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HIGH-PROFIT IPO STRATEGIES

3 THIRD EDITION

FINDING **BREAKOUT IPOs** FOR **INVESTORS AND TRADERS**

TOM TAULLI

Contents

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Finding Breakout IPOs for Investors and Traders

Third Edition

Tom Taulli

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Foreword

Most any small private company that has a vision to become a major influencer in its industry also has a vision to go public. The seeds of an initial public offering (IPO) are often sown as the company starts up, providing a framework that guides business evolution over the ensuing years. That was certainly the case with NetSuite when we launched in 1998, at the height of the Silicon Valley dot-com boom, with the vision of delivering a business management application over the Internet. An IPO was in our DNA from the start.

I met Tom Taulli as we enjoyed an Oakland Athletics baseball game shortly before we went public. At that game, which I'm sure the A's won (full disclosure: A's General Manager Billy Beane is on NetSuite's board), Tom told me about his forthcoming book to demystify the IPO process for individual investors. This Foreword, which I was honored to be asked to contribute, appears in the third edition of that groundbreaking book. Having read it, I would say it is not only incredibly useful to the individual investor, it is also a must-read for those CEOs facing their first trial in the public markets.

In 2007 when we decided the time was right to go public, we viewed the IPO as a way to satisfy three main objectives: as a marketing strategy to raise our profile and credibility among customers, prospects, and industry influencers; as a validation for our employees that their hard work was paying off; and as a way to raise capital to fuel further growth. Our IPO in December 2007 was remarkably successful. We'd set an offering price of $13 to $16 per share, but market demand drove the price to more than $26

—a figure that was the largest jump in initial-to-final pricing since the Google IPO a few years earlier.

Some of our IPO ideas were considered trendsetting in 2007 but have since become far more prevalent (and of course, this book does a great job of explaining the ins and outs of these various choices). For instance, we conducted a true Dutch auction rather than a traditional IPO sale, and we believe that approach raised more cash for the company than a more common approach to the IPO would have. We raised $175.9 million, and though we didn't realize it at the time, that capital would prove useful when the financial crisis of 2008–09 unfolded. It was a key factor in our ability to grow the business during the global slowdown, even as companies in technology and other industries shrank or folded.

We also sold a very small percentage of the company—just 10 percent, far less than the norm at the time—to raise adequate capital while not diluting the company. And we decided to list on the NYSE rather than on the NASDAQ. We were one of the few technology start-ups listed on the NYSE at the time, and since then, we have been joined by many others, including LinkedIn and SolarWinds. In the final analysis, the goals we had for our IPO to enhance our customer success, employee pride, and cash on the balance sheet were met with flying colors.

Successfully executing an IPO—and meeting the demands for transparency and compliance that attend a public company—is a rite of passage that leverages the management skill and processes developed during the private years. The IPO is a major milestone for a successful company that fosters even greater discipline, focus, and leadership, and ultimately strengthens our great engine of capitalism. Conversely, history has shown that ill-prepared companies can stumble and fail at the IPO and in the harsh light of public scrutiny. Helping investors understand the risk and rewards of an IPO and apply their own due diligence is what this third edition of Tom Taulli's *High-Profit IPO Strategies* is all about.

Zach Nelson, CEO

NetSuite Inc. (NYSE: N)

Introduction

I’ve been involved in the initial public offering (IPO) market since the mid-1990s, which was certainly a great time to get involved. Netscape sparked the Internet revolution with its massive IPO on August 19, 1995. On its first day of trading, the stock soared from $14 to $57 and then ended the day at $58.25. The company sported a market value of $2.9 billion even though revenues were meager.

During this time, I got Internet fever and co-founded a company called WebIPO. It was an early player in the industry to allocate IPO shares to retail investors. All in all, it was a tremendous experience, but I also realized how difficult it was to break through the walls of Wall Street.

Of course, the IPO market today is much different from IPOs during the dot-com boom. It’s rare to see an IPO double or triple on the first day of trading. In fact, the volume of deals is much lower today. Whereas the late 1990s may have had 500 to 600 a year, the number is now about 100 to 150.

But this is not necessarily a bad thing. The fact is that the IPO market provides a vetting process. That is, it makes it tough for a flaky company to hit the markets. Don’t expect to see crazy deals like Pets.com.

The IPO market remains a great place to find tremendous investment opportunities. Even though the past decade has seen two recessions and a horrible financial crisis, there have been standout public offerings, such as Google and Salesforce.com.

