

THE RISE AND FALL AND RISE AGAIN OF THE UNITED STATES IPOs

Arvin Ghosh, William Paterson University of New Jersey

ABSTRACT

Initial Public Offerings (IPOs) of securities are among the most significant phenomena in the United States stock markets in recent years. In the so-called "New Economy" of the 1990's, IPO's ushered in the information technology revolution of the world. In this paper, the rise and fall of IPOs in the United States during 1990-2001 are examined. During 1996-2000, the first-day return of NYSE from 1996-2000 are found to be IPOs was on average 11.97%, while for the NASDAQ IPOs, were 63.33%, and for Internet IPOs it was a whopping 90.28%, resulting in first-day return for all IPOs of 15.24%. But the one-year return for all IPOs was a very modest 3.23%, and for the NASDAQ IPOs, it was only 11.49%. The regression results show consistently positive association between the first-day closing price and the return statistics. Finally, the paper discusses the ten recent trends that have become evident since the revival of the IPO market in the United States in 2004.

INTRODUCTION

Initial Public Offerings (IPOs) were the most prevalent form of security issues by firms wanting to raise capital in the United States during 1990-2000. The IPO phenomenon got a tremendous boost in the late 1990s from the popularity of Internet stocks. When Yahoo!, an online search engine, went public in March 1996, the investing public went agog with excitement, particularly the online traders. In the so-called 'bubble period' of 1998-1999, hardly a week went by when one or two IPOs, particularly Internet IPOs, did not appear in the capital market. In 1998, 5 IPOs had first-day returns of over 200%, while in 1999, 48 IPOs had that distinction, with 8 having returns of more than 400% on the first day. In 1999, 117 IPOs doubled their prices on the first day of trading. It was quite possible that without the IPOs, the stock market boom of the 1990s would not have been sustained for such a long time and with such vigor. In the bull market of '90s, it was the IPOs that created the climate of 'irrational exuberance,' particularly in the technology-heavy NASDAQ market (to quote Federal Reserve Board Chairman Alan Greenspan in a speech on December 5, 1996).

Unfortunately, with the stock market taking a sharp downturn after March 2000, many of these firms have succumbed to the market pressure and have gone out of business. However, of the many well-established companies in the United States that also entered the IPO market, most are still in business and a number of them are, in fact, thriving. Although the NASDAQ stock market had the largest number of IPO listings, the New York Stock Exchange (NYSE) also listed a significant number of IPOs. By studying the IPOs in these two markets, it will be possible to understand the stock market dynamics that shaped and molded the United States economy in a most fundamental way.

IPOs did not burst onto the scene, of course, in 1990. They had a long and checkered history before evolving into an effective tool for raising capital for companies wanting to go public. In their extensive data base of 4,753 IPOs during 1970-1990, Professors Loughran and Ritter listed 876 IPOs during 1970-72, 634 IPOs during 1980-82, and 1,315 IPOs during 1983-85 in the United States alone (Loughran & Ritter, 1995).

The initial public offerings market fared worse in 1990, mainly because of Iraq's occupation of Kuwait in August of that year and the impending threat of the Gulf War to be launched by the United States. The dollar volume of IPOs in 1990 slumped, from 1989's already paltry level, to \$10.2 billion. In the fourth

quarter of 1990, just 59 IPOs were issued – the lowest quarterly total in more than ten years. Additionally, the \$3 billion raised in the fourth quarter was the lowest in six years. The White House admitted that the United States economy was in recession and predicted that the downturn would last until summer. The stock market ended its worst year since 1981, when the DJIA closed at 2,633 on December 31, 1990. After a slow start in January 1991 with 4 deals, there were 7 in February, 18 in March, and 28 in April. From then on the IPO market did not slow down again until September 1998. Investment bankers sold \$16.4 billion in shares from 360 IPOs in 1991, just behind the 1986 record of \$18.3 billion. An additional 454 already-public companies sold over \$29 billion more in new shares, making 1991 a record year for seasoned equity offerings, according to IDD Information Services, Inc. Leverage buy-outs, which were the craze in the 1980s, almost died out as the 1990s' dawned.

The year 1999 was *The Year of the IPO*, particularly for Internet IPOs. The surge in the IPO market witnessed in late 1998 carried through all of 1999 and dried up only in March 2000 when the stock market in general, and the IPO market in particular, went sour. There were 544 public companies in 1999 were 544 in number, up from 373 in 1998, but less than the record set in 1996 of 872 companies. The IPOs in 1999 raised \$69.1 billion, which was nearly double the 1998 total of \$36.5 billion, and close to 40% higher than the previous record of \$49.9 billion in 1996, according to the Securities Data Company of Thomson Financial. These figures include both large and small capitalization companies, but exclude closed-end mutual funds and real estate investment trusts. As of June 1999, IPOs soared an average 43% from their opening price, compared to an 8.5% gain of the S&P 500 stock index.

