Summary of the article “What CFOs Think About the IPO Process – Practice, Theory and Managerial Implications”

Handed in by

1 Introduction

The article “Evidence on What CFOs Think About the IPO Process: Practice, Theory and Managerial Implications” shows the result of a survey and additional insights outside of the survey which aim at finding out what CFOs think about IPO processes. The uncertain, time-consuming and expensive IPO process can result in a company that is set back a year or more if the company is not well-informed and prepared. Therefore, the article also tries to offer some recommendations on what CFOs have to consider in terms of IPOs.

There are basically two reasons for privately held companies to go public through an initial public offering (IPO). The first reason is that companies can raise huge amounts of capital. The second reason is its wealth creation for company insiders and pre-IPO investors. However, an IPO process can be very complicated and costly. Hence, many companies withdrew the offering in the past due to the many uncertainties.

The survey points out the following main findings:

1) Primary motive for going public is to fund growth opportunities by creating a currency (publicly-traded shares) with the IPO

2) Timing of an IPO depends more on the overall stock market conditions than on the IPO market conditions

3) Underwriters are chosen by the CFOs based on their reputation and industry expertise. Issuers were not very concerned about the underwriter fee structure

4) For CFOs, underpricing is a mean to compensate investors for taking on the risk of IPO

5) The history of strong earnings and a top investment bank are the two strongest positive signals for issuers while the sale of insider shares in the IPO is the most negative signal

6) Companies mainly prefer to stay private to maintain decision-making control.
2 Detailed findings

Motives for Going Public

According to several theories in academic literature, companies choose to go public in order to raise WACC-lowering capital and to allow insiders to cash out when the price is high. Surprisingly, the survey found out that minimizing the cost of capital is not one of the top reasons for CFOs to go public (only 42.5% agree). Also running out of equity (28% agree) and expensive debt (14% agree) are not that essential for the decision of going public. Instead creating public shares for use in future acquisitions (59.4% agree), establishing a market price/value for the firm (51.2% agree) and enhancing the reputation of the company (49.1% agree) were the top motives for CFOs.

Created public shares can be used as equity to fund growth opportunities. It could serve as a mean to pay M&A transactions. Additionally, having a market price/value helps for price negotiations in M&A processes. Investigations outside the survey showed that companies rather became acquirers after the IPO process than targets. Further, the M&A activities increased after an IPO process, showing the importance of going public for acquisition-based growth strategies. Compared to an IPO, insiders in a takeover cash out less due to the decreasing risk assumed by the exiting insiders.

One has to know that the motives between CFOs that have never attempted to go public ("non-tried CFOs") and their counterparts differ a lot. While the opportunity to cash out and diversify holdings is the most-cited reason for "non-tried CFOs", that are usually also less-concerned about the market value or reputation, these motives are the opposite for CFOs that had either considered or done an IPO.

The Timing of IPOs

In practice, the timing of an IPO is one of the most important aspects of the decision process. The article suggests two explanations for the timing, the life-cycle theory and the market timing explanation. According to the life-cycle theory, at one point of the company's growth stage raising capital with an IPO is more economical. Usually this growth stage is reached when a company needs an IPO to raise capital in order to fund growth as well as to create a public and liquid market for ownership. So, the maturity of a company decides about the right timing. According to the market timing explanation, insiders use their superior information about the firm’s prospects to find a good timing ("windows of opportunity") to issue shares in order to avoid dilution of existing shareholders’ claims. How to define this window is highly debated in theory.
Industry conditions, momentum of the IPO market or overall market are among the debated main drivers. The result of the survey shows that the overall stock market conditions (82.9% agree) are the main driver for determining the perfect IPO timing. Industry conditions also play an important role and were ranked second (69.8% agree). Indicators related to the IPO market conditions such as comparable firms going public (24.3% agree) are less important for the timing decision.

In contrast to empirical research, CFOs claim that IPO market conditions are irrelevant while empirical research shows that in particular IPO market factors such as underpricing within an industry are significant for the IPO timing. An explanation for this contradiction is that CFOs focus on broad market conditions while their investment bankers pay attention to the IPO market. The underwriter can influence the timing decision a lot as it is the advisor of the company.

(Excursus) Definition of underwriter: The underwriter is the investment banker that raises investment capital from investors on behalf of corporations and governments that are issuing either equity or debt securities.

