The Story and the Numbers: How to Evaluate an IPO
Let's begin by briefly reviewing what exactly an IPO is

An IPO is the first sale of stock to the public by a company or existing shareholders. IPOs are undertaken for a variety of reasons and can occur at different points in company life cycles. Since an IPO is first and foremost a financing mechanism, companies in growth phases are more likely to undertake IPOs than those in mature steady-state phases.

However, assuming willing investors, there is nothing that precludes a company at any stage in its life cycle from completing an IPO.

Evaluating IPOs centers on balancing the company's potential for sustained superior growth with financial, management and competitive risks. And like any investment, one has to be careful not to overpay – so a reasonable valuation against peers and reasonable growth and profit assumptions are critical.

Long-term investors are best served by focusing on high-quality companies that exhibit strong sustainable growth prospects and have reasonable valuations – these firms offer the greatest potential for long-term share price appreciation.

Identifying high-quality companies can be daunting but focusing on the common characteristics that define a “high-quality” company helps identify the outperformers.

These characteristics include a:

• Sustainable competitive advantage
• High market growth prospects
• Superior management team
• Solid financials and reasonable valuation

SEC Documents and the Road Shows

The IPO process begins when a registration statement, called the S-1 or red herring, is filed with the Securities and Exchange Commission (SEC).

After a review process, the SEC declares the filing effective. From the time of initial filing until 25 calendar days post-pricing, the company is in the “quiet period,” which is an SEC-imposed ban on all written or verbal promotional publication. An exception to the quiet period occurs after the S-1 has been declared effective, but prior to pricing, and it is known as the “road show.”
During the road show, top company executives and the underwriters’ sales forces meet with prospective investors to communicate the company’s story. Individual investors can gain access to road show materials through a company’s underwriters.

Traditionally, IPOs have been sold on a fully underwritten or a best-efforts basis. In a fully underwritten deal, the underwriters guarantee a price (to the company) for all of the shares being offered. Best-efforts deals are those where underwriters do not guarantee a price but will use their “best efforts” to sell the shares being offered. The underwriters’ target pricing range typically values the IPO at a slight discount to its comparable public peers so that it opens well. Ultimately, IPO pricing is a function of expected demand.

As the road show culminates, the underwriters aggregate their order books and determine the market-clearing price at which the IPO can be offered.

More recently, the IPOs of Google and Morningstar witnessed the emergence of a Dutch auction pricing mechanism. A Dutch auction uses a bidding process to find the price at which an issuing company can sell all its available shares, diminishing the underwriters’ pricing role. From the seller’s perspective, the price determined in a Dutch auction should be optimal since it is set at the sweet spot of supply-demand balance. While new to equity markets, Dutch auctions continue to be the method used for U.S. Treasury auctions. The future use of Dutch auctions to price IPOs is uncertain.

**The S-1: Understanding the Firm**

Even more important than understanding the IPO process is reviewing and understanding the information provided in the S-1 statement. Although somewhat long, repetitive and tedious to get through, the S-1 should be read carefully by any serious IPO investor. These documents will provide you with your most basic understanding of the company, though always bear in mind that from the underwriter’s perspective, part of the goal is to sell the deal.

The S-1 of any IPO is available on the SEC’s website ([www.sec.gov](http://www.sec.gov)). When downloading an S-1, make sure that the most recent amendment is selected.

Although the S-1 is your most valuable source of information, recognize that the company, its underwriters and lawyers craft the S-1 to properly communicate the company’s story from their perspective. Also recognize that the SEC review process is focused on the company’s compliance with filing requirements and not a review of the facts.

Start reviewing the S-1 by identifying the underwriters. Are the underwriters blue-chip, top-bracket firms or are they unknowns? If you do not recognize the underwriters, caution is warranted, although there are a number of lesser-known, reputable regional and boutique underwriters.
Next, carefully review the prospectus summary, which contains an executive overview of the business, key risk factors, summary financial information, information on the offering and other key data. This high-level overview determines if the IPO fits a specific investment strategy or if it should be investigated further. It also should allow you to evaluate how well the company meets the characteristics of a quality company with sustainable growth prospects.

Here are some of the most important issues you should focus on.

**The All-Important Storyline**

A very successful IPO will always have a compelling story. Even if the numbers are excellent, the company has to frame the itself in a story that attracts the attention of the financial media.

