Secrets of a successful IPO

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- Managing the process of an Initial Public Offering or IPO can be one of the most challenging roles for corporate governance professionals.
- For many directors and senior executives, the pathways to raising capital for a new business can be confusing, time consuming and downright daunting.
- The options range from convertible hybrid debt-equity issues, backdoor ASX listings, private equity, venture capital, angel funding and the emerging social media-based innovation of crowdfunding.

The Facebook IPO of 18 May 2012 is a great case study of what can go wrong. This article contrasts that IPO with the most successful IPO of 2012 on the Australian Securities exchange, that of Perth-based African oil explorer Pura Vida Energy (ASX:PVD).

The article also looks at what lessons can be learned from both floats.

The secrets of a successful float are complex. For a junior resource company planning to list on the ASX it may simply be a combination of assets, achievable goals and a sound capital structure. Throw into this mix hard work, a network of contacts and good timing.

But if you have an internet or tech stock like Facebook which was described as the biggest IPO in internet history it can be a lot more complex.

The facts show how tough the market is for new capital raisings. In 2012 out of the 51 new companies listed on the Australian Securities Exchange, only 20 were trading in positive territory by 31 December.

In its *Annual IPO Watch* leading accounting firm HLB Mann Judd reported that 2012 'saw just 46 IPOs being successfully concluded which was significantly down on the previous two years (2011: 104, 2010: 96). The total funds raised by IPOs were down 75 per cent to $382 million compared to 2011's $1.5 billion. This was lower than any of the previous five years reflecting the current state of the market.'

There was a marked shift towards larger IPOs in 2013, with 96 per cent of all funds raised completed by companies with a market capitalisation of more than $100 million.

In 2013, 25 out of 49 newly listed companies finished the year even or in the black, with several recording gains of over 100 per cent on their listing price.

IPO activity by sector in 2013 has seen greater diversification than in previous years, with 15 different industry sectors being represented, compared to just seven in 2012.

The 2014 IPO pipeline is extremely thin with only five planned listings. This is in comparison to 14 planned listings at the start of 2013 and 26 at the beginning of 2012.

Case study: Facebook biggest internet float in history

The hype prior to 18 May 2012 for the Facebook IPO was stratospheric. The media were calling it a 'cultural touchstone' and 'the next great blue chip'.

Recently shares hit an all-time high and the stock has rallied roughly 65 per cent from its May 2012 IPO price of US$38. This is on the back of rising advertising revenues for the social media giant and in particular mobile. Revenues are at US$2.59 billion.

But its IPO was not all plain sailing and is a case study on what can go wrong.

Investor confidence in technology-based IPOs has suffered because of the lack of transparency in informing the market fully about revenue forecasts in the lead up to its May 2012 IPO.

In terms of context, Facebook founder Mark Zuckerberg resisted many buyout offers for the firm and was in no rush to complete an IPO.

A major reason the company decided to go public according to commentators was because it crossed the threshold of 500 shareholders.

Here's a short timeline of valuations (US$) prior to the IPO:

2006 Facebook reportedly turned down a $750 million offer from Viacom, Yahoo! attempted to buy the company for $1 billion and *BusinessWeek* reported a $2 billion valuation for the company.

2007 Microsoft beat out Google to purchase a 1.6 per cent stake for $240 million, giving Facebook a notional value of $15 billion at the time.

2009 Valuation drops to $10 billion when Digital Sky Technologies bought a nearly 2 per cent stake for $200 million–a larger stake than Microsoft had purchased at a lower price.

2011 An investment report values the company at $50 billion.

2012 Completes IPO with a peak market capitalisation of more than US $104 billion.

This background context shows how difficult it is to value technology and internet companies operating in the social media space.

The problem was compounded between February when the IPO was announced and 18 May 2012 the day of listing.

For example, in early May, the company was aiming for a valuation somewhere from $28 to $35 per share ($77 billion to $96 billion).

On 14 May, it raised the targets from $34 to $38 per share with some analysts suggesting a $40 valuation because of strong demand, especially from retail investors. Ultimately underwriters settled on a price of $38 per share.

On 16 May, two days before the IPO, Facebook announced that it would sell 25 per cent more shares than originally planned due to high demand. This meant the stock would debut with 421 million shares.

This was considered a bad move when the shares were overvalued, and it led to forced selling from investors who were allotted more shares than they expected and when quick profits failed to materialise a couple of days after the IPO.

The stock fell as soon as it opened, and the share prices crashed more than 50 per cent over the next couple of months, see Table 1. It took more than a year for the shares to trade above the $38 listing price, as there was concern earlier in 2013 that the company wouldn't make as much money from mobile ad revenue as it could from online ads.

The lessons to be learnt here are not to offer more shares just prior to an IPO even though it may be considered more a cultural phenomenon than a business.

Compounding this was the fact that on the day of the trading, the stock opening was delayed due to technical glitches, as NASDAQ's electronic trading platform was unable to handle the high volume of trades. This also prevented some investors from selling the stock during the first day of trading while the stock price was falling — forcing them to incur bigger losses when their trades finally went through.