Many of the top deals were not necessarily tech companies, either. Just look at the successful IPOs from Chipotle Mexican Grill and Buffalo Wild Wings.

The good news is that the IPO market will continue to be the place to catch companies that are trailblazing the next big thing. Without a doubt, the tech sector already has promising megatrends like cloud computing, mobile, social networking, and big data.

But we'll also see much progress in other categories like biotechnology, new forms of energy, and transportation. There may even be advances in space exploration. Consider that SpaceX launched a rocket that docked with the International Space Station in May 2012. The company's ultimate goal is to reduce the costs of space exploration by a factor of 10. Oh, and the company has plans to go public.

Now, as of this writing, there is still a lot of skepticism. The U.S. economy is sluggish and unemployment is too high. Europe is having severe troubles, and even China is experiencing a slowdown.

Yet such things will not blunt innovation. After all, Bill Gates started Microsoft in the mid-1970s, when the U.S. economy was mired in a terrible recession. It didn't matter much to him.

So in my book, I want to help make your IPO investing a success and catch the next big waves of innovation. To this end, there are four main parts. Part One covers the fundamentals, such as the IPO process and how to obtain shares. Next, we do a deep dive into strategies and research. This includes covering online resources like EDGAR and RetailRoadshow. We also look at how to interpret the S-1 document—spotting the risk factors and analyzing the financial statements.

There's even coverage of short selling. Unfortunately, there are still many lackluster IPOs, but you can short them to make a tidy profit.

Part Three covers the many sectors of the IPO market. These include technology, biotech, financial services, retailers, energy operators, and real estate investment trusts (REITs). We also look at how to invest in foreign companies. Let’s face it—there are many growth opportunities in global markets.

The final part of the book looks at specialized transactions, such as spin-offs. There is also coverage of the emerging area of secondary markets. Essentially, these allow you to buy shares in pre-IPO companies.

Throughout the book, I cover a variety of short-term investment strategies. While they can be good for decent gains, I think these can miss the big picture, though. Getting the big gainers often means holding on to a stock for several years. Just imagine if you had sold Amazon.com or Microsoft in the early days. If so, you would have missed out on massive profits.

It’s true that IPOs are unpredictable. But then again, buying the no-brainer blue-chip stocks can be risky, too. Just look at what happened to companies like Eastman Kodak and Lehman Brothers.

As with any effective investment strategy, the way to deal with risk is to diversify. You might, for example (depending on your risk profile), invest 5 percent of your net worth in IPOs. You can then allocate the rest of your funds to other asset classes, such as stocks, bonds, and perhaps a little bit of gold.

In fact, chances are that you have already participated in the IPO market and don’t realize it. How is this possible? The reason is that mutual funds are the biggest purchasers of IPOs.

But again, if you want to get the big gains, you’ll need to do some research and buy the stocks. And in this book, I give you all the information you need to get going.

So let’s get started.

Part I

IPO Fundamentals

Chapter 1

Getting IPO Shares

The most common question I get from investors is: How do I get shares in a hot initial public offering (IPO)? After all, many IPOs have strong gains on the first day of trading. During the dot-com boom of the late 1990s, there were many that more than doubled. The environment got so crazy that Barbra Streisand offered free concert tickets to get allocations of hot IPOs.

But even as things have calmed down, there are still IPOs that surge. And yes, they get lots of headlines.

Unfortunately, it is extremely difficult to get shares at the offering price. Instead, often individual investors have no choice but to buy the stock once it starts trading, which can be risky. If anything, it is usually a good idea to wait a few days until the trading activity subsides.

For the most part, the investors who get IPO shares at the offering price are large players—like wealthy investors, endowments, mutual funds, and hedge funds. They have the ability to buy large chunks of stock. Plus, these investors may be more willing to do heavy trading with other investments. In a way, IPOs are a nice reward for top clients.

Seems unfair? Perhaps so. But it is legal, and the Securities and Exchange Commission (SEC) actually encourages it. This is from the agency's website at www.sec.gov:

> By its nature, investing in an IPO is a risky and speculative investment. Brokerage firms must consider if the IPO is appropriate for you in light of your income and

> net worth, investment objectives, other securities holdings, risk tolerance, and other factors. A firm may not sell to you IPO shares unless it has determined the investment is suitable for you.

