

Discussing Google's Rather Unique IPO Auction Plans: We Should All Hope It Works

Posted: 07/11/2004 08:33 AM

By Justine Eidt Tobin, Special To LTW



Editors Note: Justine Eidt Tobin is the founder of the Charlotte investment bank of Tobin Advisors LLC. This was submitted in response to a TechLaw OpEd which appeared in LTW on June 30. The story has been updated to reflect the fact a line of the story was omitted due to a coding error.

CHARLOTTE – Recently, Amalie Tuffin gave LTW's readers the scoop on Google's IPO auction plans. She explained, with the help of related SEC filings created by Google and its advisors, what an auction process is and the risks of such an auction. Importantly, Ms. Tuffin's article focused on the risks and disadvantages of this "new" approach to IPOs. She also noted at the end of her article that the auction might not work, and if it doesn't, that auctions may not be used again to price an IPO.

Let's hope Ms. Tuffin and the SEC are wrong!

Many readers of LTW are stakeholders (i.e., founders, owners and employees) in companies which may one day go public via the IPO process. All of us as stakeholders will benefit if the Dutch Auction process becomes the standard in the industry for IPOs. But there are plenty of naysayers, including some other types of stakeholders, namely the investment bankers, who would rather see IPOs priced the old fashioned and outdated way.

The risks of this Dutch Auction process are necessarily overstated in the document filed with the SEC. Have you ever seen an SEC document that explains all of the good stuff that could happen to a company and its stock? No way! It's the obligation of the SEC to point out every risk, even if some of them may be remote at best.

The advisors to the issuing company, namely the lawyers and investment bankers, accede to such requests from the SEC, because, well, they don't really have a choice.

In fact, when the SEC faxes its "comment letter" to the issuer's attorney (yes, they still use a fax machine to communicate with their constituents), everyone on the client team breathes in deep with dread and gets ready to do what the SEC tells them to via this letter – there is no questioning the logic of SEC comments.

Luckily, in complement to the SEC-required comments regarding all of the risks that you and I might be taking as prospective Google investors, the Google prospectus (a.k.a., the S-1) contains a long letter, called the "An Owner's Manual", written by the founders of Google.

This letter attempts to offset and ameliorate the comments required by the SEC. You should pull up the S-1 document online and read it – the founders' letter is well written and is a wonderful explanation by some really talented men (go to <http://www.sec.gov/edgar.shtml> and look for the company and then for the amended S-1 filed on June 21, 2004).

What is the auction process?

Although Ms. Tuffin spent part of one paragraph explaining why Google favors this approach of the Dutch Auction for its IPO allocation process, the reasons really should be explored more fully. The founders of Google have been disgusted by the unethical and self-serving behavior that has existed in the traditional process of allocating IPOs. This traditional process entailed folks from the syndicate desk and other areas of the sales and trading floor of an investment banking company.

These folks would look at the comparable company multiples crunched by some young analyst in the investment banking division of the same investment banking company and might rely on those multiples to price the stock. But what really mattered was trying to get a low valuation (based on this supposedly scientific analysis) so that the investment banking client (the issuer) would leave money on the table so that the sales and trading client (the guy who buys stocks, like the big mutual funds) could get a big "pop" in the stock price.

Many people have seen for a long time how goofy this process is and Google finally decided to do something about it.

But, in deference to the old system, Google is required to say in its prospectus, "Our initial public offering price may have little or no relationship to the price that would be established using traditional valuation methods, and therefore, the initial public offering price may not be sustainable once trading begins."

I would argue that IPOs traditionally priced in the information technology market have never initially traded based on traditional valuation methods, although they are priced using those methods, which may explain why they soar again in price after trading

begins! But again, this is a factor that Google was duty-bound to explain as a risk - thanks, again, to the SEC – rather than as a benefit of this Dutch Auction process.

Why an auction process?

Google is executing this IPO via the Dutch Auction for a number of reasons. First, it doesn't want the practice of "spinning" associated with its own IPO. The process of allocating shares to favored prospective clients by an investment bank is called "spinning." It was discussed a lot in the Frank Quattrone case, in which Quattrone, a former CSFB investment banker, was found guilty on two counts of obstruction of justice and one count of witness tampering.

This process of spinning and lining one's own pockets and those of your friends has bugged a lot of people for a long time. The problem is that if you worked for the investment bank that was doing it, you couldn't complain, because, well, you'd lose your job since spinning was one of the ways your employer made money. If you were the client company whose IPO was being priced, you couldn't complain – come on! Are you going to waste the millions of dollars you've spent up front on starting this process and walk away because you don't like the price? That would mar your "brand" in the IPO marketplace and it would be tough to come back to the well again.

Second, Google is auctioning its shares because it wants investors who are long term holders of the stock. This is what the founders say in their letter: "We would like you to invest for the long term, and you should not expect to sell Google shares for a profit shortly after Google's IPO."

By correlation, they don't want Frank Quattrone's buddies or future clients getting some stock just to flip it that very same day – in fact, Larry and Sergey, the founders of Google, wouldn't want its competitors, to whom the stock would normally be "spun", holding any of their stock at all. So Google is pursuing the auction process so that it can garner investors who are willing to spend the money to be "buy-and-hold" investors rather than short term "flippers."

Third, Google wants the IPO to be designed to be inclusive for both small and large investors. Ms. Tuffin mentions the recent Washington Post article ("Google Gives IPO Details, Warnings") that quotes one analyst (note, this is ONE analyst) who suggests that some major institutional investors may choose to boycott Google's IPO. Good news!

This is the discussion that Google is attempting to create – it wants to show that these standard institutional investors, who have so much to benefit from the old traditional pricing process where a stock price "pop" was essentially guaranteed, are only in it for the immediate stock price increase – they are not long-term investors. Google wants the little guy included in this auction, too. So it's good news if some of the big boys take their marbles and go home; it leaves some pricing room for small investors like you and me.

After the offering

The risks highlighted by the SEC in the Google prospectus are mitigated by the hope that this new approach of the Dutch Auction may be the fix for a very broken IPO system. The IPO pricing market is one market in our capitalistic society that is certainly not efficient. In this day when simultaneous communication should be able to make all markets more efficient, we should applaud Google for being a standard bearer in this effort for change and for increasing market efficiency. These two founders have taken a risk, but have also seized upon the realization of the immense influence they have in using their company as a tool for creating change.

These guys are just trying to do the right thing. Let's all hope that they succeed so that IPOs are no longer priced in the back hallways of investment banking houses through secret deals and handshakes, but rather priced in the bright sunshine of the open market called the Dutch Auction. Let's insist that this auction succeed – so that all of us can have a more ethical, fair and prosperous outcome when we take our own companies public.

The successful Google IPO will not only be good for Google and its stakeholders in the short term, but it will be good for all issuers and investors over the long term.

Tobin Advisors LLC is an investment bank which serves the small and middle market. Justine Tobin, CEO, has been serving clients as an investment banker for twenty years at premier firms including Goldman Sachs and Salomon Brothers. She will be teaching Managerial Ethics at the Belk College of Business at UNCCharlotte this autumn.

Questions or comments can be sent to Justine@TobinAdvisors.com.

TechLaw on Google: localtechwire.com/article.cfm?u=8558