Although a legal dispute over this has been dismissed, the lesson for future regulators is to double check technical issues with the trading platform prior to an IPO.

These issues were overcome for the $US14.4 billion Twitter IPO in early February of this year. For example, Twitter offered 70 million shares on the New York Stock Exchange, generating $US1.82 billion ($A1.9 billion), and gave underwriters a 30-day option to purchase an additional 10.5 million shares.

Twitter increased by 80.7 per cent to $US47, a day after the initial public offering (IPO) at $US26 per share.

So was Twitter's IPO a success and Facebook's a failure because of a lack of a so called 'price pop'?

'First, stocks typically close above the offer price on the first day of trading. The technical term for this phenomenon is initial underpricing. These first day price pops were unusually high during the dot com bubble, when the typical pop was 65 per cent of the offer price, well above the 7–15 per cent range at other times. Twitter's pop was 73 per cent, reminiscent of the dot com mania days when investor psychology allowed companies yet to show a profit to trade at high prices on unrealistic hopes,' commented analyst Hersh Sheffrin.

A group of Facebook shareholders filed a lawsuit in a New York district court after the IPO, alleging that important information about Facebook's financial outlook was 'selectively disclosed' to big banks ahead of the IPO.

Table 1: Significant price moves in US$

Trading days after IPO	Date	Share price at market close	Market capitalisation	Daily change	Net change from offering price
Offering price	18 May 2012	$38.00	~$90B	N/A	N/A
First day	18 May	$38.23	~$90B	0.6%	0.6%
1	21 May	$34.03		11%	10%
2	22 May	$31.00		8.9%	18%
6	29 May	$28.84	$69.17B	9.6%	24%
8	31 May	$29.60		5%	22%
9	1 June	$27.72		6.4%	27%
19	15 June	$30.01		6.1%	21%
68	20 August	$20.011		5.04%	47%
578	20 December 2013	$55.12	$140B	0.13%	45%

Source: http://en.wikipedia.org/wiki/Initial_public_offering_of_Facebook [6 February 2014]

Investor confidence in technology-based IPOs has suffered because of the lack of transparency in informing the market fully about revenue forecasts

The legal action followed a Reuters report posted prior to the IPO, which alleges that analysts at lead underwriter Morgan Stanley received privileged information about Facebook's financials — information that wasn't shared with the public.

As a separate Reuters report noted a few hours later, Morgan Stanley and three other major underwriters — Goldman Sachs, JPMorgan and Bank of America reduced their earnings outlooks for Facebook to strikingly similar levels ahead of the IPO.

More specifically, the lawsuit alleges that Facebook told analysts at its underwriters to materially lower their revenue forecasts for 2012.

In the consolidated class action complaint after the IPO, Facebook investors allege:

1. Facebook incorrectly reported its revenue prospects from increased mobile usage to the SEC, inflating these figures, and

2. Facebook initially disclosed this negative information privately to a 'select group of potential investors.'

The consequences were dramatic. Many high powered investors who received this non-public information about Facebook's dimming revenue prospects cancelled their orders or slashed the number of shares they intended to buy, dropped the price they were willing to pay, or sold their shares immediately after the IPO.

When the media reported on this asymmetrical information sharing investors were furious, causing Facebook's stock price to plummet even further.

The lessons learnt here are to always keep the market fully informed over any market sensitive information.

Case study: Pura Vida Energy ASX: PVD most successful ASX float of 2012

As a corporate advisor to Perth-based African-focussed oil explorer Pura Vida Energy, I got an intimate view of the company through the pre-IPO stage, the listing process and then the post IPO rush of finally becoming a listed company.

While not in the league of Facebook, I'm proud that Pura Vida Energy was the most successful IPO of 2012 in a tough market for capital raising. In fact, in terms of value generation, in the first 12-months of listing market capitalisation grew from $10 million to more than $70 million dollars.

Here's the story in the words of managing director, Damon Neaves:

'When we began it was tough, very tough. It was a small capital raising and we were rattling the tin pretty hard. One of the toughest challenges prior to the IPO was achieving the spread requirement, which was then 400 individual investors. So you can imagine I knocked on a lot of doors and called in favours.

We also saw lots of brokers. Importantly, half of the IPO raising was done by CPS Securities who really believed in the story and that conviction generated a lot of support for both the raising and after-market.

Valentine's Day 2012 was the day we officially listed at 20¢ and to be honest it was challenging because we had a fairly average start to our life as a listed company. With the knowledge that we had a good story to tell and a punishing roadshow schedule both in Australia and overseas, our stock rose steadily in the second half of the year to end 2012 at 80¢ — a 300 per cent increase on our IPO price.

Our rise was rewarding because we followed up our IPO with further capital raisings — a $3 million equity placement at 25¢ in July and a further raising of $6 million at 70¢ in November to fund our entry into Gabon.

With the second capital raising in November, I was in Houston negotiating the farm-out deal and the brokers were given notice overnight we wanted to raise more money for an acquisition and we built the book in 48 hours such was the pent-up investor demand. We could have raised $20 million dollars.