Interestingly, though, even some large investors fail to get allocations of hot deals. The process can be hit-or-miss. In fact, it is often the case that a big investor will get only a portion of the shares requested. This is actually a way for the underwriters to create a sense of scarcity. After all, if you got all the shares you wanted, might this indicate there is not much demand for the IPO?

Despite all this, there are still ways to get in on the action. Let's take a look.

Risk

Even if you can get shares in an IPO, this is no guarantee of getting profits. These types of deals are always risky. For example, on August 11, 2005, Refco went public, with the stock increasing 25 percent on its first day of trading. The company was a top broker for futures and options. It also had top-notch private equity investors, such as Thomas H. Lee Partners.

Unfortunately, Refco's CEO, Phillip R. Bennett, had been cooking the books for at least 10 years and failed to disclose as much as $430 million in debt. By October 17, the company was bankrupt and the stock was worthless.

True, this is an extreme case. But it does happen, although a more common event is a broken IPO. This is when the stock price falls on the first day of trading. This is often a bad sign and may mean further losses down the road as institutional investors try to bail out.

Yet there is still a lot of opportunity when getting shares in an IPO. So in the rest of the chapter, we'll look at some key strategies.

The Calendar

Before investing in IPOs, you need to track the calendar. This is a list of the upcoming IPOs. A good source is Renaissance Capital's IPO Home at www.renaissancecapital.com, shown in Figure 1.1. It will show the upcoming IPOs for the next month or so. This gives you time to check out who the underwriters are so as to perhaps get an allocation of shares, as well as to do research on the companies.

FIGURE 1.1 Renaissance Capital IPO Calendar

Source: Renaissance Capital, Greenwich, CT (www.renaissancecapital.com)

As you follow the calendar, you'll notice some things. First, there is seasonality to the IPO market. Generally there are no more IPOs during mid-December, and the market does not get started again until mid-January. The IPO market is also closed in August and does not get going again until mid-September.

Moreover, there will usually be five to 10 deals in a normal week. But when there is lots of instability in the market, there may be none. Keep in mind that during the fourth quarter of 2008—when the world was ensnared in the financial crisis—there was only one IPO.

Some deals may be postponed. And yes, this is not a good sign. A company will usually blame “adverse market conditions,” but the real reason is probably that investors are not interested in the deal. In many cases, a postponement will turn into a withdrawal of an offering.

Online Brokers

In the IPO market, there has been resistance to the changes in technology, and there are still many elements of the old boy network. However, the Internet has certainly made a huge impact.

A key was the emergence of Wit Capital.

In 1995, a beer company called Spring Street Brewery, a microbrewery that sells Belgian wheat beers, needed to raise money. Unfortunately, the company was too small to interest a Wall Street underwriter, and venture capitalists wanted to take too much control of the company.

So the founder of the company, Andrew Klein, decided to sell shares of the company directly to investors. One option was to sell directly to his growing base of customers—by putting a notice of the offering on the beer bottles.

Because Klein had considerable experience in finance (he was once a securities attorney at one of the most prestigious Wall Street firms, Cravath, Swaine & Moore), he decided to take another, more sophisticated, route. He organized the prospectus, made the necessary federal and blue-sky filings, and prepared to sell the offering over the Internet. He posted the prospectus online, and Spring Street raised $1.6 million from 3,500 investors. Overnight he became a celebrity, as the *Wall Street Journal*, the *New York Times*, CNBC, and many other media covered the pioneering IPO.

However, Klein did not stop with the Spring Street Brewery IPO. He recognized the need for a mechanism to buy and sell stock on the open market for companies such as Spring Street that are not on a regular stock exchange. So he created a trading system where buyers and sellers could make their transactions commission free.

