

Things To Consider Before Investing In An IPO

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IPOs or Initial Public Offers are means by which a company can raise debt free capital through sharing the ownership and profits. There have been many companies opting for the IPO route over the last two decades. There have also been many big success stories with people making decent profits through these investment tools. However, there are always some items to consider when investing in an IPO that can reduce the risk in this.

IPO Basics

As the company starts growing, there is a time when it needs huge capital to take it to the next level of growth. Some companies decide to raise debt to get this capital; others opt for profit sharing without adding to the debt. The second option is the IPO route. In effect, when you invest in an IPO you are opting for part of its profits and losses too! So you need to be very selective on which companies you want invest in.

No History

It's hard enough to analyze the stock of an established company. An IPO company is even trickier to analyze since there won't be a lot of historical information. Your main source of data is the red herring, so make sure you examine this document carefully. Look for the usual information, but also pay special attention to the management team and how they plan to use the funds generated from the IPO.

And what about the underwriters? Successful IPOs are typically supported by bigger brokerages that have the ability to promote a new issue well. Be more wary of smaller investment banks because they may be willing to underwrite any company.

Studying the Company

A good starting point for your IPO analysis is to look at the financial reports of the company for as many years as possible. One thing that every company must publish is its total debt and total asset value. As long as the asset value is more than the debt, you know that enterprise can pay off its debts so it would survive. Also look at the difference in the assets value and debt which in effect is like the company value. Check what is the effective company value

based on the IPO price and number of shares. If the IPO price is less than this value you are in for good profits on listing.

Besides value, another good indicator is the company growth seen in the profits it has made over the past few years. Sometimes the enterprise is new, so its current value is less, but a strong growth pattern would be that its value is going to increase in future so it is a good longer term investment.

Third important thing to look at is whether the company is stuck in some legal tangles. Typically, if the verdict goes against it, it would affect its finances and more importantly the stock price in the market. You could lose lot of money, in that case. So study these aspects well before investing.

Lastly, analyse its market standing among the peers. If you use its products, you know it is a good company and you can invest with lesser risk. But if it is an unheard commodity, you need to be cautious.

The Lockup Period

If you look at the charts following many IPOs, you'll notice that after a few months the stock takes a steep downturn. This is often because of the lockup period.

When a company goes public, the underwriters make company officials and employees sign a lockup agreement. Lockup agreements are legally binding contracts between the underwriters and insiders of the company, prohibiting them from selling any shares of stock for a specified period of time. The period can be anything from 3 to 24 months. The problem is, when lockups expire all the insiders are permitted to sell their stock. The result is a rush of people trying to sell their stock to realize their profit. This excess supply can put severe downward pressure on the stock price.

Flipping

Flipping is reselling a hot IPO stock in the first few days to earn a quick profit. This isn't easy to do, and you'll be strongly discouraged by your brokerage. The reason behind this is that companies want long-term investors who hold their stock, not traders. There are no laws that

prevent flipping, but your broker may blacklist you from future offerings or just smile less when you shake hands.

Of course, institutional investors flip stocks all the time and make big money. The double standard exists and there is nothing we can do about it because they have the buying power. Because of flipping, it's a good rule not to buy shares of an IPO if you don't get in on the initial offering. Many IPOs that have big gains on the first day will come back to earth as the institutions take their profits.

Avoid the Hype

It's important to understand that underwriters are salesmen. The whole underwriting process is intentionally hyped up to get as much attention as possible. Since IPOs only happen once for each company, they are often presented as "once in a lifetime" opportunities. Of course, some IPOs soar high and keep soaring. But many end up selling below their offering prices within the year. Don't buy a stock only because it's an IPO - do it because it's a good investment.

Conclusion

Besides these points, other items that could affect the IPO price on listing are market sentiments, the economic outlook, general industry news, etc. These are so dynamic that they cannot be used as guidelines, and you need to go with the market flow.

In short, investing in IPOs is risky, but with careful analysis you can reduce the risk. For this there are some items to consider when investing in an IPO. As long as you do your homework, the risks are limited.

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