Contrast this with the IPO experience where we just got over the line. This new capital raising at a higher premium price was an exciting time and a great outcome. The belief in our story, our people and our Moroccan asset was strong.

Quality asset

We purchased the acreage on very attractive terms and our timing has been fortuitous. We were either very smart or very lucky to pick up the asset when we did because there's been a land grab since and a lot of transactional activity, including super majors, so values are considerably higher and the environment is competitive.

For example, our neighbours now include Chevron, BP, Kosmos Energy, $2.1 billion UK company Genel Energy (headed by former BP oil chief executive, Tony Hayward) and $1.5 billion London-listed Cairn Energy.

The timing has played out well for us because there is now significant drilling activity and news flow offshore Morocco commencing as early as July this year. Pura Vida is well placed, with a big acreage position right in the heart of this activity. Our own drilling will commence Q1 2014.

This shows how you can raise money based on a quality asset and because we are small and nimble, our point of difference is the ability to be the first mover on these assets. We secured a US$230 million farmout deal with Freeport-McMoRan (NYSX:FCX). The farmout crystallised significant value for Pura Vida and illustrates the value that our early entry strategy can generate in the pre-drill phase.

Achievable goals

Our strategy has been to take an early entry strategy and to negotiate a big equity direct with the government, which gives us huge leverage. One of the reasons we chose Morocco was because of the favourable fiscal terms. The country genuinely wants to attract more offshore investment to its oil industry and they liked our innovative technical approach.

So in Morocco we turned a four million dollar commitment into a $230 million farmout deal — which brings $US15 million cash in and up to US$215 million funding for two exploration wells.

When we first went to market, investors saw us as ambitious and perhaps rightly the question was asked — would we ever secure funding for a drilling program in deep water Morocco? Investors were very cynical given the cost of deepwater exploration. We definitively answered the question on funding by securing a US$230 million farmout deal.

We will be targeting our Toubkal prospect with the first well. So it is a great position to be in — to be fully funded. This concrete example demonstrates how our strategy works and we have confidently managed every goal we have set ourselves.

This strategy is exactly what we hope to replicate with our second and third asset in Gabon and Madagascar. We have gone in with a direct negotiation with the government, taking 80 per cent equity in high quality acreage.

When we took the story of Pura Vida to the market we had a very clear strategy around the use of funds in achieving these goals. Knowing where the money is going and that the company is adequately funded to achieve its goals is critical.

Our strategy from the very beginning was about building a diversified exploration and production company, and we hope to replicate the success of Morocco in Gabon and Madagascar.

Keeping momentum in the second year of listing is equally important to building shareholder value in the first year of being on the boards. Once again, we have very clearly articulated our goals in 2013 to the market.

So achieving goals and delivering on what we have promised to investors has been a crucial part of our successful first year as an ASX listed company. We had regular news flow and were able to manage market expectations. If you start missing milestones people quickly start to lose faith.

Capital structure

You also need a good capital structure. It's got to be clean so you can get institutions involved. You see a lot of recapitalised shells, with big overhangs in terms of options on issue, legacy shareholders looking to exit at the first opportunity.

A lot of companies fall into the trap of just desperately trying to raise money, no matter the consequences. They don't think about tomorrow.

Now that we are fully funded for drilling in Morocco and have diversified our portfolio we expect to see our shareholder register change, including greater participation from institutions. This is part of the normal transition for juniors and we are on the cusp of making that transition.

Our tight capital structure also provides investors with significant leverage to success.

Lastly, the success of any company is driven by the people. Pura Vida's team have shown extraordinary dedication, commitment and professionalism. Their personal sacrifice has allowed the company to achieve a great deal in a short time.'

The dos of a successful IPO

- Keep the market fully informed, especially with materially significant information
- Have a small board with a mix of technical and commercial experience and qualifications
- Separate technical and commercial director roles and physical separation of offices
- Have a proven track record of success with directors
- Approach governance as a value-adding process for shareholders, not a compliance nuisance
- Invest in a culture of transparency and good shareholder communications
- Automate email news alerts and build your email database
- Communicate frequently and regularly with stakeholders
- Have a combination of quality assets
- Set achievable goals
- Implement a sound capital structure
- Network
- Pitch and refine the investment story
- Seek external help in non-core areas such as marketing and financial PR
- Keep momentum in your second year.

The don'ts of a successful IPO

- Overhype the stock prior to IPO
- Set-up large boards
- Directors that don't have the right skill set
- Avoid recapitalised shells, with big overhangs in terms of options on issue
- Watch for legacy shareholders looking to exit at the first opportunity
- Be wary of cross-board directorships
- Miss strategy milestones
- Complicated or highly technical presentations no one can understand
- An unstructured haphazard approach to marketing
- Poor quality marketing materials
- Poor timing trying to raise capital during major holiday periods
- Avoid long periods with no news flow to investors
- A lack of support from a major broking house or institutional investor.

In summary for success with IPOs it is important for companies to continue to focus on the basics.

Companies that are most successful in listing have strong management teams well favoured by investors, solid business or project fundamentals and good investor support and communication.

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