IPO underwriters JP Morgan, Morgan Stanley and Bank of America/Merrill Lynch, who were given the sweet chance to buy at half what the market wanted to pay for the shares.

Meanwhile, Facebook, the company, got full price for the shares it sold to the public; that is, the IPO price turned out to be surprisingly close to what the market as a whole wanted to pay for shares of the social media company. In all, the company raised $16 billion to build or enhance its franchise and acquire competitors. The insiders who got favored access to the shares got virtually nothing when they tried to flip them on the open market.

These facts represent more than just a way to look really really smart the next time you talk with friends about the investment markets. There's a serious issue buried in these routine mispricing's, and in the way the media has been trained to think about (and cover) initial public offerings.

The brokerage companies that underwrite IPOs are paid handsomely for selling a company's first publicly-traded shares to the investment world--roughly 7.5% of the money raised, or about $1.3 billion on these two IPO deals alone. The firm is supposed to be working purely for the benefit of the company whose shares it is selling, and the only goal that makes sense is to raise as much money as possible for that company so its executives can deploy the capital and grow its business and shareholder value.

But in fact, in the real world that we happen to live in, the brokerage underwriters have actually made a practice of deliberately undervaluing shares when they bring them to market. They then dole out the underpriced IPO shares to their best customers, who can flip them for an immediate profit. Some of those big customers are, themselves, the people who make decisions about which company will be given the lucrative contract to sell their own company's shares on the open market. If this looks to you like a way to bribe people to bring you business, then you are reading carefully and correctly.

The difference between the initial share price and the higher price you see in a lot of IPOs directly benefits the brokerage firm itself. These deliberate underpricing's have become a clever, perfectly legal way for the brokerage firm to reward the very customers who pay (or will someday pay) these firms ginormous fees for their own IPO. In legal terms, this is a huge conflict of interest, and it is interesting that our media reports favorably, with breathtaking excitement, whenever these large institutions visibly take advantage of the firms they supposedly work for to the tune of hundreds of millions of dollars. And the media gives us an endless stream of negative headlines in cases like Facebook where, apparently by accident, the brokerage underwriters do their job well.

Sincerely,

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President, Founder, and Chief Investment Officer

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