Many large and small companies went public that year, with Web-based and technology start-ups being the most prominent. The biggest IPO in the U.S. history occurred that year when UPS, in early November, raised \$4.38 billion. Goldman, Sachs & Co. raised \$2.72 billion in the U.S. when it went public in May. But price-performance wise, it was the software company VA Software Systems, Inc. which ruled the roost when its shares soared 697.50% on the first day of trading on December 9, heading the list of all-time first-day IPO price increases. MarketWatch. Com Inc. jumped 474% in its first day trading in January, and iVillage Inc. soared 232% on its debut in March of that year. IPOs such as Juniper Networks and Gadzoox Networks, which made their debut in June and July, rose 191% and 256%, respectively, on their first day of trading. Business-to-business IPO, FreeMarkets, Inc. rose 483% on its first-day trading in December 1999. According to the World Finance Net.Com, 117 or 23% of the year's IPOs had increased more than 100% in price on the first day of trading.

In Table 1, performance statistics of the best and worst 10 United States IPOs through December 31, 1999 are presented. Here we find that the top performer was an investment holding company called Internet Capital Group, with an incredible 5,567% increase in share price from the offer price over only five months. Next came Commerce One, another e-commerce company with a stock price increase of 2,707.1. All of the other best performers were either Internet companies, or software equipment or management companies like Brocade Comm.Systems and Vignett, respectively.

But not all IPOs performed well in 1999. Table 1 also shows the 10 worst performances by IPO firms during 1999. Here Value America topped the list, with a drop of 78% through December 31, from its offer price of \$23.00, although its first-day price gain was 140%. Next was Insurance Management Solutions with a 77.3% price decline from its offer price of \$11.00. Interestingly, almost all the companies in the 10 worst performers list were in the finance or manufacturing sectors, not in the Internet-related businesses. Also some IPOs, like Vitaninshoppe.com, 1-800-flowers.com, and Mothenature.com fell in price during the first day of trading.

Table 1: Best 10 and Worst 10 Annualized Performances of the IPOs in 1999

Company	Offer Price	% Change from Offer Price First Day's Trading	Dec. 31 1999
<u>A. The Best Performers</u>			
Internet Capital Group (ICGE)	\$12.00	103.7%	5567.0%
Commerce One (CMRC)	21.00	190.3	2707.1
Purchasepro.com (PPRO)	12.00	117.7	2479.7
VerticalNet (VERT)	16.00	183.6	1950.0
Brocade Comm. Systems (BRCD)	19.00	138.2	1763.2
Vignette (VIGN)	19.00	124.7	1615.8
Liberate Technologies (LBRT)	16.00	26.6	1506.3
Redback Networks (RBAK)	23.00	296.6	1443.5
Ariba (ARBA)	23.00	291.3	1442.4
Red Hat (RHAT)	14.00	271.4	1408.9
<u>B. The Worst Performers</u>			
Value America (VUSA)	\$23.00	140.0%	78.0%
Insurance Mgmt Solutions (INMG)	11.00	Unch.	-77.3
Stalia Terminals (STNV)	20.00	-8.1	-73.1
Trion Technology (TRIN)	7.00	22.3	-69.6
Argosy Education (ARGY)	14.00	-4.0	68.3
Fashionmall.com (FASH)	13.00	Unch.	-65.4
Skechers USA (SKX)	11.00	-3.4	65.4
FlashNet Communications (FLAS)	17.00	156.6	63.6
HI-Q Wason (HIQW)	7.00	-4.4	62.4
Package Ice (ICED)	8.50	-2.9	61.8

Source: Securities Data Company/Thomson Financial.

Table 2 contains the 25 IPOs issued in 1999 with the highest first-day returns, along with their offer price and first-day opening and closing prices. VA Software Corporation – an Internet company – had an incredible first-day return of almost 700%, followed by a 525% first-day return for Foundry Networks, Inc. Of the four other IPOs with over 400% first-day returns, three were also Internet companies. There were 6 companies whose first-day returns were over 300%, followed by 14 companies with first-day gains over 200%. *As a matter of fact, there were no IPOs in this list whose first-day return was not 200% or more.* In total, 21 or almost 85% of the companies in Table 2 were *Internet-related* companies.

But the IPO market, especially the Internet stocks, went sour after March 2000. The NASDAQ was at its peak of 5,048.62 on March 10 and the DJIA was at its highest level on January 14, when it stood at 11,722.98. After that, the DJIA started to go downhill, just as the NASDAQ did after March 10. Even some of the IPOs which gained spectacularly in the first quarter, came tumbling down during the second quarter of 2000. For example, Palm Inc., the maker of handheld computer which went up to \$165.00 per share during March, came down below its offer price of \$38.00 during the first week of April 2000. By the end of 2000, the NASDAQ index fell by 51% and the DJIA by almost 8 % from their historic highs.

