

# [A report on new issues market essay](https://assignbuster.com/a-report-on-new-issues-market-essay/)

Since 1980, the first day price increase after an initial offer has averaged 18. 8%. (Ritter 2002)[1]. The increase in price benefits early investors but represents market value not captured by the firm.

But some companies have fought against the traditional IPO system. An alternative that exists in the IPO auctions, which is currently gaining popularity. Most IPO auctions had been small offerings until Google, the leader in the online search industry, announced its intention in April 2004 to auction its shares to the public.

This paper does a comparative analysis of the IPO pricing through the traditional DCF way and the modified Dutch auction method. Given this framework, we then analyze Google’s IPO as a case study. Problem IPO pricing – a Comparative analysis of Traditional DCF way and the Dutch auction method with findings reinforced by a live industry case study – Google.

The book-building method tends is supposed to underprice the IPO much more than the auction method because the auction IPOs accurately reflects market demand. Thus the issuing company tends not to experience enormous aftermarket price fluctuation.

Unlike book-building, where the underpricing can guarantee the institutional investors a profit and thus they have incentive to “ flip shares” shortly after the IPO, in the auction IPO, shares will not change hands immediately following IPO because participants value the shares more[2]. These owners are not willing to sell for less than what they perceive a share’s value to be, and those who are unsuccessful in bidding will not buy the shares in the secondary market at the price higher than where they value it. Despite these advantages, was the modified Dutch auction the right way to go about it.

Did the Dutch auction IPO pricing leave money on the table and if so, what might have caused it? Was $85 per share really the best price? And was the auction really any better than traditional methods of taking the company public? These are some of the questions that we hope to answer through this paper Google Case: Overview When a company is not only innovative in its service, but also in the way it does business by going against the hard-set grain of Wall Street, it offers some lessons in risk-taking.

Google, Inc. is such a company.

In addition to providing the world of internet users a new type of search engine, Google again set itself apart by choosing the Dutch Auction method in going public. While the risk of a new product becomes easily assessed in its profitability and popularity, assessing the risk of challenging the bookmaking method of going public is somewhat more involved. But as in many Silicon Valley startups, challenging traditional corporate modes of behavior seemed to be an inherent part of Google’s business. The Company Google is a public and profitable company focused on search services.

Named for the mathematical term “ googol”, Google operates web sites at many international domains, with the most trafficked being www. Google. com. Google is widely recognized as the “ world’s best search engine” because it is fast, accurate and easy to use.

The company also serves corporate clients, including advertisers, content publishers and site managers with cost-effective advertising and a wide range of revenue generating search services. Google was incorporated in September 1998 and by September 1999 the beta label was worn off. Initially Google could gather a investment of $ 1 Million.

When still in beta version, Google was answering 10000 queries per day and hence it caught fancy of the media.

Being declared the search engine of the year, Google started achieving milestones and is still a huge success. Google’s mission is to organize the world’s information and make it universally accessible and useful. As a first step to fulfilling that mission, Google’s founders Larry Page and Sergey Brin developed a new approach to online search that took root in a Stanford University dorm room and quickly spread to information seekers around the globe.

Google is now widely recognized as the world’s largest search engine — an easy-to-use free service that usually returns relevant results in a fraction of a second. Google’s utility and ease of use have made it one of the world’s best known brands almost entirely through word of mouth from satisfied users.

As a business, Google generates revenue by providing advertisers with the opportunity to deliver measurable, cost-effective online advertising that is relevant to the information displayed on any given page. This makes the advertising useful to you as well as to the advertiser placing it.

Other than the search engine, Google also sports various other tools that are innovations of the company. Other than the Google toolbar and the oogle desktop it also has tools like Google earth and online shopping facility. During its short life, Google it has achieved a lot.

Competition Primary competition in the search engine marketplace includes Yahoo! , MSN, and AOL. While Google commands a wide lead over these competitors, there will be increased pressure from well-funded rival entities, particularly Microsoft, who perceives Google as a threat to their dominant desktop position

The IPO Google’s management team is highly protective of the firm’s control over its business, so it was in no rush to take the firm public. But they did so in order to maximize their disclosure of information as mandated by the SEC (Securities and Exchange Commission). The threshold of SEC rules requiring quarterly disclosures is 500 stock or stock-option holders and $10 million in assets.

As Google approached this threshold, the management team decided to fully utilize their disclosure to increase capital. The public offering, however, would not be only a matter of convenience.

Aside from creating a public market for its shares and facilitating future access to market, the public offering also goes to finance Google’s expansion. On August 19, 2004, Google went public issuing 19, 605, 052 shares.

