

IPO as a Key Process for a Successful Company

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Abstract. IPO is the most popular business practice today, which can be seen as the key to a successful company. IPO could bring a lot of benefits to the company like additional capital raised, a better international reputation, deeper consumer recognition, liquidate benefits for the shareholders and investors, greater employee benefits, and higher valuation because of transparency, compared to a private business. During the crisis, there was less focus on maximizing IPO proceeds due to both an increased emphasis on research coverage and allocations of hot IPOs to the personal brokerage accounts of issuing firm executives. But the company should consider the costs of IPOs carefully, initial underpricing is likely to cause underperformance in the long run, mandatory disclosures may increase the competitive cost, especially for biotech companies, and the substantial fees of an IPO have to be considered. In this paper, a literature study of the pros and cons of an IPO and IPOs are crucial to the development of a business.

Keywords: Initial public offering; funding; valuation.

1. Introduction

The full name of IPO is Initial Public Offerings, it is the process when a private company publicly issues additional shares to new investors for the first time through the stock exchange, in order to raise funds for the future development of the firm. Typically, the shares of a listed company are sold through a broker or a market maker according to the terms and rules agreed in the prospectus or the registration statement. Once the process of initial public offering is complete, this private company becomes a publicly listed company that could freely trade its own shares in the stock market [1]. This concept was introduced in the United States in the later 1990s, it is the period of the dot-com bubble in the United States. The founders established companies with independent capital and aimed to raise capital through an IPO during the bull market. Since investors believed that these internet companies had a great chance to become the second Microsoft, the stock price usually overperformed in the early stage of their IPOs. As a result, many of the founders became billionaires overnight, and employees also earned significant income from their pre-emption rights. The pre-emption right is the right to subscribe to a certain number of new shares at a specified price in the preference to the original shareholders. Most of the stock raised through IPOs are traded on NASDAQ, then many Asian companies use IPO to raise capital to expand [2].

There are three main processes of IPO. In the first step, the company need the assistance of three main types of professional institutions: investment banks, accounting firms and law offices [3]. More precisely, the investment banks take a leading role in providing sponsorship and underwriting tasks. The accounting firms are responsible for issuing the audit report to ensure no financial irregularities, the law firms issue legal opinions. In addition, this relevant information is included in the prospectus, including three years of audited account, the price of its share, financing scale, main operational data and a description of the risks that the company faces. Secondly, roadshows are an important tool for promoting shares' public offering successfully under conditions of full communication between investors and securities issuers, to ensure the successful issuance of shares. It mainly refers to the roadshow activities conducted by the shares issues to attract and communicate with potential investors before the issuance. In addition, it is a way to demonstrate the value of their shares and deepen the level of awareness of investors, in order to understand their investment intentions, the demand and the shares' value proposition. Thirdly, after the completion of the prospectus with the cooperation of the three institutions, the shares can be listed in accordance with the agreement with the stock exchange. Once listed, the shares are ready for public trading and the IPO is complete.

According to Lipman (2009), for private firms, an IPO may be seen as a necessity for future success [4]. Despite the many benefits that an IPO can offer, such as additional capital raised, better global reputation and greater customer recognition, an additional profitable exit way for shareholders and overperformance after IPO because of underpricing. However, there are some negative factors that the firms have to take into account. It is important to note that the uncertainty and risks of IPO could have negative impacts on the survival time of the company, especially those internet companies [5]. Meanwhile, required disclosure in the IPO prospectus may disadvantage the firm in the biotechnology industry competition. Based on the research of Guo et al. (2004), this is because the progress of high-barrier products and the protection of patented technologies are crucial to them [6]. In addition, the costs of IPOs have to be considered from a company perspective [7]. In reality, IPOs are very popular among companies all over the world, even billion-dollar IPOs are becoming more common than ten years ago. The market has been changing over time, as well as the impacts of international relations and the COVID-19 pandemic [1]. Some new IPO companies can be used to analyze the advantages and disadvantages of an IPO. This paper aims to find and analyze several advantages and disadvantages of an IPO, and give a reasonable conclusion that overall IPO is a key process of a successful company.

