PART I

How to Go Public

CHAPTER 1

The Initial Public Offering

Introduction

The initial public offering (IPO) is considered by many business owners to be the true sign of success—they have grown a business to the point where its revenue volume and profitability are large enough to warrant public ownership. However, the road to an IPO is both expensive and time consuming and requires significant changes to a company. This chapter describes the pluses and minuses of being public, as well as the steps required and costs to be incurred in order to achieve that goal.

Reasons to Go Public

Though a management team may not say it, a major reason for going public is certainly to create a market for the shares they already own. Though these shares may not be available for sale for some time after the IPO, management will eventually be able to cash in its shares and options, potentially generating considerable profits from doing so. This reason is not publicized to the public, since the public would be less likely to invest if investors think the management team is simply cashing in and then leaving the business.

A slight variation on the wealth creation theme is that, by having a broad public market for their shares, original shareholders are likely to see a rise in the value of their shares, even if they have no intention of selling the shares. The reason is that there is no longer a penalty for not having a ready market for the shares, which adds a premium to what the shares would have been worth if the company had remained privately held.

The same logic can be used as a tool for employee retention. A private company can issue options to its employees, but they are worth little to the employees unless there is a market in which they can sell the shares. By going public, a company may experience increased employee retention, since they wish to wait until their options vest so they can cash in the resulting shares for a profit.

Going public is also useful from the estate planning perspective. If the owner of a private company dies, his or her heirs are frequently forced to sell the entire business in order to pay estate taxes (though with proper planning, life insurance payouts can be used instead). By taking the company public, the heirs are only forced to sell a portion of the company to pay estate taxes, at least leaving them some portion of the business as a residual.

From an operating perspective, going public gives a company a large pot of cash, which it can use to increase its competitiveness by increasing its asset base, improving marketing, hiring qualified staff, funding more product research, and so on. This can be such a competitive advantage that other companies in the same market segment may be forced to go public as well, just to raise enough funds to survive against their newly funded competitor.

Along the same lines, having publicly held shares allows a company to more readily include its shares in the purchase price of an acquisition. The acquiree is much more willing to accept this form of compensation, since it can sell the shares for cash to other investors. This is a powerful tool for some companies, which use it as the primary method for consolidating a group of smaller, privately held organizations within an industry.

From a financing perspective, going public lowers a company's cost of capital. The main reason is that investors are willing to pay a higher price for a company's stock than if the shares had been privately issued, since they can easily sell the shares. This premium can reduce the cost of capital by several percent. In addition, issuing shares to the public reduces the power that private investors previously may have had over the business, which could have included restrictions on operations, guaranteed dividend payments, or their prior approval of a potential sale of the business. Also, by being publicly held, it is much less time consuming and less expensive to raise funds through subsequent rounds of financing.

Another financing reason to go public is that new equity drastically lowers the proportion of debt to equity that is recorded on the corporate balance sheet, which is looked upon with great favor by lenders. With the new equity in hand, a company can then ask lenders for a larger amount of debt, which they will be likely to lend until the amount handed over results in a significantly higher debt/equity ratio.

Thus, there are excellent wealth-creating, operating, and financing reasons to pursue an IPO. However, there are just as many reasons for not doing so, which are itemized in the next section.

Reasons Not to Go Public

One of the best reasons for not going public is its cost. These costs are detailed in the following section, while the fees for trading on an exchange are listed later in Chapter 3, "Listing on a Stock Exchange." In brief, a small company will be fortunate indeed to incur less than $1 million in upfront fees as part of an IPO. A large company can expect to pay many times these base level expenses. Also, a company conducting a small offering will find that the proportional cost of obtaining equity funding is extremely high, since the underwriter will charge a higher fee as a percentage of the amount raised in order to cover its costs and still earn a profit on the transaction.

Besides the initial cost of going public, there will be incremental increases in ongoing expenses. Most obviously, additional staff must be hired into the accounting department, whose job will be to keep up with all reports required by the SEC. In addition, the cost of director's and officer's insurance (D&O) will skyrocket from what would have been paid when a company was privately held, assuming that the insurance can be obtained at all. The reason for this increase is the vastly increased pool of investors who may be tempted to sue the company on the grounds of material misstatements in its public comments (such as its registration statement for the IPO) in the event that the stock price drops. One can reasonably expect the cost of this insurance to increase by a factor of at least ten. The cost of documenting a control system under the stipulations of the Sarbanes-Oxley Act will also require additional staff time, as well as more review time by outside auditors. There will also be a considerable investment in legal expenses for the construction and review of public filings. For these reasons, even a smaller firm can reasonably expect to incur anywhere from $500,000 to $1,000,000 per year on an ongoing basis in order to remain public.

Another problem is that a smaller company with a modest market capitalization will have difficulty establishing a market for its stock. If it is too small, institutional investors (who like to buy and sell in large blocks of stock) will have minimal interest in making an investment. Because of this small market, a company's stock will be more likely to be subject to manipulation by a small number of investors, who can short sell it to drive the stock down and then purchase large blocks of stock at a reduced price in order to gain some measure of control over the company.

Loss of control is quite possible, unless the owner has retained a large proportion of corporate stock or unless a separate class of super voting stock has been established that gives the owners additional votes at shareholder meetings. Otherwise, outside investors can either buy up shares to create large voting blocks or band together to create the same result.