Table 2: Highest First-Day Gains of 25 IPOs, 1999

Company	Offer Price	First Day Opening Price	First Day Closing Price	First Day Return
1. Value Software Corp.	\$30.00	\$299.00	\$239.25	697.50%
2. Foundry Networks, Inc.	25.00	109.00	156.25	525.00
3. FreeMarkets, Inc.	48.00	248.00	280.00	483.33
4. MarketWatch. Com	17.00	90.00	97.50	473.53
5. Akamai Technologies, Inc.	26.00	110.00	145.19	458.42
6. Blue Coat Systems, Inc.	24.00	110.00	126.38	426.58
7. Sycamore Networks, Inc.	38.00	270.00	184.75	386.18
8. Ask Jeeves, Inc.	14.00	72.00	64.94	363.86
9. Finisar Corporation	19.00	95.00	86.88	357.26
10. Crossroads Systems, Inc.	18.00	36.50	78.72	337.33
11. Priceline.com Inc.	16.00	81.00	69.00	331.25
12. Wireless Facilities, Inc.	15.00	37.50	62.00	313.33
13. WebMD Corp.	8.00	21.88	31.38	292.25
14. Ariba, Inc.	23.00	61.00	90.00	291.30
15. Experdia, Inc.	14.00	37.00	53.44	291.71
16. Red Hat, Inc.	14.00	46.00	52.06	271.86
17. Digital Impact, Inc.	15.00	34.00	55.50	270.00
18. Redback Networks, Inc.	23.00	67.25	84.13	265.78
19. KANA Software, Inc.	15.00	50.50	51.50	243.33
20. Quest Software, Inc.	14.00	20.50	47.00	235.71
21. Chinadotcom Corp.	20.00	45.75	67.11	235.55
22. iVillage, Inc.	24.00	95.88	80.13	233.88
23. Paradyne Networks, Inc.	17.00	50.00	56.25	230.88
24. Copper Mountain Networks	21.00	63.00	68.44	225.90
25. Extreme Networks, Inc.	17.00	54.00	55.38	225.76

Source: Hoover.com, 1999.

It was soon apparent that the Internet sector was simply overextended and real new ideas for products or services became few and far between. At the same time, money poured in from all quarters --institutional and individual alike – including venture capitalists. But most of the Internet companies had little or no earnings and would be in the red for the foreseeable future. As a result, the collapse of the Internet market was inevitable as the valuation of these stocks was simply too high. The question was when. And when the NASDAQ market did take a nosedive after March of 2000, it brought down the whole IPO market as well, including the Internet stocks. The total loss in the ‘dot-com bubble’ was put at \$4 trillion, as reported in the Wall Street Journal (Feb 12 2002).

THE MELTDOWN AFTER MARCH 2000

Two thousand started as a strong market for IPO issuance when by February of that year, some 31 IPOs had already hit the market and 15 of them had enjoyed a first-day price increase of double their offer prices. But after the DJIA and NASDAQ reached their highest points, and the stock market bubble was about to burst, the IPO market started to go down. Most of the 67 IPOs brought to market before October 2001, traded below their offering prices. And when the terrorist attack on the World Trade Center came on "9/11," September of 2001 became the first month since December 1975 in which there were no IPOs, according to the SDC/ Thomson Financial. That company found 19 individual months with no IPO

offerings since 1970, and 18 of these 19 occurred between July 1973 and December 1975 during the worst recession the country has experienced since World War II.

The 'dot-com bust' led to the IPO downturn in 2000 when prices of many IPOs fell so sharply that they become virtually worthless. In Table 3, the performance of 30 IPO stocks during 2001-2002 whose first-day returns were over 200% are presented. When this table is compared to Table 2, we find that VA Software Corporation – the company with the highest first-day return – was also the company with the worst decline during this period. This company had a first-day offer price of \$30.00, which shot up to \$239.25 at the close of first day trading, but its 52-week low of \$0.67 during 2001-2002 represents a 99.99% stock price drop. Similarly, Akamai Technologies was the fifth highest ranking firm in Table 2, but became the third worst performer in Table 3.

Table 3. Performance of 30 IPO Firms Where First-Day Returns Were Over 200 Percent