2. Advantages of Going Public

It is obvious that an IPO could bring many benefits to a company. Firstly, Lipman (2009) states that an IPO allows a listed company to access more capital than a private company [4]. According to the requirement of a prospectus, a prospectus needs to include the issue price and number of new shares to be issued by the firm through an IPO, the expected amount of funds raised and the purpose of the funds. Ideally, this means that underwriters could help the companies to sell these new shares to the investors in the primary market, allowing companies to obtain the funding they desire. The amount of capital raised through an IPO should be compatible with the existing production and operation scale, financial status, technical level and management capacity of the issuer, these factors are positively related to the value of the company, and they also determine the amount of money raised through an IPO. More precisely, the subscription price is critical to a company's financing through an IPO. If the subscription price is too high, there is a risk of insufficient financing if the expected number of shares cannot be sold, and if the price is too low, there is an opportunity cost for the company to lose money they can raise. As a result, IPOs are systematically underpricing, which means that companies expect to lower the subscription price to attract investors in order to sell all new shares through an IPO [8]. According to the research of Solomon (2011), the US IPOs have been underpriced by 16.8 percent on average within the last 50 years [9]. Meanwhile, in developing countries higher underpricing figures are higher than in developed countries like China. Underpricing could help companies to raise the money they expected. For example, the Chinese technology company Alibaba listed on the US New York Stock Exchange in 2014, its subscription price is \$68 dollars per share which is an underpricing price, Alibaba started its first day of trading at \$92.7 per share and then its share ended at \$93.89 per share on its first day, there is a significant increase about 36 percent from its subscription price. Alibaba raised about \$21.8 billion dollars through an IPO, which is the largest U.S. IPO. Moreover, Didi went public in 2021 on the New York Stock Exchange. On the first day of listing, DiDi's share price once soared to \$18.01 dollars, an increase of 28.6%. Based on the closing price, \$14.14 dollars, DiDi's market value reached \$67.793 billion. In addition, after the IPO, listed enterprises could issue new shares and bonds through the primary market, which allows the company to access additional capital to improve the asset structure of enterprises and their ability to resist risks, thus facilitating their subsequent development. This is called Seasoned Equity offering, it is the act of a listed company issuing new shares to existing shareholders or new investors or financial institutions on a pro-rata basis at a discount price, in order to raise funds [10]. For instance, Goldman Sachs is a listed investment banker in 1999, it completed 5 billion post-IPO equity offerings

on April 13, 2009, and the purpose of the money raised is to redeem all the TARP capital for future development [11].

Secondly, IPOs could help companies to build a better reputation and increase consumer recognition, in order to benefit their future development. Nowadays, it is a globalized world, many multinational companies choose to list overseas for future expansion. For instance, Alibaba as a well-known Chinese Internet technology company, they were officially listed on the New York Stock Exchange on September 19, 2014, creating the largest IPO record in history. This has not only made its founder, Jack Ma, very well-known in the world but also made Alibaba become one of the top companies in the world. From the roadshow stage, Jack Ma has become the image of Alibaba, Jack Ma's successful experience has largely shaped Alibaba's corporate culture and increased customer loyalty, establishing a good foundation for future growth. In PR Newswire's "Global Corporate Brand Influence in 2018" ranking, Alibaba was ranked NO. 1, surpassing major U.S. technology companies such as Amazon, Apple and Google. Moreover, Didi is also a famous example of a Chinese company going public in the US. Regarding the use of the fund raised through the IPO, DiDi disclosed in its prospectus that it plans to use approximately 30% of the fund raised to expand its business in international markets other than China, 30% of the fund to develop its technology capabilities including shared mobility, electric vehicles and autonomous driving, approximately 20% to use in Research and Development of new products and expand existing product categories, in order to continuously improve the user experience. After the IPO, DiDi has expanded significantly in overseas markets, including Japan, Australia, Africa and Latin America. DiDi is also competing with its main competitor Uber in Europe by acquiring local European ride-hailing companies. In addition, Didi agreed to a strategic partnership with BAE to develop mass production of fully driverless electric vehicles and DiDi also has cooperated with Volvo to create an autonomous driving test fleet, in order to increase the diversity of products and improve user experience. This example demonstrates how IPOs helped firms to expand overseas and increase customer recognition.

