The Hot IPO of 2017

SYNOPSIS

- This year is slated to be a big one for Initial Public Offerings (IPOs), which is the process where private companies sell their stock to the public for the first time.
- The IPO process is one where the biggest investors get access to the best deals, which leaves very little chance for smaller investors to participate.
- The Catch-22 for individual investors is if you can get an allocation to an IPO, it's best not to take it.

INVESTORS WANT IN

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. Rather, an investment bank assists companies in raising funds in the capital markets, provides advisory services on mergers & acquisitions, and completes other complex financial transactions.

One of the more profitable services offered by investment banks is to take the shares of private companies and sell them through an Initial Public Offering (IPO). This process is often referred to as "taking a company public."

As the economy continues to strengthen, this year could end up being a big one for IPO activity. Companies like Snap, Uber, Airbnb, Pinterest, Spotify, and many more are rumored to go public over the next twelve months.

The media and short-term traders absolutely love 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 for sale, there were more than ten willing buyers.

However, individual investors are often frustrated and confused when they learn that getting in a "hot IPO" is next to impossible. Before we explain why individual investors are almost never included in these deals, let's first explain how the IPO process works.

INVESTMENT BANKS MAKE THE CALL

When a company chooses to go public, the first step is to hire an investment bank to facilitate the sale of their stock to professional money managers.

> *...only allocate what you are comfortable losing to a newly-issued stock.*

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

NOTE: This process is similar to using a real estate agent to sell a house. An agent is by no means required, but they can make the process smoother by offering advice and marketing your home to prospective buyers.

Bankers initially target investors with billions under management because they can buy large amounts of stock and are generally considered long-term holders.

Management teams strongly prefer to sell their stock to investors who will hold the stock for many years because they believe in the strategic direction of the company.

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

A few days before the IPO, bankers will solicit orders from investors. If a money manager is interested, they tell the bank how much stock they want. 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 is much more an art than a science, and the bankers will often move the stock price up or down more than once before it begins trading as they get a better sense of the overall demand.

Bankers walk a fine line because on the one hand, they were hired by the company to get the best price for their stock, while on the other hand, they cannot price too high and risk damaging their relationships with big investors who may feel that they got a bad deal.

NOTE: Bankers try 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, the company gets a good price, and the investor now owns 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.

Simply put, retail investors and even most medium-sized institutional investors rarely get an allocation of a hot IPO because the bankers would much rather put this stock in the hands of those with the most money to spend.

CAVEAT EMPTOR

Let's assume that after a bank completes a roadshow for a company, they realize that demand is far 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 expensive.

Bankers are hired to sell this stock, and since the big money managers are not biting, they must resort to other channels to fill the demand, which is the only time smaller investors are considered.

For example, the Facebook IPO back in 2012 did not garner enough interest from large institutional investors, so the bankers filled the gap by offering stock to smaller money managers and directly to individual investors. Alibaba, on the other hand, was so heavily in demand that most big investors only received a fraction of the allocation they had requested. An order for a million shares may have only resulted in an allocation of one hundred thousand shares.

Said another way, smaller investors will only receive allocations in IPOs when the bigger money managers, the ones with an endless supply of talent and extensive experience evaluating these deals, have little interest in participating.

IMPLICATIONS FOR INVESTORS

Newly-traded stocks carry a tremendous amount of risk because it takes a while for a stock to start trading on fundamentals. In fact, the more disciplined money managers who do not get included in an IPO tend to wait a year or longer before buying because they like to watch how a stock trades while they conduct proper due diligence.

Therefore, if you miss out on the hot IPOs of 2017 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 earlier, a good rule of thumb is to only allocate what you are comfortable losing to a newly-issued stock. 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, and for those who are offered, keep in mind that you are only getting the opportunity is because the larger, more sophisticated investors did not like the deal and chose to pass.

Sincerely,

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