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The Marketing and Sale of Initial Public Offerings (IPOs) through Internet-Based Investment Bankers

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Abstract

Internet-based investment bankers provide companies with another sales channel for selling stock through initial public offerings (IPOs). The research issue that arises from this new process is to identify the differences between the traditional process and the new online process. Based on evidence from several investment banking firms that provide an electronic market for IPOs, we evaluate the new IPO sales process using transaction cost economics analysis. We find that the new online process typically results in benefits to the seller such as lower investment banker commissions and higher receipts from the sale, but also involves a higher level of risk when compared with the process that uses traditional investment bankers. Our overall conclusion is that the new process is a benefit to both IPO companies and investors because it provides an alternative online market that increases the level of competition for investment bankers and improves the overall efficiency of the market for IPOs.

Introduction

In the past five years there has been a growth in Internet markets, run by online investment bankers, or "e-managers" (Dorsey, 1998), where companies and investors can buy and sell initial public offerings (IPOs) for corporate stock. These new markets provide companies with a choice of whether to use a traditional investment banker, or an online investment banker, when selling their IPO. When companies are considering an IPO they must first evaluate the financial issues to decide whether it is a viable financing option, and second they must identify which channel they wish to use to sell the IPO. In this paper we focus on the second decision. The issue that arises from this choice is to identify the differences between the traditional IPO process and the new information technology enabled process. In this paper we describe the traditional IPO process and the new Internet market enabled process. Based on an analysis of several online investment banking firms, we identify the implications this new market has for companies making a stock offering, traditional investment bankers, the new online intermediaries, and both larger and smaller investors. This is an important research area because it potentially affects all public companies, or companies considering going public, the investment banking industry, and all stock investors. It is also important because of the large amounts of money typically involved in IPOs. This is indicated by the growth in online stock trading, of which IPOs are one component. Online trades accounted for 17% of total retail trades in 1997; and this figure will approach 30% in 1998 (Dreyfuss, 1998).

Traditional IPO Process

The traditional IPO process involves the company selling the IPO, an investment banker that acts as an intermediary between the seller and buyers, and a select group of typically larger investors. The structure of this process is described in Figure 1.

This process has been used for IPOs for well over a century, but some inefficiencies have evolved during that time. The traditional investment banker provides services such as pricing the initial offering and providing access to a select group of large investors. This comes at a price because the traditional investment banker receives a commission on the amount of money raised in the IPO. Besides these transaction costs, there is the practice of "spinning." Spinning involves investment bankers giving out shares to favored or potential customers in hopes of winning future business. Several securities firms are currently under investigation by the Securities and Exchange Commission (SEC) for such practices (Bransten and Wingfield, 1999). Consider the case of Theglobe.com, a Website builder that debuted in February. Theglobe's bankers, Bear Stearns and Volpe Brown Whelan, underwrote its shares for $9, raising

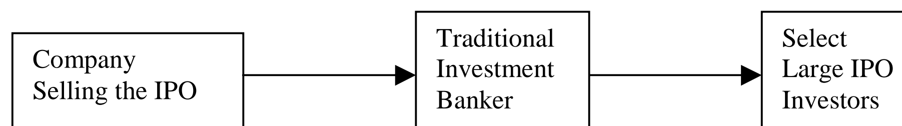

Figure 1. Traditional IPO Sales Process

$27.9 million in capital. The first day of trading, small investors drove the price up to $63.50. Had Theglobe sold its shares for the $63.50 investors were willing to pay, rather than the $9 the banks told it the shares were worth, the company would have collected not $27.9 million but $197 million – seven times the money to build the brand and develop new products (Tully, 1999). Because of high transaction costs, and a less than open market, a new information technology enabled IPO process has emerged in the past few years.

New IPO Process Enabled by Internet Markets

The new IPO process involves the same seller, but a different form of intermediary. The new online investment banker provides an Internet-based IPO market with access to a more open market including a larger number of smaller investors. Bob Lessin, CEO of Wit Capital, identified this as a primary goal: to level the Wall Street playing field by giving the little guy, individual investors, a chance to invest in a company when it first offers shares to the public and before the stock actually begins trading in the markets (Dorsey, 1998). The online IPO sale process is described in Figure 2.

One example of how the new IPO process can work is the plan developed by William Hambrecht, owner of W. R. Hambrecht & Co. Under Mr. Hambrecht's plan, dubbed OpenIPO, would-be investors submit bids for the number of shares they would take and at what price; to participate, bidders will need to have a brokerage account through W. R. Hambrecht or one of the five small brokerages that have agreed to participate in the process. After a few weeks of taking bids, the offering price will be set at the lowest price at which all shares can be sold. Those bidding above the offering price will get all the shares they asked for at the offering price; those bidding at the offering price will get a portion of their bid; and those bidding less than the offer price won't get any shares. No more than 10% of the shares sold can go to a single bidder, and Hambrecht reserves the right to limit the purchase of anyone seeking to buy more than 1% (Bransten and Wingfield, 1999).