Some IPOs are just beyond the pale in terms of pricing and valuation. Take the recent Rivian IPO which, after two days of trading, put Rivian’s market value at $115 billion even though it has minimal orders and will only be able to deliver electric trucks in any numbers until 2023-2024.

It is critical that executives tell a good story while still managing expectations. With the CEO as the key spokesperson, the company's message should be short, precise, consistent and interesting across stakeholders – the Board, shareholders, Wall Street, the financial media and employees. The message should also include answers to the following questions:

- Where are we now?
- Where are we going?
- How will we get there?
- How will we measure success?

These questions provide a framework that explains the effect that new economic or market conditions could have on the company's goals and how it will react to these changes. Managing expectations and building trust requires a good forecasting tool to help you calibrate performance and should be based primarily on the key business drivers highlighted in your prospectus.

**Company Operating History**

What is the company's operating performance? Reviewing the financial statements and business sections will provide you with more than you need to address some key questions:

How long has the company been up and running?

Has the company been in operation for some time as a private company or is it a private-equity-sponsored roll-up that has been financially engineered? In an effort to create value,
private-equity sponsors will “roll-up” industry segments by purchasing a platform company and making multiple acquisitions. Here the concept is that the sum of the parts is more valuable than the individual parts. Such roll-ups are not necessarily bad, but they present higher risk and require more careful evaluation since they usually come with debt issues.

Should the company even be a public company? The late 1990s were a time when venture capitalists and private-equity sponsors took nascent companies public, shifting traditional private-company early-stage risk to public-market investors. In many cases, this strategy turned out to be very profitable for the equity holders and sponsors and painfully unprofitable for individual investors in the IPOs.

**Management Ownership and Selling Shareholders**

Pay close attention to management ownership and the motives of selling shareholders.

Are the IPO shares primary or secondary? IPO primary shares are shares offered for sale by the company and secondary shares are those offered for sale by existing shareholders. If the shares are primary, how does the company plan to spend the money and what does the capitalization look like post-offering?

If the shares are secondary, who is cashing out? Why are they cashing out at this time? Is management cashing out completely or selling only a portion of their ownership position? Are members of management subject to lock-up agreements prohibiting them from selling shares for a period of time?

It's usually a very positive sign if management announces to the public they won't sell any shares, so pay attention to this fact during the IPO process.

**Use of Proceeds**

Underwriters reserve the right to issue an over-allotment of up to 15% of the offering (green shoe). Where might the proceeds from the over-allotment be headed?

Companies go public for a variety of reasons including capital needs, liquidity needs or a desire to have a publicly traded stock to use as acquisition currency. What is the primary reason in this case?
Other Key Questions

There are no right or wrong answers to these questions, but the combination of answers should be considered in the context of the overall opportunity.

✓ Number of shares authorized by charter? (Look under Capitalization)
✓ Number of shares to be sold in IPO?
✓ Number of shares outstanding after IPO? (Look under Dilution)
✓ What percentage of stock outstanding will be owned by the public after the IPO?
✓ How much capital will be raised by this IPO? (Subtract actual from “as adjusted”)
✓ What percentage of stock outstanding will be held by the primary shareholders?
✓ What percentage of stock outstanding will be held by major private placement?
✓ What is the projected IPO price?
✓ What is the Pro forma net tangible book value per share of the IPO offering? (See Dilution)
✓ What is the Dilution per share to investors?
✓ What is the Dilution Ratio? (Equal to [Dilution per share/IPO price])

IPO Valuation

Making sure that the eventual IPO issue price is not too high is absolutely essential.

Of course, value is a relative and subjective concept – after all, the value of anything is what someone is willing to pay for it.

There are many common valuation techniques for stocks, including multiples of various ratios, discounted cash flows and dividend-discount models.

But this MBA language should not obscure a simple fact – pricing of IPO shares has to reflect basic supply and demand.

Investment bankers set IPO pricing ranges using comparable company valuations. This is the best place to start assessing value. Understanding how Wall Street analysts value comparable companies should provide insight as to how the market will value a specific IPO. The best place to find this information is in sell-side analyst research reports.

The main way IPOs are priced is by comparing the firm’s growth rate, profitability, size, and potential to existing publicly traded companies. Generally, there is an IPO discount relative to growth due to the lack of a trading track record. Investment banks that take companies public want to provide some cushion so investors don’t get burned. At the same time, investment banks don’t want to price the IPO too low and
leave money on the table. There will be intense pricing discussions after the books have closed. Twitter could have raised $1.6 billion more dollars from investors by pricing the stock at $45 instead of at $26. But if they priced at $45, the chances are high the stock would have tanked on day one, thereby sullying the reputation of the bookrunners and the company.

