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Viewpoint

A new way to measure IPO success

The double-digit first-day jump, celebrated as the measure of success for an IPO, must be replaced by metrics that include longer-term vision.

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The IPO market is beginning to show signs of recovery. While uncertainty hangs over equity markets as a whole, many analysts are taking encouragement from post-IPO pricing well above the initial list. Some anticipate a surge in IPOs as companies proceed with offerings postponed from 2001.

As the market recovers, one common indicator of success that many IPO watchers continue to apply is the increase in share price on the first day of trading. During the 1990s IPO boom, some considered a two-digit increase to be *the* measure of IPO success. Others drew a benchmark from so-called daily doublers, or IPOs that doubled their share price on day one. True, an argument can be made that some measure of underpricing is appropriate compensation for first-round investors who face levels of risk that they would not face for secondary offerings.[1] But even then, from the perspective of issuing shareholders, an excessive first-day jump should be viewed as a measure of the mis-pricing and failure of an IPO, rather than as a measure of its success.

No question, extremes such as Theglobe.com's November 1998 IPO, with first day returns over 300 percent, helped to firmly establish an industry norm of significant IPO under-pricing—offering shares at prices far below the expected first-day closing price. On average, IPOs were underpriced by only 11 percent between 1990 and 1998, but that gap soared to almost 70 percent during 1999 and 2000. Indeed, the enormous jumps of the 1990s have even sparked regulators to scrutinize numerous deals. Whether driven by capital market inefficiencies or inappropriate pricing, the fact is that issuing shareholders probably got short shrift. In 1999 and 2000 alone corporate America left more than $60 billion on the table[2]—money that could have been invested in the development of the newly listed companies.

How should IPO success be measured? To answer that question we examined 230 IPOs around the world between 1991 and 2000, ranging from $50 million to $18 billion. We included a broad selection of IPO situations: new dot-com companies, established private companies and family-owned businesses, and spin-offs of larger corporations or state-owned companies. Within this range we sought common measures of IPO success across business sectors, economic cycles, and sources of offered assets in strong and weak markets. We analyzed financial data and detailed offer prospectus information, and conducted interviews to clarify and interpret the results.

While there are obviously large differences in the number and types of activities involved for the myriad of IPO situations, we developed a new, practical way to measure an IPO's success that eschews the goal of a huge first-day leap in share price. We view it as a more valuable metric because it takes into account a company's longer-term competitiveness and the degree to which both new and existing shareholders are fairly compensated.

Our metric comprises two parts:

1. Market Competitiveness: relative company value equal to or higher than industry peers. Within 30 days of the IPO, the company's market capitalization should be at or above the level of its industry peers. For companies in banking and financial services, for example, relative company value may be measured as market-to-book value of equity. For industrial companies, multiples such as market value of equity over earnings, entity value over EBITDA[3] or cash flow may be more appropriate. This relative value expresses a company's competitiveness in the capital markets. Investors can thus use it as a guide to better understand a company's continuing ability to attract funding.

Using this measure, 50 percent of the IPOs from the 1990s considered highly successful by the first-day jump measure (i.e., greater than 20 percent jump) would actually have been judged to have been failures. By contrast, 74 percent of the companies that proved strong relative to competitors after 30 days had less than a 20 percent first-day jump.

2. Market Pricing: Less than 20 percent change between offering price and 30-day post-IPO market capitalization. Only an offering price that reflects the market value of the assets sold ensures that both new and issuing shareholders are fairly compensated. Market value should be measured 30 days after an IPO to allow the market time to fairly evaluate the assets on offer. Once again, using this measurement many IPOs considered successful during the 1990s generally appear to have been unfairly priced. Large first-day jumps translate into significant price changes over the first 30 days of trading and are thus a significant and inappropriate transfer of value to subscribers. Only a quarter of IPOs with first-day jumps exceeding 20 percent eventually settled within 100 percent to 120 percent of their IPO price 30 days later. Conversely, only 14 percent of IPOs that did settle within 100 percent to 120 percent of their IPO price after 30 days had seen a first-day jump exceeding 20 percent.

In fact, only 8 percent of all the IPOs we measured were both competitive in terms of relative value with industry peers and offered at a fair market price. That's obviously not the kind of statistic that fits easily with the IPO hype that characterized the last bull market. But when the IPO game does return, it would be worth keeping in mind for those executives looking to take assets public in order to genuinely boost shareholder value. MoF

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[1] Information assymetry between existing and new investors can lead to underpricing, as agreed in a broader context by Nobel laureates George A. Akerlof, A. Michael Spence, and Joseph E. Stiglitz.

[2] Jay Ritter, quoted in "A penny in whose pocket?" *The Economist*, May 26, 2001, U.S. Edition. *See also,* http://bear.cba.ufl.edu/ritter/.

[3] Earnings before interest, taxes, depreciation, and amortization.

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