PRATO CAPITAL

Prato Capital Newsletter | NOVEMBER 2019

IPO's: Do Return's Live Up to the Hype?

Initial public offerings (IPOs) often attract public interest — especially when familiar brands become available to most investors for the first time.

In recent months, investors have had the opportunity to buy shares of ride-hailing networks Uber and Lyft, workplace productivity services Zoom and Slack, and other high-profile businesses ranging from Pinterest to Beyond Meat and Peloton.

The financial news outlets contribute to the frenzy, building anticipation, tracking the early hours of trading, and casting judgment on the IPO's success. Investors, often lured by tales of outsized returns, try to get in on the action early.

The news outlets do not describe the challenges investors face when trying to purchase some of these offerings. They may not be able to trade during the early hours, when the biggest price movements frequently occur. Lockup periods restrict when shares held by early investors can be resold on secondary markets, which will limit the available liquidity in the first six to 12 months after an IPO. And medium-term IPO performance is often underwhelming.

Research done at Dimensional Fund Advisors (DFA) studied the first-year performance of more than 6,000 US IPOs from 1991 to 2018 and found they generally underperformed industry benchmarks.

Short-Term IPO Returns

IPO's are commonly associated with outsized stock returns on the first day shares become available, although these returns are not attainable by all investors due to the allocation process. Accessing these first-day returns often requires an allocation from the underwriting banks. Studies have documented an adverse selection problem associated with IPO share allocations and find that allocations to IPO's having poor first-day returns have generally been easier to obtain, while allocations to IPO's with good first-day returns have usually been reserved for certain clients of the underwriting banks.[1] In other words, only institutional investors and some top clients of investment banks have access to shares of 'hot' IPO's at the offering price.

Medium-Term IPO Returns

DFA researchers have evaluated IPO returns dating back to 1992. Although the returns for some initial offerings like Google and Facebook were very good, that is not true of IPO's in general for their first 12 months of trading. From 1992 – 2018, the first 12 months of trading for IPO's have underperformed both the Russell 3000 Index and Russell 2000 Index as shown in ***Exhibit 1*** below.

Exhibit 1:
IPO Returns Analysis, 1992–2018

	1992 – 2018	*2001 - 2018*
IPO in first 12 months	**6.93%**	**3.74%**
Russell 3000 Index	**9.13%**	**5.98%**
Russell 2000 Index	**9.02%**	**7.29%**

Past performance does not guarantee future results.

Source: Dimensional using Bloomberg data. The sample includes US market IPOs, including US-domiciled companies and foreign-domiciled IPOs in the US, with an offering date between January 1, 1991, to December 31, 2018. Excluded from the sample are IPOs with an offer price below $5, unit IPOs (common stock and warrants), and IPOs involving real estate investment trusts, closed-end funds, American depository receipts, partnerships, and acquisition companies. The hypothetical IPO portfolio is formed December 31, 1991, and is rebalanced monthly to include all firms with an IPO during the prior 12-month period. Weights are based on prior month-end market capitalization. Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indices. **Indices are not available for direct investment; therefore, their performance does not reflect the expenses associated with the management of an actual portfolio.**

Recent High Profile IPO's

During 2019, the average return of the 130 IPO's so far is about 3.2%, compared to the year-to-date gains of 15.5% for the Russell 2000 Index and 20.2% for the Russell 3000 Index.

Exhibit 2 below shows some of the IPO's that have been widely discussed on the financial media outlets.

Exhibit 2:
2019 High Profile IPO'S

Company	Ticker	Offer Price	1st Day Closing Price	Closing Price 10/25/19	Percent Change from Offer Price	Percent Change from 1st Day Close
Levi Strauss	LEVI	$17.00	$22.41	$17.12	1%	-24%
Lyft	LYFT	$72.00	$78.29	$44.54	-38%	-43%
Beyond Meat	BYND	$25.00	$65.75	$100.81	303%	53%
Pinterest	PINS	$19.00	$24.40	$25.86	36%	6%
Chewy	CHWY	$22.00	$34.99	$27.79	26%	-21%
Uber	UBER	$45.00	$41.57	$32.71	-27%	-21%
Smile Direct	SDC	$23.00	$16.67	$11.38	-51%	-32%
Peloton	PTON	$29.00	$25.76	$22.40	-23%	-13%
Zoom Video	ZM	$36.00	$62.00	$63.45	76%	2%
IGM Bioscience	IGMS	$16.00	$24.30	$23.03	44%	-5%

Whenever gains or losses are reported for recent IPOs, it is always from the offering price. Unfortunately, as discussed above, only a select few are included for the allocation of these stocks at that price. It is much more likely the price the average investor can purchase is much closer to the closing price on the first day of trading. As an example, Chewy (CHWY), the on-line pet supply retailer, is up 26% from its offer price, but at the price where most investors could purchase, Chewy has led to over a 20% loss since its IPO. When looking at the actual gain most investors can achieve with IPO's, it is not very newsworthy

An upcoming IPO for WeWork has been hyped by the financial media outlets but as financial information was released, the company did not seem to be worth as much as was originally reported. With little support for its offer price, the IPO was withdrawn. It turns out that WeWork was just weeks away from bankruptcy, the CEO and Founder has been forced out and its IPO is delayed indefinitely. The most interesting part of WeWork and the IPO that didn't happen is that the investment banks supported the over-valued IPO, trying to push it out to the average investor.

Summary

Although the financial media outlets often talk of large gains from IPO's, the reality has been quite different. Returns as a group have not matched that of

the overall stock market for more than a quarter of a century now. Chasing the latest 'hot' stock offering is just another gamble trying to predict the future.

At Prato Capital Management, we are firm believers that a balanced and globally diversified portfolio based on your individual risk tolerance will capture returns when they happen without trying to predict the future or chasing past 'winners'. This is the foundation for a sound Financial Life Plan and can allow you to reach your financial goals.

---

1. Reuter, Jonathan. 2006. "Are IPO Allocations for Sale? Evidence from Mutual Funds." The Journal of Finance 61: 2289 -2324; Jenkinson, Tim, Howard Jones, and Felix Suntheim. 2018. "Quid Pro Quo? What Factors Influence IPO Allocations to Investors?" The Journal of Finance 73: 2303 -2341.

PAST NEWSLETTERS