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Google and Morningstar IPOs: Incentives for the Dutch Auction Process?

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"The term initial public offering (IPO) slipped into everyday speech during the tech bull market of the late 1990s. Back then, it seemed you couldn't go a day without hearing about a dozen new dotcom millionaires in Silicon Valley who were cashing in on their latest IPO. The phenomenon spawned the term siliconaire, which described the dotcom entrepreneurs in their early 20s and 30s who suddenly found themselves living large on the proceeds from their internet companies' IPOs."

(Anonymous)

Despite the success of Google's Dutch auction process, IPO companies that are making the transition towards public ownership will need to continue to court large institutional investors by offering them discounted insider share pricing as customarily done through traditional initial public offerings (IPO). Avoiding to do so may lead to debacles experienced by companies such as Morningstar which by opting for a seemingly more "democratic" Dutch auction IPO shunned institutional investors severely impacting its stock price valuation well into the future.

Transitioning from being a privately owned to a publicly owned company is typically seen as a sign of a successfully growing enterprise. An IPO will typically greatly increase a company's capitalization, liquidity, net worth, and prestige. However, in exchange for these benefits a public company will have to abide to very demanding and intrusive Securities and Exchange Commission (SEC) public financial disclosure guidelines. Furthermore, by going public a company ties itself more closely to the public's perception of its future value and may experience a sharp decrease in stock price value during bear markets which in turn will lower its liquidity and overall capitalization.

In order for an IPO to be successful a company needs to attract enough investors to create a level of capitalization that will be larger than the total amount previously privately invested. Institutional investors, given their large concentrations of investment capital, play a big role in influencing whether smaller investors will get involved. Traditionally, these types of investors are pitched to during extensive road shows whereby underwriting firms along with corporate executives of a prospective public company offer them stock at discounted pre-IPO rates.

“A conventional IPO is expensive and can leave a lot of money on the table if the stock booms once it begins to trade publicly. But some companies fear they will fail to attract enough attention in an auction, that big institutional investors won't bid for their stock, and analysts at investment banks, shunned in the IPO process, will ignore them as a public company.” (Syre)



The success of the Google Dutch auction IPO was an anomaly. Google waited a long time before going public and had established one of the most visible brands in the world before doing so. Unlike the majority of technology driven startups, Google had grown organically over the years and patiently transformed its Internet positioning into consistent revenues and overall profitable operations. It is difficult to ascertain whether the Google IPO would have been more successful if they had followed the traditional process. Typically, a pre-IPO road show is a very expensive affair designed to build demand and awareness regarding the investment opportunity of an upcoming IPO among institutional investors. The executives at Google may have reasoned that they had already garnered the demand and awareness among the latter group in an alternative fashion.

“It's no wonder. If IPO shares were commonly auctioned off, investment banks would stand to lose billions in underwriting fees. But more important, they would no longer control the allocation of precious IPO shares. Indeed that may be the reason why previous Morgan Stanley, Deutsche Bank Securities, and William Blair have all bowed out of the Morningstar deal.” (Carter)

Although the Morningstar IPO was seen as a success by some it ultimately failed to bring in large investments from institutional investors negatively impacting its stock price. Regardless of Morningstar's track record as a private company it did not have the brand name recognition and prestige that enabled Google to attract institutional investors through the Dutch auction IPO. Unless the process of building demand and awareness for IPO investment opportunities among institutional investors changes drastically it will be difficult for companies to avoid the traditional IPO process. The Dutch auction process right now would be a disadvantage to all the privately held prospective profitable well positioned pre-IPO companies that have not had a need to develop much media attention outside of their relative industries. The traditional IPO process enables companies to build demand and awareness for their future shares through extensive road shows where investors take the time while being wined and dined to learn everything they can about the investment proposition.

"The idea an auction just can't work seems hard to swallow," Stein says. "Nobody who does an IPO wants to do something different from the herd. But if a few high-profile companies break out and do this, we'll find out if it works." (Syre)

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