Lesson 10 What is an Initial Public Offering (IPO)?

Resources: Internet access

Objectives: Learn the difference between **primary** and **secondary stock markets**. Understand that it is difficult, if not impossible, for individuals to get shares of an IPO at the **offering price**. Through the activities in this lesson, learn the next best time to invest in IPOs.

Background: There are actually two different markets for stocks: the **primary** and **secondary** markets. In the primary market, a company decides to go public, meaning it will sell stocks to the public to raise money the first time. These new shares for sale to the public are called **Initial Public Offering (IPO)**. Buyers (usually institution investors) of these new shares of stock will later sell them to the stock market known as the secondary market.

When investors resell these new shares to the stock market, the companies that first offered the IPOs don't receive additional money in the secondary market. Sometimes, insiders (founders and employees) of a company decide to sell their own shares to the public after the IPOs. This is called a secondary offering. In this situation, the employees/shareholders, not the company, receive the money.

Once a company decides to go public, it appoints a **lead underwriter** to carry on the process. Brokerage firms such as Goldman Sachs, Merrill Lynch, and Morgan Stanley Dean Witter are the top underwriters. The company first has to officially register the IPO with the **Securities and Exchanges Commission (SEC).** Next, the company prepares a business document called the "**prospectus**." This document includes financial data, business descriptions, management teams, risk factors, competition analysis, and business plans of the company.

Then, the company's management team performs a tour, called the **road show**, to major U. S. cities such as New York City, Los Angeles, Chicago, Boston, and San Francisco to meet with prospective investors about the IPO. Only institutional investors, money managers, and analysts are invited. In these crucial meetings, investors indicate their interest in purchasing a stake in the IPOs.

After the road show, the management of the company and the underwriters determine the share price and the size of the offering. Once the final price is set and the final prospectuses are distributed, the IPO starts selling to investors. After the lead underwriter works out the details with the **syndicate** on the date of the IPO, shares of the stock may resell to the public in the secondary market. Usually, this happens late on the date or the next day of the IPO. You can buy shares of the IPOs when they become available to the public.

Activities: Investing in an IPO can be extremely profitable because investors are constantly looking out for the next Microsoft and Cisco. On the other hand, it can be a very risky investment. For example, **Theglobe.com** was traded at 250% above its **initial offering price** the first day of the IPO. Nevertheless, its share price dropped below the offering price a year later.

These activities are designed to examine the best and worst IPOs in the period of 3 months, 6 months, and 12 months after the initial offering data.

Find the three best and worst IPOs from Yahoo! Finance http://finance.yahoo.com/ under "US Market/IPOs" in the recent 3-month period.

Best Performed IPOs in the Recent 3 Months				
Name	Symbol	Offering Price	Recent Price	% Gains/Loses
1.				
2.				
3.				

Worst Performed IPOs in the recent 3 Months				
Name	Symbol	Offering Price	Recent Price	% Gains/Loses
1.				
2.				
3.				

2. Find the three best and worst IPOs from Yahoo! Finance http://finance.yahoo.com/ under "US Market/IPOs" in the recent 6-month period.

Best Performed IPOs in the Recent 6 Months				
Name	Symbol	Offering Price	Recent Price	% Gains/Loses
1.				
2.				
3.				

Worst Performed IPOs in the Recent 6 Months				
Name	Symbol	Offering Price	Recent Price	% Gains/Loses
1.				
2.				
3.				

3. Find the three best and worst IPOs from Yahoo! Finance http://finance.yahoo.com/ under "US Market/IPOs" in the recent 12-month period.

Best Performed IPOs in the Recent 12 Months				
Name	**Symbol**	**Offering Price**	**Recent Price**	**% Gains/Loses**
1.				
2.				
3.				

Worst Performed IPOs in the Recent 12 Months				
Name	**Symbol**	**Offering Price**	**Recent Price**	**% Gains/Loses**
1.				
2.				
3.				

Most individuals cannot get hot IPO shares at the offering price. Should they jump in to pay a high **premium** on the first day of trading? For example, **Theglobe.com** was priced at about $9, and the stock opened at $90. Many small investors bought the shares at $90 and watched the stock finish up at $50 at the end of the day. Theglobe.com dropped below $9 a year later.

4. Based on the data shown on the above tables, answer the following questions:

1. Most of the IPOs have negative earnings. How can you pick the winners or losers from an IPO?

2. How do you judge the earnings potential of the above IPOs? How do they justify the high **valuations** of those hot IPOs?

3. Visit the best performers' Web sites and research the companies' products and their management teams. Can you tell why some shares are selling much higher than the offering prices?

4. Visit the worst performers' web sties and research the companies' products and their managements teams. What are your findings for the depressed share prices?

5. Find those IPOs with the SEC filing on Yahoo! Finance or e-mail the company's investor relations department. Research the SEC document. Specifically look for the risk factors that would potentially cause you to lose all or part of your investments. How excited may you be about the IPOs after these fact findings?