The article suggests that CFOs should consider IPO market conditions as they have good signals showing the valuations investors will likely assign their company. There is also an example shown in the article that selecting comparable multiples from recent IPOs for the current IPO leads to a more accurate pricing than industry-based multiples.

Timing the issue to exploit windows of opportunity benefits insiders and pre-IPO investors at the cost of new shareholders to the extent the shares issued in an IPO prove to be overpriced. Further, IPOs have underperformed on a risk-adjusted basis over the long run in average. But still outside investors are very interested in IPOs. Probably this is due to investors that willingly accept lower average pay-offs on securities that offer higher probabilities of a big pay-off. So, they take this risk of low returns for the chance to make a huge amount of money once.

Selecting an Underwriter

As already mentioned, the underwriter plays an important role in the IPO process but not only in terms of the perfect timing. They enhance the going public process by generating market visibility and interest in the offering. In addition to it, the underwriter advises the company, provides vital guidance on roadshows to pitch the IPO and assists in the preparation of the offering prospectus which must meet SEC (Excursus: 
SEC=Securities and Exchange Commission) requirements. Even after the IPO, the underwriter is still in close contact to the company by providing liquidity to maintain the stock’s strength.

The survey aimed at evaluating the importance of different criteria in selecting a lead IPO underwriter. The by far most important criteria are the reputation of the underwriter (90.6% agree) besides the underwriter’s expertise and industry connection (87.5% agree) and the quality and reputation of the research department/analyst (82.5% agree). The next criterion institutional investor client base of the underwriter is important for almost the half of CFOs (56.9% agree) and far off from the other 3 criteria mentioned.

The findings imply that the importance of industry expertise can be referred to the preferential selection of boutique underwriters that usually have an expertise in a certain field. Furthermore, the findings imply that CFOs prefer institutional investors over retail investors. Finally, the findings imply that CFOs trust in the work of the investment banks if they have a good reputation. They are willing to pay for their services.

CFO Perceptions of IPO Underpricing

IPO underpricing means that the offer price is lower than the first-day market closing price. The average underpricing of 18% for US IPOs during the period 1960-2004 shows that primary market investors earned an average immediate one-day return of 18%. This in turn means that investors had to pay less than the actual value of the issuing company, showing that money was “left on the table” by the issuing companies.

Setting the goal of maximizing the amount of capital raised through an IPO, one can ask why underpricing exists. The survey tackled this question by asking the CFOs which level of underpricing they expected prior to the offer. The results (expected underpricing median of 10% vs. actual underpricing median of 13.5%) suggest that CFOs were aware of the underpricing problem.

Additionally, the survey asked why underpricing exists. According to theory, underpricing is due the information asymmetry between different stakeholders. According to the survey, the most favored reason for investors was that underpricing compensates investors for taking on the risk of IPOs (60% agree). The rationale for this is the following: The initial secondary market price is uncertain when the primary
market price is set. IPO investors (primary market investors) bear the risk that would be borne by issuers or underwriters. So, the primary market investors insure issuers against a secondary market that differs from the expectations of the issuer. The underpricing can be seen as a premium charged by investors for taking this risk.

Thus, most of the underpricing can be attributed to market uncertainty while also some respondents of the CFOs show that they believe underwriters to seek to profit from underpricing by currying favor with institutional investors (42.2% agree).

Providing some examples, the article suggests that using an auction system to price the IPO also cannot avoid underpricing (Google experienced 18% underpricing). All 11 IPOs of WR Hambrecht (that specializes in auction systems) experienced underpricing of 35% overall, having one outlier with 330% underpricing.

The solution for underpricing can be seen in aggressive negotiations of the IPO offer price. Empirical research showed that 75% of IPOs during a certain period had exact integer offer prices, experiencing 25% underpricing while the non-integer priced IPOs experienced only 8% underpricing.

**IPO Signaling**

Despite the strict transparency requirements of the SEC, outside investors know little about the company during the IPO process and insiders have far more information about the company than these outside investors. Hence, insiders can time the issue to sell overpriced stock. Therefore, the outside investors are looking for firm quality signals, trying to use the signal theory which basically says, that "good" firms take actions that "bad" firms do not.

