

ZachStocks Special Report

Three Essential Issues for IPO Investing

Initial Public Offerings, or IPOs, can offer some of the most explosive investment opportunities available to individual investors. Returns can quickly skyrocket as companies who have previously been private, are now available for the general public to invest in. A successful IPO can see gains of 50%, 100% or even more within the course of just a few days (or even hours in a few special cases).

The last few months have been very dry for IPO investors. As investors have shunned risk and the economy has faltered, it has been very difficult for new companies to find willing buyers regardless of the quality of operations or profits.

But with the rebound in the market has come renewed interest in new issues. A few recent successful offerings may prime investors' appetites. At the same time, a number of companies have been waiting for a window in the market where they can go public and raise the necessary capital to grow their business.

So as the potential for new deals to price grows, investors need to be aware of the three most important dynamics surrounding every IPO. These dynamics shape how the shares are distributed to investors and can give you a clue as to how the stock will trade following the offering. Proper use of these clues could help you land a stock with the ability to post triple digit returns in a short period of time. So let's take a look at these dynamics and how *you* can claim your profits:

Who Is Selling and What is Their Agenda?

When I get a call about an upcoming IPO, the first question I always ask is *who* is selling these shares and what are they doing with the money? After all, if I'm supposed to believe that this is a great investment, then why would the shares be available for me to buy at this price?

My favorite answer to this question is "these are all primary shares." That's shop-talk for "The company itself is the one selling stock." Now if the company is selling shares, it means that when 20 million shares are distributed to the public for \$12 per share, the company will get roughly \$240 million dollars which it can use to grow operations.

Every time an IPO takes place, the company issues a booklet called a *prospectus* which gives the important information about the company, about the deal, and usually includes some of management's expectations for future growth.

The "use of proceeds" section explains whether the company will use the cash for general corporate purposes, to build a new facility, to pay off debt, or any number of projects. IPOs who use cash for purposes which will lead to higher profits are immediately interesting to me. However, sometimes the company never sees a dime of the money from the IPO – That's a red flag...

Every company is owned by “somebody.” Maybe it’s Mr. Smith who founded the company back in 1973. Or maybe it’s a private equity firm who bought the company from Mr. Smith in 2003. Either way, when these owners are listed on the prospectus as the selling shareholders, I know I need to dig deeper.

Selling shareholders don’t always disqualify a deal in my opinion. After all, if you built a company that grew to a value of \$400 million, you would want to sell a few shares yourself and buy a nice little getaway (in the Caymans). But if you decide to sell your company in one fell swoop, you can bet that the buyers will get scared.

I prefer to see selling shareholders continue to hold 60% or more of the company after the IPO is distributed. This would tell me that the owners still have confidence in the business and want to participate in the growing profits. If the sellers expect to own less than 50% after the IPO is priced, I usually pass or take a much smaller position as this doesn’t inspire confidence in how the deal will perform.

Now usually the company or the selling shareholders can’t handle the entire IPO transaction on their own. The standard procedure is to hire what is known as an *underwriting firm* to find willing buyers and get the shares actually in the hands of public investors. This brings us to our next issue:

Who are the Underwriters and What is Their Role?

Underwriting firms are typically the Wall Street firms that everyone has heard of. While there used to be more than a dozen top tier underwriters, the loss of Lehman Brothers, Bear Stearns, and consolidation of firms like Merrill Lynch and Wachovia have changed the landscape.

Still, there is a bit of an edge for investors if you understand the underwriting process and the strengths and weaknesses of each underwriter. To start with, a strong underwriter is key for large deals because of the base of clients that these underwriters can sell to. For instance, Merrill Lynch (now a part of Bank of America) has one of the widest footprints when it comes to retail customers. If a new company hires Merrill Lynch to sell their shares, Merrill has a plethora of brokers it can use to sell this stock to investors across the country and really worldwide.

Morgan Stanley and Goldman Sachs are widely considered as the “blue chip” underwriters because of their established relationships with large institutional buyers. Typically the strongest companies will hire these two firms as the lead underwriters in order to get their stock in the hands of these coveted institutional investors. Standards are usually higher for Goldman and Morgan so an IPO company would need to have an impeccable track record, a sound growth strategy, and be large enough to be worth the underwriters time.

I prefer to be involved in deals that are underwritten by Morgan Stanley, Goldman, Bank of America and Wachovia (now a division of Wells Fargo). These firms are large enough to handle and distribute a 20 million share offering while still only filling a portion of clients’ orders. (This is key because if clients only get half of the IPO shares they ask for, there is a bigger chance that the clients will buy more shares once the market begins trading).

Smaller underwriters like Raymond James or KBW have their place and sometimes come up with some very interesting niche opportunities. However, these deals typically have less liquidity and are a bit more dangerous than deals offered by the major firms. These IPOs are traded on a case by case basis with the understanding that they are not likely to have the same return profiles as those larger more popular IPOs offered by the major firms.

Pricing Dynamics Can Tell You How a Stock Will Trade

The final thing to look at when trading IPOs is the way underwriters come up with the final pricing figures. Now we've talked about the prospectus for each deal but I should tell you that the underwriters file a preliminary prospectus that is often changed several times before the deal is consummated.

Underwriters always give investors an expected price range (for instance \$15 to \$17 per share) as well as a number of shares being sold (20 million shares). As the underwriters begin to call clients to find out who will be willing to buy these shares, the demand picture begins to evolve.

Sometimes it becomes clear that there is little interest and so the underwriters must adjust the terms to get the deal done. If after a few days of calls, the price range is adjusted to \$12 to \$14, or the number of shares offered declines to 18 million, I quickly understand that the street has little interest in this deal and the underwriters are struggling to find buyers. Even though the shares are now being offered at a better (lower) price, I don't want to buy this IPO because with lower interest, there is less chance of it quickly trading higher.

On the other hand, sometimes the deal terms are markedly different. The price range can work its way higher as the transaction grows nearer. I love it when I leave work on Thursday night after being told that the range is now \$18 to \$20 and they expect to price 25 million shares. Sometimes it even goes so far as to price the full 25 million shares at \$22 the next morning, a strong indication of demand. These are the types of deals which have the potential to be trading at \$55 within the next week.

A Little Homework Can Pay Off!

Although these three issues are rarely considered by most individual investors, they can pay huge dividends when deciding whether to get involved in a new stock or not. This is just another instance where paying attention and doing your homework can yield exceptional gains in a short amount of time.

Wishing you every investment success!
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