About IPO’s and Facebook

By Craig Phillips, CFP, AIF®

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We're hearing a lot about the Facebook initial public offering.

Later this week, investors will have the opportunity to pay between $28 to $35 a share to own a piece of the addictive social networking service. People everywhere are clamoring to get at least a few of the 337.5 million shares that will be offered by Morgan Stanley and 30 other underwriters.

Most of you know that an initial public offering, or IPO, is the first time a company sells its stock to the public at large. "To the public" is something of a misnomer, however. Most of the time, the large brokerage firm that serves as the IPO underwriter will only make these new shares available to its largest institutional customers. The rest of us have to buy on the open market (Facebook shares will trade on the NASDAQ exchange), and therein lies the rub. In many cases, those initial buyers can make a significant profit simply by flipping their shares at much higher prices to people like you and me. All too often, this buying frenzy leads to long-term disappointment.

The numbers tell an interesting story. Research by University of Florida finance professor John Ritter shows that from 1980 through 2010, the three year performance of IPOs that had been bought on the first day has lagged the broad market by an average of 20%.

Recent social media IPOs have not even done this well. Yandex, Russia's most popular search engine company, is down 20.8% from its IPO price last May. Zynga, which raised $1 billion last December, is down 5%, while Renren ("the Facebook of China") has so far lost 76.4% of its IPO investors' initial outlay. Pandora Media is down 37.4% from its June 2011 IPO price. LinkedIn and Groupon are the exceptions to this depressing story; they are up 37.2% and 13.1% respectively since their IPOs.

But these figures only apply to those who were fortunate enough to buy at the initial price. Ritter has calculated that ordinary investors who aren't on the investment bank's speed dial have paid much higher prices for their shares--and, of course, suffered correspondingly higher losses. When institutions flipped their shares on the first day of trading for the 1,096 IPOs sold from 2001 to 2011, ordinary investors paid, on average, 11.7% more than the IPO price offered to institutions and friends of the brokerage underwriter. (11.7% in one trading day translates into roughly a 3,200% annual return.) In the frothy 1999-2000 period, ordinary shareholders had to pay an astonishing 64.5% premium to get in "on the ground floor." You don't even want to know what that would look like on an annualized basis. Going back a little further, from 1990 through 1998,

the premium that mortals paid for IPO shares averaged 14.8% above the initial share price. This is not a short-term trend.

There are a few other warning signs to consider. If the Facebook IPO comes in at the widely-reported target price of $35 a share, those institutional investors will be paying a whopping 143.71 times the company's earnings per share, based on its 2011 net income of $668 million. If the share price bumps up, the aftermarket buyers might be paying closer to 200 times earnings per share--or about nine times the PE level of the stocks that make up the Standard & Poor's 500 index.

To put that price difference in perspective, consider whether you would go to the grocery store and buy any of the various cartons of eggs for 99 cents, or those cartons on the side that cost $8.91 apiece--or about 75 cents an egg. Would you buy a quart of your regular brand of milk for $1.50, or load up your shopping cart with the special new brand at $13.50 a quart? If its IPO goes well, Facebook, as a company, will be priced at a higher total market value than Visa, Inc., McDonald's, the Walt Disney Company, Home Depot or American Express. It would be worth more than Starbucks, Dow Chemical and Panasonic COMBINED.

Obviously, no company is worth this kind of valuation unless investors are pretty sure it will grow its revenues rapidly in the future, the way Amazon did after its IPO almost exactly 15 years ago. That's why it is so interesting to read in Facebook's most recent S-1 filing with the Securities and Exchange Commission that the company's income actually *fell* in the first quarter of 2011. Net income and earnings per share have also taken a tumble. This may be one more example of the truism among professional investors, that not all good or interesting companies are good or interesting investments. You won't get access to Facebook shares at the IPO price, but even if they were offered to you, you should probably take a pass. And then post your decision on the wall of some of your closest friends.

Market cap data: http://ycharts.com/rankings/market_cap

Facebook S-1 filing: http://news.cnet.com/8301-1023_3-57419311-93/facebooks-revenue-rises-in-first-quarter-but-profit-falls/?tag=mncol;txt

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Jay Ritter research: http://scholar.google.com/scholar_url?hl=en&q=http://inethub.olvi.net.ua/ftp/Library/DVD-013/Ritter_J.R._The_Long-

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