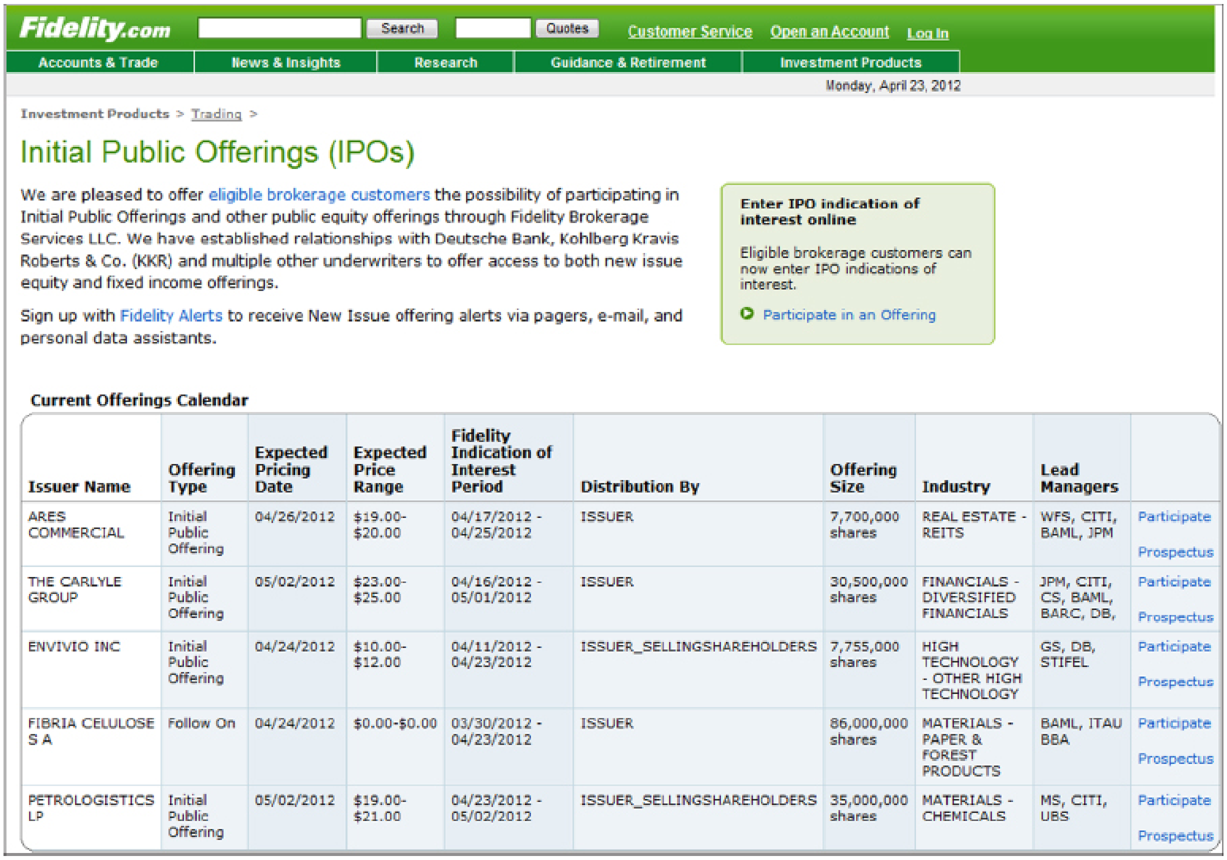
The SEC stepped in and suspended trading, but to the surprise of many, within a few weeks, the SEC turned around and gave conditional approval of the online trading system. From there, Klein decided to build an online investment bank, called Wit Capital. It would be a place where individual investors had access to IPOs at the offering price and to venture capital investments. Before that, such services had been provided mostly to high-net-worth individuals and institutional investors.

But of course, a big driver for Wit Capital—as well as other IPO digital brokers—was the dot-com boom. Investors had a huge appetite for new issues, and the market exploded.

Yet after the market fell apart, so did many of the online brokerages. As a result, the main players in digital IPOs are the larger players, such as Fidelity, E*Trade, and Charles Schwab.

So it is worth checking out these firms and seeing what deals are available. But they all have eligibility requirements; take Fidelity (see Figure 1.2).

FIGURE 1.2 Fidelity.com IPOs



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Initial Public Offerings (IPOs)

We are pleased to offer eligible brokerage customers the possibility of participating in Initial Public Offerings and other public equity offerings through Fidelity Brokerage Services LLC. We have established relationships with Deutsche Bank, Kohlberg Kravis Roberts & Co. (KKR) and multiple other underwriters to offer access to both new issue equity and fixed income offerings.

Sign up with Fidelity Alerts to receive New Issue offering alerts via pagers, e-mail, and personal data assistants.

Enter IPO indication of interest online

Eligible brokerage customers can now enter IPO indications of interest.