Thirdly, IPOs also could help companies to achieve higher valuations than private companies due to transparency. In general, market capitalization equals net income multiplied by a price-earnings ratio (PE ratio), which means that high earnings do not mean high valuation. A higher PE ratio means that the investors believe that the company's performance is improving, it is important to raise the confidence of investors in the company, particularly for listed enterprises. This is because the share price of a listed company depends on the demand for its shares, which is perfectly correlated with investors' confidence. For listed companies, they tend to have more transparency and credibility than a private company, and the level of information asymmetry between a private firm and investors is higher than a listed firm. The listed companies need to disclose the relevant information in their annual and quarterly reports accurately, truthfully, and completely, including audited financial statements, major contracts and shareholdings of the company's directors, supervisors and senior management. Any misleading statements or material omissions can drive a listed company to lawsuits. Meanwhile, during the process of an IPO, the firm is also required to disclose this related information in their prospectus, including information about the company's main products, descriptions of business territory and core technologies. These mandatory disclosures give investors a comprehensive view of the company, showing the company's core competencies and prospects, in order to enhance investors' confidence and increase the company's valuation [12]. As a result, the market value of a listed firm is typically higher than a private firm before it goes public. For example, the valuation of SF Holdings before its reverse takeover is ¥43.3 billion yuan and its market value after listing peaked at ¥307 billion yuan, and its value is ¥215.1 billion yuan in 2017. More precisely, based on the common PE ratio in the market, SF Holdings was valued at 19.8 times the PE ratio before its reverse takeover. By contrast, its market value reached a maximum of 116 times the PE ratio, and its value was 81 times the PE ratio in 2017, the difference in market valuation before and after the listing is obvious.

Moreover, IPOs also could provide an exit and liquidity strategy for its shareholders and investors [13]. Typically, the financing before an IPO can be divided into angel financing, venture capital and

private equity. Most companies are prepared to expand after the initial start-up stage, this is the time to venture capital. Venter capital is not a one-step process, with different stages of expansion, each financing is recorded as Series A, B and C. For example, based on the financing history of Alibaba, Softbank and Yahoo are the two largest shareholders of Alibaba. In January 2001, Softbank led a group of six investors, including Fidelity Capital, Transpac Capital, JACI and TDF Capital, jointly invested \$25 million dollars in Alibaba, including \$20 million dollars from Softbank. In the second half of 2003, Softbank invested again \$60 million in Taobao of Alibaba individually. Then in August 2005, Alibaba formed a strategic alliance with Yahoo, which offered \$1 billion in cash and all of Yahoo China's assets in exchange for a 40% ownership in Ali Group. After Alibaba's successful IPO, Softbank has become the biggest winner of Alibaba with an initial investment of \$80 million to gain a market value of over \$70 billion. Meanwhile, according to the prospectus, Yahoo sold 121 million shares in the IPO, worth about \$8.6 million, and Yahoo still owned about 16.3% of Ali's shares after the sale was completed. In summary, IPOs offer huge returns to these investors and provide them with the opportunity to liquidate.

Fourthly, IPOs allow companies to have more money to reward their employees, in order to motivate them. For example, according to Alibaba's third quarterly report in 2014, its profit increased by about 16% compared to the pre-IPO period and sales revenue has grown by 54%. Meanwhile, Alibaba spent RMB 3.01 billion on employee incentives. This represents 17.9% of Alibaba's total revenue for the third quarter of 2014, compared to RMB 8.64 million in the same quarter last year, an increase of 248.4%.