Company	First-Day Closing Price	52-Week Low (2001-2002)	% Decline from First-Day Closing
VA Software Corp.	\$239.25	\$0.67	-99.99%
Redback Networks	84.13	0.24	-99.99
Akamai Technologies, Inc.	145.19	0.56	-99.99
Crossroads Systems, Inc.	126.38	0.38	-99.99
Finisar Corp.	86.88	0.42	-99.99
Tut Systems, Inc.	57.50	0.41	-99.00
KANA Software	51.50	0.59	-99.00
Sycamore Networks	184.75	2.20	-99.00
FreeMarkets, Inc.	280.00	3.50	-99.00
Ask Jeeves	64.94	0.92	-99.00
Ariba	90.00	1.30	-99.00
Extensity, Inc	71.25	1.11	-98.00
Paradyne Networks, Inc.	56.25	0.95	-98.00
Marimba	60.56	1.10	-98.00
Blue Coat Systems, Inc.	126.38	2.50	-98.00
WebMethods, Inc.	212.63	4.25	-98.00
Turnstore Systems, Inc.	97.00	2.00	-98.00
Neoforma, Inc.	52.38	7.20	-86.00
Digital Impact	55.50	1.23	-98.00
IVillage	80.13	1.82	-98.00
Foundry Networks, Inc	156.25	4.08	-97.00
Chinadot Corp.	67.11	1.90	-97.00
TheStreet.com	60.00	1.91	-97.00
MarketWatch.com	97.50	3.88	-96.00
Extreme Networks, Inc.	55.38	2.33	-96.00
Copper Mountain Networks	68.44	3.17	-95.00
Red Hat	52.06	3.46	-93.00
Priceline.com	59.00	6.30	-89.00
Quest Software	47.00	7.30	-84.00
WebMD	31.38	4.25	-86.00

Source: Securities Data Company/ Thomson Financial.

Most of the other companies which had the best performances in 1999 also appear in Table 3's list of worst performances. For example, Redback Networks was number 2 on the worst performance list in Table 3, but was number 18 on the best performance list of Table 2. The best of the performers in Table 3

was Quest Software Corp. whose decline from its first-day closing price was 84.00%. It was number 13 in Table 2, with a first-day return of over 292%.

Table 4 contains stock returns for several time intervals for IPOs that occurred during 1996 – 2000. While the mean first-day return was very high for both NYSE and NASDAQ IPOs, they became negative for the second and third days. The Internet IPOs, however, remained positive during this period. While the mean one-month return was negative for the NYSE IPOs, it was positive for the NASDAQ IPOs. The reverse was true for one-year returns as the mean return of the NYSE IPOs was positive, but that of NASDAQ was negative. But both the Internet IPOs and All IPOs showed positive returns throughout the period, although the annual return was much lower than the first-day return

Table 4: IPO Returns 1996-2000

IPO Returns 1996 – 2000				
Term Period	NYSE n=300	NASDAQ N=99	Internet N= 177	All IPOs N= 576
First day	11.97	63.33	90.28	15.24
Second day	-0.04	-0.40	3.85	0.37
Third day	-0.17	-0.18	2.79	0.21
One month	-0.01	8.11	19.18	2.43
Six month	6.09	-6.47	45.69	5.37
1 year	11.49	-16.92	21.47	3.23

In table 5, the IPO calendar year returns of the United States IPOs for 1991-2000 are presented. In 1990, the mean return of the NYSE IPOs was 20.68%, but for the NASDAQ IPOs it was -18.08%, resulting in a return of 9.01% for all the IPOs covered by this study. In 1999 – the so-called ‘bubble’ year – it was 6.6% for the NYSE IPOs, 29.97% for the NASDAQ (without Internet) IPOs, 45.75% for the Internet IPOs, and 23.05% for all the IPOs sampled. But in 2000, that all came crashing down, with a 1.37% for the NYSE IPOs, -64.37% for the NASDAQ IPOs, -73.44% for the Internet IPOs and -34.55% for all the IPOs.

Table 5: Calendar Year Returns of All IPOs 1990-2000

Year	NYSE Mean	NASDAQ Mean	Internet Mean	All IPOs Mean
1990	20.68	(18.08)	-	9.01
1991	7.89	34.78	-	15.62
1992	62.51	(9.35)	-	40.88
1993	3.78	52.12	-	18.33
1994	13.52	44.84	-	22.95
1995	40.45	51.84	-	43.87
1996	42.83	31.83	39.67	39.56
1997	(3.59)	(36.56)	59.45	8.06
1998	(1.13)	80.32	184.87	70.71
1999	6.61	29.97	45.75	23.05
2000	(1.37)	(64.37)	(73.44)	(34.55)

Table 6 contains selected asset management ratios for the NASDAQ IPO sample firms during 1990-2000. The mean inventory turnover ratio jumped from 6.59 in 1990 to 18.86 in 2000. However, the mean fixed asset turnover ratio declined considerably during the same

Table 6: Selected Asset Management Ratios of NASDAQ IPOs, 1990 – 2000

Year	Inventory Turnover		Fixed Asset Turnover		Working Capital Turnover	
	Mean	Median	Mean	Median	Mean	Median
1990	6.59	6.39	13.60	9.55	2.07	2.04
1991	8.77	5.36	6.33	4.81	0.18	1.13
1992	7.64	5.48	5.48	5.76	2.00	1.76
1993	9.29	7.54	15.02	13.89	5.48	2.10
1994	14.22	13.11	14.24	12.75	4.39	2.21
1995	16.62	15.35	14.41	13.74	4.06	1.73
1996	16.73	15.98	11.58	10.06	13.36	12.17
1997	15.44	13.31	9.25	6.73	13.48	12.09
1998	14.70	13.64	6.53	4.88	(9.69)	(11.91)
1999	17.16	15.95	6.01	5.86	(4.03)	(3.14)
2000	18.86	17.17	6.75	5.66	1.08	1.03

period – from 13.60 to 6.75. This decline was also present in the firm’s working capital turnover when in 1990 it was 2.07, but became negative in both 1998 and 1999, and increased slightly in 2000. This deterioration of both fixed asset turnover and working capital turnover indicates that both sales and total assets of many NASDAQ companies started to shrink long before the stock price of these companies plummeted during 2000-2001.

