

# The IPO Prospectus: How to Read the Fine Print

By John Deysher

**A**s a mutual fund manager, one of the ways I gauge market sentiment is the height of the stack of IPO red herrings (preliminary prospectuses) in my in basket. This past summer, my basket was overflowing.



An IPO or “initial public offering” is the first sale of stock to the public by the company or existing shareholders. This year, every conceivable type of company is coming public, which coincides with most major market indexes trading near multi-year highs during the summer, although in the past month the indexes have retreated markedly.

How does an investor sift through the rubble to get to the few gems?

You need to start with the prospectus, a formal written document to sell shares—it is the only way a new issue may be sold. Your broker must send you one—make sure you read it!

Although these documents are written by lawyers, a prospectus is straightforward and covers most of the important areas you need to focus on. Here’s what you should look for:

## Prospectus Summary

This usually provides an overview of the company—what it does, strategy and strengths, management depth, deal size/terms and consolidated financial data. This section is generally several pages long and is designed to whet your appetite.

## Risk Factors

Due to investor complaints about the performance of past IPOs, this section is now placed early in the prospectus.

Normally this section is several pages long and should be read with great care, since it details potential risks which may include:

- New internal growth initiatives that may require significant commitments of capital and management resources.
- A “growth by acquisition strategy” that could result in financial or operational distress from overpaying or integration issues. Acquisitions rarely go smoothly.
- Dependence on a particular customer(s), product line(s), employees(s) or vendor(s).
- Substantial indebtedness or a highly leveraged balance sheet.
- Exposure to raw material price fluctuations (i.e., steel prices).
- Vulnerability to imports or other substitute products.
- Increasing competition from other domestic or even foreign firms.
- Pending lawsuits or government investigations.

## Use of Proceeds

IPOs may be made by the company itself, by existing shareholders (the insiders), or both.

Generally, an IPO does better when the company is selling a larger proportion of total shares offered than the insiders. Proceeds flowing directly to the company have a chance of earning a return for new shareholders. Offerings made by the insiders simply line their pockets with cash while providing no tangible benefits to the company. Currently, many IPOs are providing a convenient exit strategy for private equity/leveraged buyout shops that bought companies cheap a few

years ago and are harvesting their gains in a hot stock market.

If family or founding shareholders are selling large amounts of the IPO, beware—no other group has better knowledge of future prospects than the insiders.

IPO proceeds should be used for one of three purposes: to fund internal expansion via working capital or the purchase of facilities and equipment; to fund external expansion via an acquisition; or to improve the balance sheet by paying down debt. The more specific the language on use of proceeds, the better. Be especially aware of “blind pools,” which usually surface near every bull market peak. These vehicles are usually assembled by financiers to make acquisitions of yet to be specified companies.

## Capitalization & Selected Financial Data

The new firm should be well capitalized to survive the inevitable downturns every firm faces. Generally three to five years' worth of financial data will be presented. On the income statement, look for rising sales and earnings, but not at too quick a pace. If the financials show soaring sales, margins and earnings, competitors may be on the verge of jumping in. Also, higher growth rates usually mean higher IPO valuations and the potential for a declining share price when growth rates slow. Also, beware of firms with lackluster results that have one big year just before the IPO, which may not be sustainable.

## Industry & Business

Another section well worth reading covers industry growth fundamentals, demand and supply trends and corporate history, strategy and structure, properties, competition, legal proceedings and regulatory matters. Avoid faddish companies and industries that may languish once investor enthusiasm wanes. In the past these have included

biotechs, dot-coms, bowling alley operators, solar energy purveyors, uranium mines and others.

Avoid development stage or “story” companies that tend to be speculative. Getting government agency approval and products to market usually takes much more capital than is secured by the IPO. Remember, subsequent secondaries dilute exiting shareholders.

## Discussion & Analysis of Financial Condition and Results of Operations

Seek firms that have at least a five-year (and ideally a 10-year) operating history. Analyze the financials the same way you would a firm that's already publicly traded. Check for sales and earnings progression, margin expansion and returns on capital. Is the business seasonal/cyclical? How will the balance sheet look after the deal? While the optimal ratio of debt to equity or debt to total capital varies by industry, most financial pros say the level of debt should not exceed equity. How do valuations compare with comparable public firms?

## Management

The future of a firm about to go public depends largely on the quality of management. History has a way of repeating itself and management at the new firm should be responsible for the firm's past success. If new managers have been hired, evaluate whether they were successful in previous positions. Experience in the industry is important and I generally prefer that key management members have 10-plus years in the field. Check out the board of directors—has management been able to attract competent, honest people?

## Related-Party Transactions

This section highlights transactions and relationships that, while not illegal, should be examined carefully for unethical behavior. Too many transactions may indicate the firm is being run as a

personal piggy bank for the insiders. The most common examples are real estate or business transactions between the company and management which may not be at arm's length. Company loans to insiders on generous terms are also a red flag.

## Principal Stockholders

Of course you want the insiders to have a serious equity stake post-deal. I generally like to see management and directors owning at least 10% of post-deal shares outstanding. A buyout or venture capital firm that retains a sizable stake is usually a good sign. Check to see when lock-up periods expire allowing execs to sell shares on the open market.

## Underwriters

Evaluate the quality of the underwriter—your odds should improve if you stay with the major ones. They are most likely to commit capital to after-market trading and do follow-up research reports. An obscure underwriter is usually (but not always) indicative of a riskier firm that couldn't attract a reputable underwriter.

## Conclusion

While not for everyone, IPOs can offer attractive returns to investors who do their homework. New issues should be subjected to careful examination and rigorous tests of quality and value.

Remember, most new issues are sold under “favorable market conditions,” generally more favorable to the seller and consequently less favorable to the buyer.

New issues also have a special salesmanship behind them, which calls for an extra dose of sales resistance. Make sure you know what you're buying and the risks involved.

Understanding why a firm is going public can mean the difference between a winner and a dud. Happy hunting. ▲

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