Session 18

Get in on the ground floor: The IPO story

Test

1. When a private business becomes a publicly traded company, which of the following best characterizes what happens to its riskiness as an investment?
    a. The company's risk does not change.
    b. The company becomes less risky, because it is publicly traded.
    c. The company becomes more risky, because it is publicly traded.
    d. The company's risk does not change, but the investors in the company are more likely to be able to diversify away some of that risk.
    e. The company becomes more risky, but the investors in the company are more likely to be able to diversify away some of that risk.
    f. The company becomes less risky, but the investors in the company are more likely to be able to diversify away some of that risk.
2. When a company decides to make an initial public offering, it usually uses an investment bank or banks to manage the offering. These banks generally offer an underwriting guarantee. Which of the following best describes this guarantee?
    a. The bankers guarantee that they will deliver the fair price of the shares to the issuing company.
    b. The bankers guarantee that they will deliver the highest price that they can get to the issuing company.
    c. The bankers guarantee that they will deliver the intrinsic value to the issuing company.
    d. The bankers guarantee that they will deliver the offering price (that they set) to the issuing company.
    e. The bankers guarantee that they will deliver the book value of equity to the issuing company.
3. Which of the following best describes what studies that look at the offering date for IPOs have found?
    a. The stock price for every IPO increases about 10-15% on the offering date.
    b. The stock price for most IPOs increases about 10-15% on the offering date.
    c. The stock price for some IPOs increases about 10-15% on the offering date.
    d. The stock price increases, on average, about 10-15% across on all IPOs on the offering date.
    e. None of the above
4. Assume that you decide to set up a mutual fund to invest in IPOs. To take advantage of the underpricing found in IPO studies, you decide to apply for an equal dollar allotment in every listed IPO. Which of the following can you expect to see in your portfolio?
    a. An equally weighted portfolio of all IPOs.

b. A portfolio that is weighted more heavily with under priced IPOs.
c. A portfolio that is weighted more heavily with over priced IPOs.

Explain. What can you do to mitigate this effect?

5. If you invest in IPOs after the offering date and hold the stock for the long term (3-5 years), what do studies suggest about your returns?
    a. You will generate positive risk-adjusted returns, i.e., you will generate higher returns on a risk-adjusted basis than you would have investing in seasoned stocks.
    b. You will generate zero risk-adjusted returns, i.e., you will generate about the same returns on a risk-adjusted basis than you would have investing in seasoned stocks.
    c. You will generate negative risk-adjusted returns, i.e., you will generate lower returns on a risk-adjusted basis than you would have investing in seasoned stocks.

Solution

1. When a private business becomes a publicly traded company, which of the following best characterizes what happens to its riskiness as an investment?
    a. The company's risk does not change.
    b. The company becomes less risky, because it is publicly traded.
    c. The company becomes more risky, because it is publicly traded.
    d. The company's risk does not change, but the investors in the company are more likely to be able to diversify away some of that risk.
    e. The company becomes more risky, but the investors in the company are more likely to be able to diversify away some of that risk.
    f. The company becomes less risky, but the investors in the company are more likely to be able to diversify away some of that risk.

Explanation: It is still the same company the day after the IPO as it was before. There has been no change in its operating risk but investors in the IPO are more likely to be diversified (since they are not so heavily invested in the company) and therefore more likely to look at only the portion of the risk in the company that is market risk.

2. When a company decides to make an initial public offering, it usually uses an investment bank or banks to manage the offering. These banks generally offer an underwriting guarantee. Which of the following best describes this guarantee?
    a. The bankers guarantee that they will deliver the fair price of the shares to the issuing company.
    b. The bankers guarantee that they will deliver the highest price that they can get to the issuing company.
    c. The bankers guarantee that they will deliver the intrinsic value to the issuing company.
    d. The bankers guarantee that they will deliver the offering price (that they set) to the issuing company.
    e. The bankers guarantee that they will deliver the book value of equity to the issuing company.

Explanation: It is a bit of an empty guarantee, since you are guaranteeing a price you will set after you have given the guarantee. You can (and often do) reduce the risk by lowering the offering price.

3. Which of the following best describes what studies that look at the offering date for IPOs have found?
    a. The stock price for every IPO increases about 10-15% on the offering date.
    b. The stock price for most IPOs increases about 10-15% on the offering date.
    c. The stock price for some IPOs increases about 10-15% on the offering date.

d. **The stock price increases, on average, about 10-15% across on all IPOs on the offering date.**
e. None of the above

Explanation: The studies look at the average price change across all IPOs. Some IPOs do drop in price on the offering date, but the average IPO does go up about 10-15%.

4. Assume that you decide to set up a mutual fund to invest in IPOs. To take advantage of the underpricing found in IPO studies, you decide to apply for an equal dollar allotment in every listed IPO. Which of the following can you expect to see in your portfolio?
   a. An equally weighted portfolio of all IPOs.
   b. A portfolio that is weighted more heavily with under priced IPOs.
   c. **A portfolio that is weighted more heavily with over priced IPOs**.

   Explain. What can you do to mitigate this effect?

   Explanation: You will end up with your entire allotment in over valued IPOs and less than your asked-for allotment in under valued IPOs. Hence, you will be over invested in over priced IPOs. You can try to mitigate the effect by doing your own IPOs valuations to make judgments on which ones are more likely to be under priced. If your valuations skills are good, you may be able to narrow down your IPO requests to only under priced companies.

5. If you invest in IPOs after the offering date and hold the stock for the long term (3-5 years), what do studies suggest about your returns?
   a. You will generate positive risk-adjusted returns, i.e., you will generate higher returns on a risk-adjusted basis than you would have investing in seasoned stocks.
   b. You will generate zero risk-adjusted returns, i.e., you will generate about the same returns on a risk-adjusted basis than you would have investing in seasoned stocks.
   c. **You will generate negative risk-adjusted returns, i.e., you will generate lower returns on a risk-adjusted basis than you would have investing in seasoned stocks.**

   Explanation: Studies that look at the post offering performance of IPOs find that they lag seasoned offerings over the 3 to 5 years after the offering. That may be because our risk measures (beta etc.) do not capture some risk that young companies are over exposed to that seasoned companies are not.