While some recent IPOs have blossomed, many others have slumped on their trading debuts. How can a small investor separate the wheat from chaff?

Warren Buffett once expressed his disdain for initial public offerings (IPO) by saying something to the effect that IPOs are always tilted in favour of sellers who have more inside information.

That may be true, but investors can at least narrow their handicap by knowing the meanings of some important terms in the IPO business, how IPOs are managed and common tricks of the trade.

1. Pre-IPO Placements

Pre-IPO placements refer to the issue of shares or convertible bonds (often at a substantial discount) to early investors for the purpose of increasing the credentials of an IPO candidate or to provide incentives to parties who could persuade other investors to subscribe to an IPO.{load position advert1}

Pre-IPO investors take on a certain amount of risk since the IPO may not materialize, but a significant amount of pre-IPO placements is usually not a good sign. Firstly, these pre-IPO investors have a lower entry price than subsequent investors and thus have more headroom to exit their investments and still make a profit. Secondly, if an IPO offer is compelling, there should be little need to provide any pre-IPO incentives to investors.

That the pre-IPO discount can predict first day share performance is epitomized by the Oxley Holdings IPO, in which pre-IPO investors received some 25% in discount. Oxley plunged as much as 9.2% in its first day of trading.

2. Vendor Shares

A vendor usually refers to the selling party in a transaction. Vendor shares thus refer to shares which are put up for sale to the public by existing shareholders. This is opposed to new shares which are usually issued by a listing aspirant during an IPO.

The sale of vendor shares during an IPO is generally frowned upon, as it signals that current shareholders are seeking to offload their investments and are thus pessimistic about the company's prospects.

Moreover, the proceeds of sales of vendor shares do not go to the issuing company, and therefore do not contribute to working capital or aid company expansion.

The best example is the recent Amtek Engineering IPO, in which 100% of shares offered are vendor shares. Incidentally, STX OSV and Tiger Airways are two other companies whose IPOs also comprised many vendor shares and their share debuts on the Singapore Exchange were lacklustre.

Indeed, investors should be particularly wary if current shareholders are exiting through the IPO.

3. Deferred Shares and Share Options

Besides the usual executive remuneration information, small investors should also look out for any specific clauses in the prospectus which reward IPO sponsors and management in the form of shares to be issued at a deferred date, since these deferred issues can greatly inflate short-term key stock indicators such as earnings per share (EPS) and net asset value (NAV) per share.

Some early Suntec Reit investors were not amused when they discovered only subsequently that more than 200 million deferred units would be issued to the original vendor of the property portfolio over 6 installments, the first of which falls 42 months after IPO.

4. The “Greenshoe”

Underwriters these days can almost never lose money and that is down to a clever but simple invention known as the “greenshoe” option. The greenshoe is officially known as an over-allotment option. It is named after the first company Green Shoe Manufacturing to have such a feature in its IPO.

Suppose a company (the issuer) aims to issue 10 million shares at a top-end of what the investing community considers a “fair” price range, but wants to preempt traders from short-selling the shares at the commencement of trading. Underwriting syndicates may thus sell upfront more shares than the official target (say 11 million in total), through aggressive road shows to institutional investors.

At the start of trading, should the newly-listed shares come under attack by short-sellers, the underwriters may undertake “stabilizing” actions by buying back the excess shares that had been “pre-sold”, up to the excess of 1 million shares.

On the contrary, if the shares trade above the offer price and stabilizing actions are not required, the underwriter may exercise an over-allotment option of up to 1 million shares (the green shoe). In the latter case, the newly listed company would have raised more funds that it had originally asked for.

However, not all IPOs have the greenshoe option, since some companies strictly do not want to raise more funds than they need, while others they may be confident that the IPO offer price is fair. Yet other underwriters may decide to remove the greenshoe option if they receive overwhelming response during the book building process.

In the absence of an over-allotment option, depending on how the underwriting agreement is structured, the underwriter may be allowed to sell the excess shares back to the issuer at the offer price.

From another perspective, an IPO with a large greenshoe option probably suggests that the underwriters are not confident that an IPO will be well-received.

5. Bookbuilding

Bookbuilding refers to the sales process during which underwriters pitch a soon-to-be-listed company to institutional investors to invite orders for IPO shares. Based on a price range provided by the underwriters, cornerstone investors may decide to make firm commitments, while fence sitters may provide only indicative commitments to invest.

The results of the book building exercise thus serves to determine the exact offer price and the final number of shares to be sold.

Some of these shares may be placed to high net-worth individuals with the aid of brokers who in turn get a commission from the underwriters.

As might be expected, popular share issues may attract informal bidding wars among institutional investors and thus invoke upsize options which allow underwriters to increase the size of the IPO. In the opposite case, poor investor response would often result in the number of shares being cut and/or the offer price being set at the bottom of the indicative range.

In a great contrast of fortunes, STX OSV and Amtek Engineering suffered the ignominious fate of having their IPO sizes and offer prices cut, apparently due to weak interest from institutional investors during book building, while the Global Logistics Properties IPO attracted so much interest that it was priced at the top range and the overalloment option was fully exercised.

6. Clawback

As the term “public” implies, an IPO is often by law required to be offered to the general public, so as to meet rules to achieve a minimum number of shareholders. While some smaller issues may be exempted from the rule, most underwriters allocate a small portion of the offering to small (retail) investors.

In certain IPOs, underwriters often reserve the right to “clawback” and reallocate shares between the institutional placement and the public tranche, when response is poor in either tranches.

This arrangement typically disadvantages retail investors who receive their allocations after large investors. For example, when market mood suddenly worsens during an IPO (such as in the event of an international terrorist attack), institutional investors may at their discretion renege on earlier commitments to subscribe in an IPO. This leads the underwriters to divert more shares towards the public tranche and small investors are thus left to “hold the baby”.

In one notable case, in February 2010, retail investors in Singapore put in applications for more than 113 million shares in China Hu An Cable, presumably to increase their chances in the ballot for just 5 million shares in the public tranche. On the other hand, it turned out that the underwriter and its placement agent were just barely able to place out all shares in the placement offer. Based on the clawback provision, the overallotment (greenshoe) of 35 million shares were thus fully channeled towards the public offer. Not unexpectedly, despite overwhelming retail interest, Hu An tanked 12.8% on the first day of trading.

Small investors should therefore refrain from oversubscribing to an IPO in hope of increasing their chances during a ballot, especially if the prospectus contains specific clawback provisions and when the institutional investors’ response to an IPO is lukewarm.

7. Lock-ups

IPO sponsors and key management of the company may be subject to lock-up periods ranging from months to even several years after an IPO, before they can dispose of shares on the open market.

Such conditions are to prevent a short-term overhang of shares. An absence of lock-up clauses would thus suggest that the IPO has been intended as an avenue for existing shareholders to exit their investments and as such, the IPO should best be avoided.

Conclusion

In an IPO, conventional wisdom says that the odds are often stacked against the buyers, perhaps even more so for small investors.

To level the odds, other than scrutinizing the financial numbers, investors should also understand the implications of such terms as greenshoe and clawback. By knowing what underwriters, sponsors and vendors are up to, small investors may yet stand a better chance of profiting from an IPO.

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