Determining the value of a company is difficult and comes with experience. IPO or not, we find it helpful to look at the implied valuation and ask: Does this value make sense given the opportunity? How realistic is the valuation given the company's growth prospects?

Try to be wary of unsustainable values driven by momentum investors. Sure, its nice to benefit from an IPO “pop” but many investors will then head to the exits leaving long-term investors holding the bag.

The IPO Market Environment

Generally, when equity markets are strong, they are more receptive to new offerings, even those with non-traditional business models.

In hot IPO markets, more poor-quality issues will be completed than would have otherwise under normal conditions. Going public in a hot IPO market says little about a particular issue, but successfully pricing in a weak, difficult IPO market lends credibility to the company.

Similar to hot IPO markets, there are hot IPOs. Deciding whether to invest in a hot IPO can be particularly precarious.

Hot IPOs are notoriously volatile and have a unique element of uncertainty driving the hype. Determine why an issue is particularly hot and what may be fueling the speculative demand. Paying a premium for a hot IPO may be a good investment decision, if the decision is based on fundamental facts, not hype.

How do you identify hot IPOs and hot IPO markets? This is really a subjective determination. Hot IPOs are those that generate considerable “buzz” in the investment community and are generally, in retrospect, characterized by too much demand relative to supply. Similarly, hot IPO markets are those where there is considerable demand for IPO issues and more marginal-quality issues get completed. A high level of IPO activity can be an indicator of an overheated market.

The “Buy Now vs. Wait and See” Decision

When in doubt, err on the side of caution and wait to see how the company performs before investing. Waiting will flush out short-term holders and allow a trading pattern and chart to develop.

Many investors fall into the trap of feeling like they need to invest on the day an IPO starts trading or they will miss the opportunity. This is not necessarily the case – IPO investing can follow several different timelines.
Five Steps to Identifying High-Quality IPOs with Sustainable Growth

1. Assess Competitive Position

Understanding the company’s position within its industry context is critical. High-quality companies have dominating market leadership resulting from unique businesses that cannot easily be replicated. Such businesses enjoy competitively advantageous positions fortified by high barriers to entry. Technology, patents, brands, intellectual property, capital investments, cost advantages, regulations, and contractual relationships are among the types of barriers that create defensible competitive positions.

Identifying how a company competes can provide insight:

- Is the company a low-cost producer?
- Does the company differentiate itself through branding?
- Does the company have a regulatory advantage?
- Would the company’s business model be extremely difficult to copy?

Focusing on the key competitive advantages and assessing the defensibility of those advantages provides insight about performance sustainability.

Often, market leaders are first movers, creating new industries with their products and services. Being the first to market is often important in establishing dominant market share. However, first movers without defensible competitive positions will fall victim to competition. Try to avoid “me too” competitors. The people who benefit from investing in “me too” firms are the private-equity sponsors who identify the opportunities early, fund these companies and shortly thereafter sell them to public investors.

2. Determine Future Growth Prospects for the Market and the Company

Earnings increases propel stock prices, and the market values visible growth at a premium. Identifying companies poised to deliver growth involves assessing the company’s business model and the underlying drivers for the company’s product or services.

Industry trends and dynamics deserve attention. Is the industry new and growing or is it mature and declining? How does the industry benefit from demographics, new technology, globalization, outsourcing or other trends? Is there pricing power? Assess how these macro influences impact the company. What is the company’s growth strategy? Is the company gaining or losing market share?

Visible growth is a byproduct of high-quality business models. Understanding a company’s business model provides insight about visibility and tells the investor how the company generates cash. This is made easier by following Warren Buffett’s suggestion to invest in those businesses that you understand and are familiar with.
The most prized business model is a company with high percentages of steady, recurring revenue. Products and services that require repeat purchases, updating or maintenance enhance visibility. Long-term contracts and subscription-based pricing also enhance visibility. Companies such as the newly public Morningstar provide significant visibility, as over 70% of its revenue is generated from existing contracts and contract renewals.

On the other end of the spectrum are emerging biotech companies that may never generate revenue. While successfully identifying the next biotech blockbuster will provide a windfall, the chances of this happening are relatively low.

3. **Check Financial Metrics, Test Assumptions Going Forward, Make Sure IPO Valuation is Reasonable**

High-quality companies have excellent prospects for profitability and more importantly, the ability to generate free cash flow, which is the cash available after satisfying all other obligations including debt.