Participate in an Offering

Current Offerings Calendar

Issuer Name	Offering Type	Expected Pricing Date	Expected Price Range	Fidelity Indication of Interest Period	Distribution By	Offering Size	Industry	Lead Managers	
ARES COMMERCIAL	Initial Public Offering	04/26/2012	$19.00-$20.00	04/17/2012 - 04/25/2012	ISSUER	7,700,000 shares	REAL ESTATE - REITS	WFS, CITI, BAML, JPM	Participate Prospectus
THE CARLYLE GROUP	Initial Public Offering	05/02/2012	$23.00-$25.00	04/16/2012 - 05/01/2012	ISSUER	30,500,000 shares	FINANCIALS - DIVERSIFIED FINANCIALS	JPM, CITI, CS, BAML, BARC, DB,	Participate Prospectus
ENVIVIO INC	Initial Public Offering	04/24/2012	$10.00-$12.00	04/11/2012 - 04/23/2012	ISSUER_SELLINGSHAREHOLDERS	7,755,000 shares	HIGH TECHNOLOGY - OTHER HIGH TECHNOLOGY	GS, DB, STIFEL	Participate Prospectus
FIBRIA CELULOSE S A	Follow On	04/24/2012	$0.00-$0.00	03/30/2012 - 04/23/2012	ISSUER	86,000,000 shares	MATERIALS - PAPER & FOREST PRODUCTS	BAML, ITAU BBA	Participate Prospectus
PETROLOGISTICS LP	Initial Public Offering	05/02/2012	$19.00-$21.00	04/23/2012 - 05/02/2012	ISSUER_SELLINGSHAREHOLDERS	35,000,000 shares	MATERIALS - CHEMICALS	MS, CITI, UBS	Participate Prospectus

A customer must have a minimum of $100,000 in assets with the firm, or must have placed 36 or more stock, fixed-income, or option trades during the past 12 months. Also, there must be at least $2,000 in cash in the account.

Then there is the following process:

- *Alerts*. This is an e-mail system that will indicate when an IPO is available. There will also be e-mails for when offers are due, the effectiveness of the offering, the pricing, and the share allocation.
- *Q&A*. A customer must answer a variety of questions (which are based on securities regulations). Essentially, these are meant to flag a so-called restricted person, a customer who has some type of connection to the financial services industry that may forbid him or her from participating in the IPO.
- *Review the preliminary prospectus*. This is done by downloading the document.

- *Enter an indication of interest*. This is the maximum number of shares to buy in the offering. You will not be able to indicate a price since it has yet to be determined. Instead, the deal will have a price range, such as $12 to $14.

  Keep in mind that you may not get the amount of shares requested—or any shares. The offer is not binding.
- *Effectiveness*. On the day the deal is declared effective, you will get an e-mail to confirm your indication of interest. You can also withdraw the offer before the transaction is priced, which usually happens within 24 hours.
- *Allocation*. You will receive an e-mail showing the number of shares you have purchased. In the case of Fidelity, the allocation is based on a propriety system that evaluates a customer's relationship, such as the level of trading and other activities with the firm. According to the website at www.fidelity.com:

  > The allocation methodology is done as fairly and equitably as possible. The size of a customer's indication of interest is not considered during allocation other than the fact that we will not allocate more than the customer requested. Therefore, you should only enter an indication of interest for the amount of shares you are interested in purchasing as entering a larger number will not help you receive additional shares and there is always the possibility that you could be allocated everything you ask for.
- *Check your account*. Make sure you received the allocation. Mistakes do happen.

  There will also be a link to the final prospectus.
- *Trading*. You can sell the shares at any time. But again, you may be penalized for flipping them. According to

Fidelity:

> If customers sell within the first 15 calendar days from the start of trading in the secondary market, it will affect their ability to participate in new issue equity public offerings through Fidelity for a defined period of time.

Build Relationships with the Syndicate Firms

A company will usually have two or more underwriters. They manage the offering. But they also form a syndicate of many other brokerage firms to sell the deal. You'll find these firms in the prospectus. Interestingly, you will often see many boutique operators.

So a good idea is to contact them and learn about these firms. How do they allocate IPOs? Do they like to have a certain level of assets in your account? By building a relationship, you are likely to get allocations in IPOs. You may also get some deals for secondary offerings.

Dutch Auction

More and more, auctions are becoming a popular way for people and companies to do business on the web. It was the Nobel Prize–winning economist William Vickrey who developed the ingenious auction system. It's the same system that the U.S. Treasury uses to auction Treasury bills, notes, and bonds. Why not use it for IPOs?

Actually, a firm called WR Hambrecht + Co does have an auction system set up for IPOs. It is called, appropriately enough, OpenIPO. The founder of the firm is William R. Hambrecht, who is also the founder of the traditional