In Table 7, the IPO sample was partitioned into cold, cool, hot, and extra-hot IPOs, following the methodology of Krigman, Shaw and Womack (1999). The first-day mean excess return of extra-hot IPOs was 121.5%, while that of cold IPOs it was -3.8%. But for one-month excess return it was only 6.9% for the while for the cold IPOs it was again -3.8%. For the six-month excess return, the mean was again high for the extra-hot IPOs and positive for the cold IPOs. But the one-year excess return for the extra-hot IPOs was a moderate 12.3% and a mere 1.4% for the hot IPOs and both the cold and cool IPOs showed negative returns. Thus the findings in Table 7 support the findings of Krigman et.al. That is, that the first-day winners continue to be winners over the first year, and the first-day losers continue to be losers during the same period.

Table 7: IPO Returns Partitioned By Mispricing

	Cold ($\leq 0\%$) n=27	Cool (0%-10%) n=23	Hot(10%-60%) N=59	ExtraHot(>60%) n=73
<u>First Day Mean Return</u>				
	-0.038	0.053	0.412	1.215
Median	-0.016	0.046	0.379	1.016
<u>One Month Mean Return</u>				
Mean	-0.038	0.029	0.083	0.069
Median	-0.028	0.014	0.042	0.054
<u>Six Month Mean Return</u>				
Mean	0.029	-0.041	0.018	0.315
Median	0.019	-0.026	0.0005	0.252
<u>One Year Mean Return</u>				
Mean	-0.032	-0.094	0.014	0.123
Median	-0.021	-0.055	0.027	0.119
<u>% Change From Filing Price</u>				
Mean	0.035	0.112	0.294	0.936

Table 8 contains a regression analysis of the sample IPOs. Here, the first-day closing price (FC) was significantly associated with annual returns. Offer price (OP) was significant only for the first-day return and the sign was negative, indicating that lower offer price was a contributing factor for high first-day returns. Asset size (AS) was significant for the longer periods of time, namely, six-month and one-year returns. The debt ratios (DR) were significant in four out of six regression equations, but the signs were mixed. The asset leverage ratio (AL) was significant in two equations, namely, for the second-day and third-day equations, but not for the longer periods of time. Market capitalization (MC) was not significant at all in any of the six equations.

In Table 9, a dummy variables to indicate whether the firms were listed on the NYSE (dummy variable = 0) or to the NASDAQ (dummy variable = 1) market was added to the regressions. Here, again, the first-day closing price was significant in all the six regressions. The offer price was significant in the first-day return only regression. The asset size variable was significant for the longer periods of time, namely returns for six- month and one year. The debt ratio was significant again in four out of six equations, but the signs were significant only in two equations—for the first-day and second-day returns. But the market capitalization variable was not significant in any of the equations. The dummy variable, however, was significant for the longer periods.

Table 8: Multiple Regression Equations of IPO Returns as the Dependent Variable (Without Dummy Variables)

Dependant Variable	Independent Variables						R^2
	MC	OP	FC	AS	DR	AL	
First Day Return	0.006 (0.21)	-0.318* (5.-43)	0.106 (1.814)	-0.002 -0.063	0.005 (0.200)	0.013 (0.521)	.669
Second Day Return	0.046 (0.58)	0.019 (0.139)	0.040* (1.304)	-0.057 (0.780)	0.118* (1.839)	0.174* (2.687)	.425
Third Day Return	-0.003 (-0.03)	-0.112 (-0.79)	0.149* (1.331)	-0.020 (-0.265)	0.036* (1.553)	0.207* (3.197)	.491
One Month Return	-0.029 (0.35)	-0.098 (-0.68)	0.135* (1.501)	-0.015 (-0.197)	-0.037 (-0.561)	0.062 (0.942)	.393
Six Month Return	0.042 (0.43)	-0.124 (0.64)	0.030* (1.159)	0.203* (2.001)	-0.124* (-1.584)	-0.007 (-0.079)	.368
One Year Return	0.037 (0.44)	0.058 (0.396)	0.201* (1.461)	0.102** (1.334)	0.054 (0.805)	-0.032 (-0.479)	.389

t values are in parenthesis * 5% level of significance ** 10% level of significance