The use of lockups (agreement on not selling the shares for a period after IPO) is one example for insiders to signal high quality as they believe in future stock price increases due to strong analyst ratings and future earnings. Mimicking the strategy of a long lockup to garner a higher price will not prove to be successful because once the investors recognize this false strategy, the stock price will fall to its fair value again.

The survey asked CFOs for the most reliable signals for firm quality. Strong historical earnings (91.1% agree), using a top investment banker (88.8% agree) and insiders committing to a long lockup (77.5% agree) are the top three positive signals. Especially historical earnings are an indication for future success which cannot be easily copied by lower quality firms. However, window dressing can make the number higher than
they are. Leaving a large amount of money on the table is also a positive signal because high-quality firms can afford to sacrifice some value in form of underpricing while low-quality firms cannot. Nonetheless, empirical studies found out that firms with lower underpricing enjoy higher earnings and pay higher dividends while firms with greater underpricing are less likely to return to the market to raise more capital. The most negative signal is sent by selling insider shares in the IPO (79.9% agree) as investors signal to cash out overvalued shares.

**Why do Some Companies Choose to Stay Private?**

The authors also tackle the question why some companies do not go public. There are several reasons for it whereas maintaining the decision-making control is ranked first (55.6% agree). Among CFOs, IPOs are believed to reduce the ownership control over important investment and operating decisions. Of course, unfavorable market and industry conditions are also a major concern (48.2% agree) and a reason not to go public. Especially among CFOs that withdrew the IPO, this market and industry conditions were far more important than decision power as they already decided to go public before. CFOs that completed an IPO raised the disclosure requirements to competitors as another important concern.

**3 Conclusion and own contribution**

An IPO is a milestone in the history of every company that wants to go public. It not only provides access to public capital markets but also requires several things like specific disclosure requirements. An IPO process is a very costly and long process as the following figure shows:

![IPO Process Timeline Diagram](image-url)
Therefore, I personally think that an IPO process is very complex and requires a lot of preparation and multiple considerations a CFO and the whole management have to make. An IPO results in a change from internal to external reporting, including changing accounting standards (e.g. IFRS instead of national standards), frequency of reporting, speed of financial close, expanded financial disclosures or financial guidance to investors and analysts. All these points had to be considered within a short time and are also part of the IPO readiness.

Being listed means that companies also are exposed to certain regulations. Depending on the listing venue, regulatory requirements (e.g. tax) determined by the stock exchange or the governments have to be applied. As we talked about Corporate Governance in our class, changing regulations are accompanied by a changing corporate governance environment which has to be adjusted accordingly.

Looking from a financial point of view, the CFO and management has to consider the following:

- Does your team have the required mix of skills?
- Does the finance team have relationships across your organization with IT, legal and investor relations to satisfy the IPO requirements (e.g. disclosure)?
- Do you have to adjust your financial systems and processes to meet the changing needs (e.g. changing accounting standard)?
- How does the company plan to guide the investors, how frequently do you update the guidance and how do you communicate?
- Is your audit set accordingly (e.g. independent auditors) for a public company to check the legal requirements?

Of course, the CFO has the highest responsibility in such an IPO process. He spearheads the IPO effort, coordinates internal and external resources, including the transformation of the finance function. He has to make sure that the finance function is prepared to meet enhanced demands of the regulators and public markets. Additionally, the CFO will set the team of trusted advisors, including lawyers, accountants, underwriters and independent IPO advisors. An IPO also requires the CFO to translate the company’s performance into a compelling equity story. The CFO has to implement the function of investor relations to deliver messages to stakeholders and meet regulatory compliance as well as financial disclosures.
Overall, especially in today’s IPO environment, investor scrutiny and regulatory demands are very high. Therefore, CFOs play a significant role throughout the IPO journey and has to make sure that the company’s infrastructure preparations (e.g. financial reporting systems, internal control, governance and compliance) are complete. The financial crisis froze investor appetite for IPOs. But after the global economy recovered and investors looked for growth companies to drive portfolio value, the interest in IPOs increased significantly as the statistic below shows. To make the best out of it, the whole IPO journey has to be planned perfectly. This will remain the major challenge for CFOs in the future.

US IPO Activity

Data set includes IPOs with a market cap above $50 million, and excludes closed-end funds, unit offerings and SPACs. Proceeds totals do not include the exercise of underwriter overallotments. Source: Renaissance Capital.