3. Disadvantages of Going Public

On the other hand, IPOs also have some drawbacks. Firstly, IPOs generally underperformed in the long run because of IPOs' underpricing. According to Shefrin (2002), Boston Chicken is a classic example of long-run underperformance because of initial underpricing [14]. They went public in November 1993 with a subscription price of \$20 dollars per share. On their first day of trading, there was a lot of investor demand for their shares, causing the stock price to soar and its closing price was \$48.5 dollars per share, which was up 142.5 percent. However, during the five years after the IPO, its stock price fluctuated a lot. In October 1997, its share price dropped 82 percent reaching a price of \$8.47 dollars per share, which was one of the most frustrating stocks on the NASDAQ at that time. Then this company went out of business in 1998. There are two main reasons for this failure. Its subscription price was underpriced, and the number of shares issued was in short supply. There is no doubt that initial underpricing could make the share price outperform in the short run, but optimistic investors and an overheated market gradually return to rationality in the long run, with a decrease in demand and thus the share prices are falling. In addition, underwriters use a lot of sales techniques to promote the shares when an IPO takes place, but when there is no underwriter in the long run, the share price will fall.

Secondly, mandatory IPO and post-IPO disclosure may have a negative impact on some high-barrier industries, such as biotech companies [15]. Information on new product Research & Development and patent protection is critical for biotech companies. Although they should prevent this material information from being known by their competitors, the disclosure of these core technologies and operational data in their prospectus and annual or quarterly report is beneficial for the confidence of outsider investors, in order to increase their share price. Meanwhile, the research and development period of pharmaceutical and biotech products is a very long time and costly, usually taking six to eight years. Since the patent registrant holds the patent for 20 years, if the patent is registered by its main competitors after the company has disclosed it, the company will suffer a huge loss.

Thirdly, IPOs create a lot of substantial fees including costs for underwriters, legal and accounting firms [16]. The underwriting fee usually is the largest compared to others, taking 3.5% to 7% of the total IPO proceeds on average. More precisely, Visa Inc. is the world's largest credit card company,

raising \$19.65 billion dollars in the IPO at \$44 dollars per share in March 2008, it reached a new record in US IPO at that time. Its lead underwriters are JP Morgan and Goldman Sachs. Visa paid \$533.7 million dollars to these two investment bankers as underwriting fees, representing 2.8% of total IPO proceeds, and this is the highest underwriting fee in U.S. IPO history. These substantial fees are direct costs, initial underpricing may cause opportunity costs for the company as indirect costs [17].

4. Conclusion

In summary, the advantages of IPOs have outweighed the disadvantages of IPOs, an IPO is a key process of a successful business. IPOs could lead the company to access more capital than a private company, it also could help the company to have a better reputation, deeper consumer recognition and loyalty, like the global popularity of the company's founder and increase the diversity of the products. In addition, the market valuation of a listed company is generally higher than a private firm, because an IPO increases the transparency of a firm, in order to increase the confidence of outside investors. IPOs also provide an external way to liquidate and exit for its shareholders and investors, they can decide to sell or not sell their shares in the secondary market to make a profit because the market capitalization increases after listing. After an IPO, a listed firm may have more money to motivate its employees. On the other hand, initial underpricing IPOs are systematically underperformance in the long run due to the disappearance of the overheated market. Mandatory IPO and post-IPO disclosures may have negative impacts on certain industries like biotech companies, the exposure of their core technologies reduces their competitiveness. Meanwhile, substantial underwriting costs also need to be considered. Finally, this paper is a study of IPO based on some successful causes. But in reality, there are many uncertainties and risks that can lead to unexpected failures. Furthermore, different companies in different industries have unique characteristics and conditions that need to be analyzed individually. Overall, based on the general upward trend of IPOs today, many companies are choosing to go public through an IPO.

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