Table 9: Multiple Regression Equations of IPO Returns as the Dependent Variable (With Dummy Variables)

Dependant Variable	Independent Variables							R^2
	MC	OP	FC	AS	DR	AL	Dummy	
First Day Return	0.007 (0.23)	-0.314* (4.681)	0.204* (3.803)	-0.001 -0.043	0.006 (0.256)	0.012 (0.506)	0.008 (0.305)	.639
Second Day Return	0.042 (0.53)	0.005 (0.136)	0.066* (1.483)	-0.061 (0.826)	0.108* (1.650)	0.176* (2.716)	-0.053 (-0.771)	.553
Third Day Return	-0.002 (-0.02)	-0.112 (0.79)	0.143* (1.450)	0.019 (0.25)	0.038* (1.577)	0.207* (3.173)	0.013 (0.183)	.494
One Month Return	-0.018 (0.22)	-0.029 (0.197)	0.062* (1.453)	-0.005 (-0.06)	-0.009 (-0.031)	0.056 (0.852)	0.149* (2.153)	.438
Six Month Return	0.042 (0.43)	0.124 (0.64)	0.030* (1.12)	0.203* (1.001)	-0.124* (-1.584)	-0.007 (-0.079)	0.179* (1.938)	.502
One Year Return	0.031 (0.37)	0.014 (0.090)	0.155* (1.198)	0.094* (1.235)	0.033* (1.483)	-0.027 (-0.406)	0.098** (1.385)	.445

t values are in parenthesis * 5% level of significance ** 10% level of significance.

WHITHER IPOs?

The IPO market is not dead as presumed during 2001-2003, one of the worst periods in the IPO history. According to Thomson Financial, just 111 companies went public for the first time in 2001, raising a total of \$39 billion in equity capital as compared to 386 companies that went public in 2002, raising an aggregate \$60 billion. In 2003, just 85 companies entered the IPO market and raised \$15.77 billion. From 2001 to 2003, there were fewer than 100 IPOs a year on average. In contrast, there were 100 or more new stock offerings each *quarter* in the late 1990's. Two thousand four was a better year for the

IPO market as 385 companies raised \$60.63 billion in equity capital. The total for 2004 was the highest since 2000, the year when the last downturn in the securities markets began.

Google.com has provided the impetus for the current IPO interest in the market when it raised \$1.92 billion on August 19, 2004, and was the largest-ever U.S. auction-style IPO. But it was not the largest IPO in 2004; that distinction went to General Electric Co.'s spun-off entity Genworth Financial that raised \$2.86 billion. Second was the insurer Assurant Inc. which raised \$2.02 billion in February 2004. Although Google's annualized return was 126.8 percent for 2004, the highest return that year was obtained by Marchex Inc., which ended the year 223.1 percent above its offering price.

There were more gainers than losers in 2004. For the year, 63 percent of the deals were companies with reported profits. By contrast, just a quarter of the IPOs in 1999 and 2000 came from companies that had reported a profit, according to ipohome.com in Greenwich, CT. The average IPO had risen 23 percent from its offering price by 2004's end, according to the same company. Investors coming back to the IPO market and undertaking risks of failure, is a sure sign that the IPO market in the United States is coming back from the abyss and is finding new growth and financial opportunities.

Today's IPOs represent a more diverse cross-section of industries and involve companies that tend to be more mature with a history of profitability than the start-up companies that were prevalent during the IPO mania of the late '90s. They are not the masters of a "parallel universe" where the hyper valuation of the Internet stocks had created a weird, separate world as in 1999. They had come down to the earth with a huge thud, so to speak in 2000-2002. Today they reflect more realistic valuation of stocks, if not tending to undervaluation. There is also an orientation toward quality in the IPO market as opposed to the high speculative content that was there in 1998 or 1999.

During the first part of 2005, the financial services sector has been the top industry in terms of the number of IPO issues. This category has surpassed 2004's dominant sectors which were health care and biotechnology, according to ipohome.com. It seemed that the unprofitable early-stage drug development companies appeared to be less appealing to prospective investors, with several companies forced to cut their offering prices sharply before they could come to market in 2005. But the operating environment for financial services firms continued to be good, with strong earnings and good growth prospects. Also, large-scale "carve-outs" from established companies have taken place recently, something not seen for a long time. A "carve-out" is a partial stock-market sale of a business owned by an already listed company. A recent public offering of General Electric Co.'s insurance unit Genworth Financial Inc., or the truck fleet charge-card unit Wright Express Corp. from Cendant Corp. are recent carve out examples. They are generally easy to market to prospective investors because they have stable businesses and prominent brand recognition.