While profitability is industry relative, the highest-quality companies also have the highest profit margins. During the Internet boom, the concept of profitability was seemingly set aside as companies were valued on multiples of projected revenues or such metrics as “eyeballs per click.” When the market collapsed, many investors were rudely reminded about the importance of profitability.

Profitability is a function of many variables, ranging from pricing power for products and services to a company's cost structure. Understanding a company's cost structure is useful, as it provides guidance on future profitability. Is the company a high-fixed-cost, low-variable-cost business, or vice versa? High-fixed-cost, lowvariable-cost businesses experience operating leverage when they grow.

The Chicago Mercantile Exchange, which had an extremely successful IPO, is a great example of strong operating leverage. The company has made massive infrastructure investments to establish its exchanges, yet the variable cost of additional volume is essentially zero. As the firm grows it becomes even more profitable as it enjoys tremendous economies of scale.

Traditional ratio analysis focusing on margins and return on invested capital provides insight into profitability. Pay attention to changes in top-line revenue and profitability over time and look for the catalysts. What is driving the change and is it a temporary phenomenon or a permanent shift?

4. **Pricing the IPO**

Perhaps the most important consideration is what price to pay for a high-quality company. This is a tricky issue that even the most brilliant minds mess up.

“[Bill] Gates had thought longest about the price. Guided by Goldman [Sachs], he felt the market would accord a higher price-earnings multiple to Microsoft than to other personal computer software companies like Lotus or Ashton-Tate, which have narrower product lines. On the other hand, he figured
the market would give Microsoft a lower multiple than companies that create software for mainframe computers because they generally have longer track records and more predictable revenues. A price of roughly $15, more than ten times estimated earnings for fiscal 1986, would put Microsoft’s multiple right between those of personal software companies and mainframers.

...By the end of the first day of trading, ... Microsoft’s stock stood at $27.75.”

*Fortune* magazine (Uttal 1986, p.26) describing the Microsoft initial public offering.

If the pricing is too aggressive however, if the company stumbles, negatively surprising the market, its valuation will be punished severely in the short term.

However, while nobody wants to overpay, investors should not be afraid to pay a premium for a high-quality business. Focus on high-quality companies at reasonable valuations.

5. Look for Experienced, Superior Management

The more you know about a management team, the better. It is difficult to assess competency from a carefully crafted executive biography. Yet, more often than not, a successful management team will have a history of success. Look for industry knowledge and leadership experiences. Is the management team deep or dependent on an individual?

The chief executive officer (CEO) and the chief financial officer (CFO) should have experience running a publicly traded company and should be adept at investor relations. Both can expect to spend about 230% of their time during the year before and after an IPO communicating with Wall Street and investors.

Also review management’s ownership and quantify how much they have at stake. Take advantage of opportunities, such as webcasts or conference calls, to hear management tell the company’s story.
Conclusion

Successful IPO investing, like all investing, involves committing significant time and resources to investment analysis and portfolio monitoring.

The additional uncertainties associated with IPO investing make it more challenging than traditional investing and, accordingly, it is more difficult, especially for part-time investors. If you are daring enough to test the IPO market, remember to do your homework and consider all the facts and circumstances when making investment decisions.

Focus on making sound decisions and don’t get caught up in market hype and timing. While it is frustrating to miss part of the price appreciation, that frustration pales in comparison to the pain of buying an overvalued, hyped-up, poor-quality stock.

Summing Up: My IPO Scoring System

**Strong Management Team (four points max)**

Is the company profitable with a high gross, operating and net profit margin?
Does the company have significant strategic partners and/or a respected brand?
Is management experienced and “from the industry”?
Does management have IPO experience?

**Competitive Advantage (four points max)**

Does the company have a strong, sustainable competitive advantage?
Can the company become the leader in its market?
Does the company have protected or proprietary products?

**High Market Growth (four points max)**

How fast is the company's market growing right now?
What are prospects for continued strong growth?

**Solid Financials/Reasonable Valuation (four points max)**

How does the company's expected IPO price range stack up with its peer group in price to sales, price to earnings, price to book value, price to tangible book value?

**Recommendation/Scoring**

(0-5 points) Avoid: overpriced or poor quality
(5-8 points) Neutral: use caution and look primarily for after-market opportunities
(8-16) Buy: take reasonable position up to 3% of global equity portfolio
About the Expert

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