Finance case 1: morningstar's initial public offering (ipo) essay

Business, Corporate Governance

Running Head: FINANCE CASE 1IntroductionAn Initial Public Offering (IPO) is the first sale of a private corporation’s stock to the public (How, J., and J.

Howe 2001). It is done with the aim of either raising money for investment or if a corporation is seeking to be publicly traded. There is usually a rush and mass publicity to register during this time. The first major decision a company makes are; a. whether the company should or should not to go public andb. If going public is the best move at that particular time.

Dutch auction IPO is one of the best modern ways. It simply uses the internet and provides a fairer way of selling stocks. In traditional auction the prices rises until one bidder is left.

In a Dutch auction, the auctioneer sets an extraordinarily high price and lowers it until someone bids on the item. In theory buyers pay more for stock in Dutch auction IPO’s than ordinary IPO’s meaning that more money will go to the firm that is selling the shares. However, this traditional approach may be superior in the long run.

The price spikes associated with a traditional IPO marks an impression of success to the stock which may in it self boost the stock further.
Google and morning Star had successful IPO’s and were the first companies to use this approach (Dutch auction). Much of the analysis of Google’s IPO has concluded that the Dutch auction is a flawed way to float shares. This has been criticized by many experts in this area. If this approach is executed correctly it provides an efficient and effective mechanism that determines a share price where supply equals demand (Melissa B. Frye. 1999).

There are various potential risks and benefits associated with a Dutch auction IPO which a chief financial officer should take into consideration before making use of this method to raise capital for his/her corporation. Potential benefits:· Dutch auction IPO limits or removes the ability of the investment bank to influence the opening price of the shares and its ability to allocate IPO shares at all. The firm has its shares equality at its best. The traditional IPO system is characterized by investment banks which set the price for the IPO (and, of course, pricing it below the real market price to guarantee a first day explosion that the press likes so much – even though it means significant financial loss to the company) and lets anyone bid on how much shares to pay, and then set the actual IPO price based on the highest price where all the company shares will set at.

Investment banks will come in, do some evaluative work on how much a company is worth, survey the market to determine the interest of potential buyers of a company at different price points and then recommend a pricing formula to the management of the company (How, J., and J. Howe 2001). For quite a long time, this option has been around but most companies have been afraid to try it out believing that they needed big name investment bankers publicizing the stock to guarantee that it got enough attention from the financial community. The idea of a Dutch auction IPO eliminates this problem as was seen in the case of Google and Morningstar.· Once the bidding is over, the management at its own good judgment can adjust down the price that successful bidders are required to pay. For example, assuming one million shares bided by several potential investors for different amounts and quantity; the share price will be determined by the lowest price offered by the lowest bidder (the bidder for the remaining number of shares).

This enhances management independence. For instance, Google reset its offer range from $108 – $135 per share to $85 – $95 per share. This provided Google with the ability to set a price that supply equals demand, based on investor demand as revealed through the bidding process.

· The increase between the offer price and the open price of an IPO is minimized providing the issuer with greater value.· Transparency of the process will increase. Investors will become less skeptical of the types of companies using the processes and the pricing of the IPO's may become more efficient.

This will make it easier for smaller, less well known firms to generate interest in a company's IPO.· Dutch auction IPO's is a more egalitarian and transparent alternative to traditional process for providing new companies with capitals (Derrien, F., and K. L. Womack, 2000).

The auction also offers various benefits to investors (Melissa B. Frye. 1999). First, individual and institutional investors enjoy equal access to participating in an IPO.

Second, these investors are allowed to present multiple, multi-tiered bids that indicate variable interest in different share prices. Third, all investors receive the same price. And finally, shares are allocated on an equal and fair basis. This is in line with the principles of efficiency and fairness. Fairness is promoted on both sides as well as the middle of the transaction. It is fair to the company whose IPO is sold at a price more reflective of market value and is fair to the investors since all investors are given a chance to attain the IPO. It is fair to the brokers because it does not tempt them with an opportunity to take advantage of the system and turn a fast profit: rather they get paid merely for their services and not their connections.

Potential Risks: Regulatory and market challenges. Google encountered both regulatory and market challenges during the IPO process. Certain slip-ups such as the failure to register employees share distribution with the security exchange commission (SEC) and the play boy magazine interview, as well as a deteriorating equity market, as evidenced by many other counsel IPO’s and a decline in technology stock management were sources of downward pressures on the offers demand.

Unforeseen government regulations can also affect the IPO process. Finance – financing may not be available for the tender offer upon terms acceptable to the company. Tender offer: the tender offer can be extended or not consummated on the terms expected by the company.

Fraud – this is one of the greatest risks in this share floating scheme. There seems to be an association in investors mind between security transactions and fraud (Mark Grinblatt, & Sheridan Titman 1997). This includes issues of bidder secrecy, fraudulent auctioneers, withdrawal threats and antisocial agents. Due to the advancement in technology, many fraudsters have turned to the internet, posting wrong information and data aimed at misleading investors. Unless proper steps are taken to counteract internet fraud, it can generate negative results to the company because when fraudulent transactions occur either through collusion, forced bids or wrong postings, it will be difficult to identify the culprit – an incentive for bidders to engage in such illegal behavior.

Fluctuations in the companies’ stock price or other factors. Stock prices are determined by the market forces (demand and supply). These forces can move to the advantage of a company or to its disadvantage. Complexity of the Dutch auction. This slows down small investor participation.

However, critics of these approaches argue that this limitation arises at the underwriter level and hence based on the underwriters interpretation of security exchange commission restrictions. In our analysis, this has been taken as a risk as the outcome is unpredictable. Inaccurate pricing-this is different from price fluctuations. There are various possible explanations for any Inaccurate pricing in the Auction process. First, the small investor, who is supposed to be a primary participant in this auction may lack access to information on how to properly price the security based on the basics. This process also requires some information to be disclosed which may also be lacking. Secondly, due to the less scrutiny by investment banks and reduction in information provided by the issuing company, the process could be used by companies that may not make a clear sense of the funds that they are raising.

Morningstar’s decision to use the Dutch auction process is actually consistent with this. It was the subject of the Security exchange commission investigation concerning inaccurate data on its website, and the agency as well as the New York Attorney General Eliot Spitzer began looking into possible conflicts of interests over Morningstar Associates’ recommendation. Finally, This is due to discretion on the part of investors over the online auction process in generalConclusionMorning star’s choice of the Dutch auction process for its IPO proved an innovative and encouraging approach to obtaining a public stock market quotation for a company’s share. The reason why it used this approach was because of Google’s successful IPO. When high profile Company like Google goes public using an approach such as Dutch option it is a telltale sign of a product change in that direction.

Despite the risks, as a Chief Financial Officer, I would highly recommend for the use of an online auction to raise capital for the company as well as obtain a stock market listing for its shares. References: Derrien, F., and K. L. Womack (2000).

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