Mergers and acquisitions activities also have picked up in 2005. So far 33 percent of the withdrawn stock offerings were due to merger negotiations by the IPOs, according to Dealogic. That rate was up from 2004 when 18 percent of the withdrawn deals were because of acquisition discussions and was also higher than 2003 when 16 percent of the deals were pulled for that reason. However, the number of public-equity deals that have changed into acquisitions after filing paperwork with the Securities and Exchange Commission is only part of the scene. The trend is even stronger if the number of companies in the pre-filing stage that switched were counted. Deals are being made in the middle of the pre-IPO road shows for investors, or sometimes even before. In the case of many IPOs, the sponsors of the offering seem ready to accept an acquisition over a public offering.

Another trend we see recently is that increasingly, IPOs are coming from companies that have been owned by private-equity investors for a year or less, according to the IPOfinancial.com.. It used to take three to five years for a firm that went private to come back to the public markets after fixing the

problems that beset the company. But now the turnaround can be as little as four months, as was the case for PanAmSat. It went private in August 2004 and filed for a new IPO in December of that year. One thing that is noticeable is that the companies that went private had a large amount of debt, and the IPO proceeds are often being used to repay at least part of the debt. Also, the money raised in the public markets is sometimes paid in part to the private-equity firms as special dividends.

A further recent development in the IPO market is that, instead of venture capitalists' major support, many IPOs are backed today by large private-equity firms such as Blackstone Group or Kohlberg, Kravis, Roberts & Co. According to the deal tracking firm Dealogic, 14 of the 40 United States IPOs that came to the market during the first quarter of 2005, or 35 percent, were backed by large private-equity firms, compared with 34 percent during the first quarter of 2004, and 31 percent in the final quarter of 2004. In contrast, just 7 venture capitalist-backed IPOs had started trading in the first quarter of 2005, compared with 10 in the first quarter of 2004, according to data supplied by Venture One. It is worth noting that at the height of the IPO market in the first quarter of 2000, 70 deals were venture-backed. Many of the large companies coming to the IPO market are old-line cyclical industries such as chemical manufacturing and non-cyclical industries like rural telecom providers. In contrast, venture capitalists have traditionally specialized in financing nascent technology and biotechnology firms, companies that have not performed well in the current IPO market.

Also, IPO growth may come with a price. History suggests that periods of growth in share sales lead to poor performance in the broader stock market. Over the past several years, the broader market as measured by the S&P 500 stock index has fallen on average 1.05 percent in the three-month period, following a one-month increase in stock offerings, according to the recent research report by Credit Suisse Group's Credit Suisse First Boston. The inverse is also true. The market is generally up 4.64 percent in the three-month period following a one-month decline in total share offerings. The data thus suggests that there is a "liquidity effect"—when there is a glut of supply, it is difficult for the market to absorb.

Also, recently some high-profile IPOs have been silent about the exchange they plan to list their shares on. While that is typical for small-scale or self-underwritten offerings that stand a good chance of never becoming public, the recent group of companies has included some of the markets' most anticipated IPOs, including online search engine Google, Inc. and the investment research firm Morningstar, Inc. NASDAQ has always marketed itself as the premier destination for high-growth technology and biotechnology companies. The NYSE has sold itself on the prestige of listing on the "Big Board." Recently, the 10 largest first-day gains have all taken place on the NASDAQ, while 9 out of 10 largest IPOs ever have been listed on the NYSE. For some IPOs, there is little choice in where to list because they do not meet the Big Board's listing requirements. So the competition is more acute for companies that meet the NYSE listing standards. In the future, both stock markets also face increased competition for new IPO listings from outside markets. Alternative trading platform Archipelago Holdings Inc. has teamed up with the Pacific Stock Exchange, to create ArcaEx, an all-electronic stock market that will give stiff competition to both the NYSE and the NASDAQ for the listing of IPOs. Although the proposed merger between NYSE and Archipelago Holdings will remove that threat, other forms of all-electronic stock exchanges may emerge in the future.

Another recent development in the IPO scene is the "auction" process of selling stocks to the public, popularized by Google, Inc. In traditional IPO selling, the Wall Street underwriters set the number and price of the stocks to be sold. With an auction, on the other hand, the investors help set the price in a bidding process – the highest price that will fill all the orders is chosen. Besides Google, Alibris Inc., an online retailer of used or hard-to-find books, have used the auction approach to sell stock to the public for the first time. It is interesting to note that while Google is a highly profitable company, Alibris is not profitable at all. If a small company like Alibris can sell shares successfully through the auction process,

then surely it will be followed by many such companies whose profit potential lies far on the horizon. That had happened in the case of Morningstar, Inc., which in May 2005 followed the auction process successfully. However, auctions do seem to be gaining ground, and not just for the IPOs. In May of 2004, online retailer Overstock.com Inc. sold 1.5 million shares of its stock in a follow-on issue placed through an auction, led by W.R. Hambrecht & Co. It marked the first time a secondary or follow-on sale took place in an auction. But still auctions are a rare phenomenon on Wall Street today. In 2004, only three out of 251 U.S. IPOs, used the auction method.