Given rational decision making on the part of the transaction participants, the choice of how to govern a transaction is commonly based on which option economizes on transaction costs (Williamson, 1985). This analysis has been applied to the choice of markets versus hierarchies in industrial organization economics, and in this case we can use transaction cost analysis to compare the traditional IPO process with the new information technology enabled process. We can compare the traditional market with the electronic market based on six cost components, product price resulting from the market mechanism, consumer information search costs, transaction risk costs, product distribution costs, sales tax, and market participation costs (Strader and Shaw, 1998). The costs relevant to our study include: (1) IPO revenues received by the seller, (2) market participation costs (investment banker commissions), and (3) intermediary risk. A comparison of these costs in the traditional and online IPO processes is discussed below.

The first difference between the traditional process and the online process is that the new process results in a closer match between the IPO share price and the initial market for the shares which results in more revenue for the company offering their stock through the IPO (Bransten and Wingfield, 1999). This is a positive for the selling company, but a negative for the large "select" investors who made large amounts of money from having first access to an IPO through a traditional investment banker. The second difference is that traditional investment banker commissions are typically higher than their online competitors. The 15 or so traditional investment banks that dominate the field charge a 7% fee. Online investment bankers are expected to range from 3% to 5%. W. R. Hambrecht & Co. charges a fee of 4% (Bransten and Wingfield, 1999; Tully, 1999). This again is a positive for the company selling their stock through an IPO, but a negative for the investment banking industry. But, not all aspects of the online process are positive for companies selling shares. The third difference is that the use of new online investment banking firms as an IPO intermediary would typically involve more risk than that associated with using a traditional investment banker. Because of this, the revenue gains, and commission savings, must be balanced with the level of risk the company perceives in the new process. This is a positive for traditional investment banking firms with long histories of success and a negative for the new firms entering the market for online investment banking services.

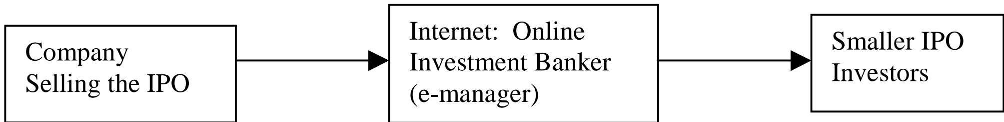

Figure 2. Electronic Market Enabled IPO Sales Process

Implications

Implications for Companies Selling Stock IPOs. The main implication that the new online process has for companies is that they have a choice of how to offer their IPO. If they use the traditional process they can likely minimize their risk in comparison to using an untried online investment banker, but will pay a higher commission rate and may receive less revenue from the sale because the IPO is marketed to a smaller number of large investors. If they use the new online process they can reduce their commissions and sell their IPO to a larger number of smaller investors which shifts profits to them and away from the investment banker and the larger investors. Their choice is the classic risk versus return scenario.

Traditional Investment Banker Implications. The first implication for traditional investment bankers is that they can expect a more competitive market for IPO offerings with the result being less demand for their services. This is especially true for new Internet-based companies that wish to maximize the revenues they receive from their IPO. The second implication is that the more competitive market will reduce the percentages paid by companies for the investment banking services. Even when their services are preferred it will be difficult to demand the traditional higher commission rates.

Implications for the new Online Investment Bankers. The first implication for online investment bankers is that they should expect an increase in the number of IPO offerings being made through the Internet because transaction fees are lower. Lower transaction fees, and access to a larger market, provide financial benefits to both IPO sellers and buyers. The second implication is that these companies have two strategic options in this new "e-manager" market. To enter the IPO intermediary market, companies will likely have to initially compete on price, by offering their services for a low commission rate. The online investment bankers who succeed in the long run will be the ones that are an early market entrant and become a trusted intermediary. Once the intermediary company has gained a reputation as a trusted broker for IPO sales, they can increase their fees as they differentiate themselves from late market entrants.

IPO Investor Implications. The first implication for IPO investors is that large investors will, in many cases, lose their protected status that allowed them the first chance to purchase a new stock offering. The market will be more competitive from the buyer side. The second implication is that smaller investors will now have a better chance to buy stock through IPOs.

Conclusions

The traditional IPO process, as well as the new process enabled by online investment bankers, are both viable options for companies to consider when selling a stock IPO. The tradeoff involves a comparison of (1) intermediary trust/risk and (2) the difference in the proceeds expected from the IPO and the commission that is paid to the intermediary. It is likely that large companies will stay with the traditional investment banks because they provide more IPO services, and have more experience, which typically results in less risk to the IPO seller. Small companies that wish to offer an IPO may choose the new online investment banks because they have a stronger desire for more revenue from the IPO sale and lower commissions. They may be more willing to take their chance with the new process. The overall conclusion of this study is that IPO sellers and buyers are better off with more investment banking options. IPO sellers now have a choice of two alternatives each with their own strengths and weaknesses.

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