This was comprised of 14. 1 million Class A shares for which Google received the proceeds of sale and 5. 5 million Class A shares for which selling stockholders received the proceeds, yielding a total of approximately $1. 7 billion dollars. By creating an additional class of voting shares (class B) retained by the company, Google retained nearly all control (99.

2%) of the company post-IPO.

The market for initial public offerings at this time was in an upward trend of a cycle that bottomed out in mid-2003 following the dot-com collapse. Notably, the number of IPOs occurring at the bottom of this cycle was the lowest it had been in over 20 years The Process The main processes for the IPO are the book building process and the Dutch auction method. The process used by Google was the Dutch auction method. Both the processes are discussed below.

The Book Building process Book Building is basically a capital issuance process used in IPO which aids price and demand discovery.

It is a process used for marketing a public offer of equity shares of a company. It is a mechanism where, during the period for which the book for the IPO is open, bids are collected from investors at various prices, which are above or equal to the floor price. The process aims at tapping both wholesale and retail investors.

The offer/ issue price is then determined after the bid closing date based on certain evaluation criteria. Book Building is a good concept and represents a capital market which is in the process of maturing. This is also the most famous method of generating equity funds.

In addition to the price band, the company can make use a fixed price method where price is known initially but the demand can not be identified till the issue closes. Main steps: • The Issuer who is planning an IPO nominates a lead merchant banker as a ‘ book runner’.

• The Issuer specifies the number of securities to be issued and the price band for orders. • The Issuer also appoints syndicate members with whom orders can be placed by the investors. • Investors place their order with a syndicate member who inputs the orders into the ‘ electronic book’.

This process is called ‘ bidding’ and is similar to open auction. • A Book should remain open for a minimum of 5 days.

• Bids cannot be entered less than the floor price. • Bids can be revised by the bidder before the issue closes. • On the close of the book building period the ‘ book runner evaluates the bids on the basis of the evaluation criteria which may include – o Price Aggression o Investor quality o Earliness of bids, etc. • The book runner and the company conclude the final price at which it is willing to issue the stock and allocation of securities.

Generally, the number of shares is fixed; the issue size gets frozen based on the price per share discovered through the book building process. • Allocation of securities is made to the successful bidders. Dutch auction method Dutch auction is generally done in five stages: qualification, bidding, auction closing, pricing, and allocation. • The Qualification Process Here the qualification of the prospective participants is defined. Eg. Google auction IPO participants were restricted to U.

S. investors; foreign investors were not eligible to participate.

This process allows potential investors to electronically submit information and is designed to access the qualification of potential investors to bid. • The Bidding Process After the confirmation of qualification to bid, investors are asked to submit bids for the number of shares and the price per share they were willing to pay. Investors are required to accept the electronically delivered prospectus and an electronic presentation from the underwriters (in some sense an electronic road show).

The underwriters collects all the bids, identity the bidders and prepare a master order book, which bidders have no access to and is only available for the company and the underwriters to view. During this process, underwriters can identify and reject any speculative bids or bids that have potential to manipulate or disrupt the bidding process. Bidders can withdraw or accept the bids anytime before the closing of the auction. • The auction Closing Process The company closes the auction process after the SEC declares the registration statement effective.

Once the auction process is closed, bidders can no longer modify or withdraw any bid, and successful bidders would be obligated to buy the shares allocated to them at the IPO price, potentially the lowest price of the successful bid. • The Pricing Process After the bidding process reveals a clearing price, the company and the underwriters would use the clearing price as a principal factor to determine the IPO price. The company can reserve the right to set the IPO price lower than the clearing price. • The Allocation Process After the IPO price has been determined, the underwriters begin to allocate the shares.

All successful bidders who have not withdrawn prior to auction closing process are eligible to receive an allocation of shares at the IPO price.

In the event that the number of shares represented by the successful bidders are larger than the number of offering shares, the underwriters allocate the offering shares among the successful bidders using either a pro rata allocation method or a maximum share allocation method. Alternative valuation technique: Book building Book building is the traditional method of valuing a company’s equity, by setting an appropriate price band.

The valuation is done by traditional DCF analysis. The cash flows can be calculated by either the dividend discount model or the free cash flow to equity approach.

We will follow the FCFE, the most commonly used approach. The method comprises of estimating the free cash flows of the company, setting a proper discount rate and thus finding the enterprise value of the firm. DCF analysis has a lot of advantages. For starters, it serves as a reality check to the fair prices found in annual reports. DCF analysis takes into account the factors that affect a company such as future growth and profit margins.