Increased regulatory pressure on the investment banks is also a recent development. Regulatory action against some investment banking firms over some IPO practices and the conflicts of interest between investment bankers and research analysts employed by the same firms had revealed that IPOs were used by investment banks as an enticement for future investment banking businesses. Company executives were offered shares in “hot” IPOs in exchange for the promise of future banking contracts from those executives. Such a practice known as “spinning” has been banned.

Similarly, the “laddering” practice has come under scrutiny by the SEC. It was found that some securities firms had doled out shares to investors based partly on their commitments to buy additional shares after trading began. This was called “laddering” of stocks sold in initial public offerings. Steering “hot” IPOs to big investors who signaled plans to buy additional shares could have stimulated additional demand for technology stocks during the stock market “bubble” of the late 1990s. It contributed to the huge first-day price gains that eventually worsened losses suffered by small investors who, lacking access to the actual IPOs, bought on the open market after trading began. If this practice is discontinued, it would create a healthier atmosphere for investments in IPOs by small investors.

Although the Sarbanes-Oxley Act of 2002 created more governmental restrictions and the greater costs to go public, that did not deter companies which really needed external funding from going ahead. Sarbanes-Oxley was designed to tighten governance and audit standards at publicly-traded companies in the wake of corporate bankruptcies such as Enron, Worldcom and others. Among other things, it forced company executives to personally certify financial results and placed more responsibility on corporate boards. Nevertheless, IPO activity has increased since Sarbanes-Oxley went into effect. According to the Thomson Financial, in the second quarter of 2004, 58 companies sold stocks to the public for the first time in the United States markets, raising \$10.2 billion. For the same quarter in 2003, just 5 companies came to the IPO market, raising \$1.8 billion. The number of companies filing with the Securities and Exchange Commission to go public had also risen considerably in 2004 from the previous three years. As one investment banker put it bluntly, “they go public because they need the capital.”

But still there is a considerable financial burden for firms to bear in going public. It is being acutely felt by smaller companies that just do not have the revenues to cover the additional expenses. For companies with revenue of less than \$1 billion, the cost of being a public company – including insurance, accounting and board compensation – rose 35 percent to \$2.86 billion in 2003 from \$2.13 billion in 2002, according to a survey done by the law firm Foley & Lardner LLP in Chicago, Illinois. The biggest cost came in areas such as directors’ and officers’ liability insurance, the cost of which has more than doubled since the Sarbanes-Oxley Act was passed. Since then director compensation has nearly tripled. But for many companies, the added costs are worth bearing. For example, many bio-technology companies that came to the IPO market had little or no revenue, let alone profit. They have survived only by receiving financing from venture capitalists. For companies such as these, they go public because of their need for external capital. In the end, the decision to go public is not driven by the new costs, but rather with how high public investors are willing to value a company.

CONCLUDING REMARKS

Initial public offerings (IPOs) are the main vehicle for firms to raise capital from the public for firms that are not blessed with substantial venture capitalists' funds. It serves the useful function of capital formation and risk-taking whereby the intrepid entrepreneurs are rewarded handsomely, or are thrown into bankruptcy. At the same time, being a public company means the firm will be subject to public scrutiny and governmental regulations not encountered before. But so long as the securities markets are fair and transparent, more and more companies will go public and channel public savings into stock investments, thereby enriching the economy and creating employment, income and growth in the private sector.

REFERENCES

Affleck-Graves, J., S. Hedge, and R. E. Miller (1996) "Conditional Price Trends in the Aftermarket for Initial Public Offerings," *Financial Management*, vol. 25, p. 25-40.

Asquith, D., J.D. Jones, and R. Kieschnick, 1998. "Evidence on Price Stabilization and Underpricing in Early IPO Returns," *Journal of Finance*, vol. 53, p. 1759-1773.

Carter, R. B., and F. H. Dark, "Underwriter Reputation and Initial Public Offerings: The Detrimental Effects of Flippers," *The Financial Review*, vol. 28, p. 279-301.

Hanley, K. W., 1993. "The Underwriting of Initial Public Offerings and the Partial Adjustment Phenomenon," *Journal of Financial Economics*, vol. 34, p. 231-250.

Krigman, L., W. H. Shaw, and K. L. Womack, 1999. "The Persistence of IPO Mispricing and the Predictive Power of Flipping," *Journal of Finance*, vol. 54, p. 1015-1044.

Loughran, T. and J. R. Ritter, 1995. "The New Issue Puzzle," *Journal of Finance*, vol. 50, p. 23-51.

Ritter, J. R., 1991. "The Long-run Performance of Initial Public Offerings," *Journal of Finance*, vol. 46, p. 3-27.

Saunders, A., 2000. "Why Are So Many New Stock Issues Underpriced?" *Financial Markets*, Section II, p. 119-128.

Shiller, J. R., 2001. *Irrational Exuberance*, New York: Broadway Books (paper).