Information disclosure is yet another problem. In addition to the expense of having additional accounting staff to organize and report this information, there is the problem of disclosing information to a company's competitors, who only need to access the SEC's Web site to access all required reports filed by the company. Although many pundits claim that the types of information disclosed will not harm the competitive posture of a public company, competitors can tell from its financial statements when it has put itself out on a financial limb by obtaining too much debt and can easily start a price war at this point that could cause the company to miss debt payments and therefore possibly go into bankruptcy.

A serious concern is the risk of shareholder class action lawsuits. These arise when there is a drop in the stock price that shareholders claim was the result of material misstatements in the registration statement or in any other information releases thereafter. These lawsuits are the reason for much more expensive D&O insurance. They will be targeted at the company as a whole, the corporate directors, whomever signed the registration statement, any experts who have given statements on behalf of the company, and its underwriters. The threat of lawsuits is one of the main reasons why IPO prices are frequently set somewhat low—there is less chance that the price will drop farther, giving investors no reason to sue.

Another issue is the constant pressure from investors and analysts to show improved results every quarter. If a company had been private, it could easily stand lower profits for a year or so while it ramps up new products and markets, but being public makes this completely practical approach to growing a business more difficult to implement. Investors can attempt to unseat the management team by approving a different board of directors if they feel that growth rates are below their expectations. This issue can only be dealt with by continually informing the investing public of management's intentions for corporate growth, so that investors will adopt a longer-term perspective.

Finally, the management team must understand that it now exists not to serve itself, but to serve the investing public. This major shift in focus calls for the elimination of unusually high compensation packages to the managers, as well as a commitment to increasing shareholder value over other objectives that may have been in vogue at the company prior to going public. Management may be uncomfortable with this paradigm shift, resulting in investor unhappiness with a perceived lack of attention to their needs by management.

There are so many negative reasons for going public that the managements of many perfectly good private companies have elected to stay away from the public markets. In addition, a great many companies that have gone public find these issues to be so burdensome that they have elected to take themselves private once again.

The Cost of an IPO

Even a small company should expect to pay a minimum of $1 million to complete an IPO. This expense is composed of a number of fees. Accounting and legal fees will consume the largest proportion of the total. Expect to pay at least $250,000 in legal fees. Audit fees will vary, depending on the size and complexity of the company, but certainly expect to pay at least three times the cost of a normal audit. This figure will increase if there are weak internal control systems that require the auditors to conduct more extensive audit tests. Further, printing costs for the prospectus will exceed $100,000 for all but the most "Plain Jane" documents, which will increase if a large number of revisions to the registration statement are required prior to printing. Also, initial filing fees with a number of government and regulatory bodies will likely consume a minimum of another $25,000.

In addition to these professional fees, the underwriter requires a significant payment that is based on the percentage of capital raised. The usual fee is in the range of 6 to 7 percent if an offering exceeds $20 million, with the percentage gradually increasing to as much as 15 percent of the total offering if it is quite small (in the $1 to $3 million range). This cost can be reduced if a company accepts "best efforts" marketing by the underwriter, whereby it does not guarantee a full sale of the entire stock offering. In this case, the percentage fee will drop by 2 to 3 percent.

To make the situation worse, with the exception of the underwriter fee, most of these costs are incurred prior to the sale of any stock, so a company will be charged with the full expense of an IPO even if it is never completed. If the company withdraws from the IPO process, it must pay the fees incurred to that point by its underwriter, though this obligation is not usually required when the underwriter withdraws. Furthermore, if the IPO is merely delayed, many of the costs must be incurred again, since the underlying operational and financial information upon which the original offering was contemplated will have changed and must be re-examined by the lawyers and accountants.

Preparing for the IPO

Preparing for an IPO begins years before the actual event, because the company must "clean up" prior to being presented to the investing public as a quality investment. This house cleaning involves the following steps:

- *Increase the competence of the management team.* The single greatest driver of corporate value is the quality of the management team. The owners must evaluate each management position and replace anyone who is not a team player, who does not drive efficiency and effectiveness throughout his or her department, and who does not have a tight strategic vision. Obtaining a manager who is well known at a national level can have a startling positive impact on the perceived value of the company as a whole. A key point is that a management team is not a one-person show. Investors need to see a competent supporting team that can readily take over the business in the event that one key manager dies or leaves the company.

- *Create a reward system that is tied to strategy.* With the assistance of a compensation expert, design a reward system for not only the management team but for the entire company that offers incentives for them to focus their activities on those areas of the business that must be improved prior to the IPO (as described in all the points in this section). A key area is in the use of stock options, which can be issued several years prior to the IPO, when the company's value is substantially lower, resulting in significant gains for the recipients after the company goes public. To do this, one should set aside a large pool of stock for option conversions, and do so well in advance of the IPO, in order to avoid having the new shareholders vote to create it.
- *Obtain audited financials.* A reputable audit firm, and preferably one with a national presence, should audit the financial statements for the three years prior to the IPO. A review or compilation is not acceptable—these less-expensive and less-thorough forms of an audit will be rejected by the underwriter and the SEC when the registration statement is filed.
- *Obtain a top securities law firm.* Although there may be little perceived need for a law firm well in advance of an IPO, it is useful to have such a firm examine the legal structure of the business and recommend changes that will properly position the company for the IPO. The need for this firm will rise dramatically during the IPO filing period, when its lawyers will review the company's prospectus and registration statement to ensure its completeness in accordance with SEC regulations. The lawyers will also channel all communications to and from the SEC in regard to both the initial registration and filings subsequent to the IPO.
- *Strip out personal transactions.* The owners of a private business typically mesh their personal affairs with those of the company to a considerable extent. This can include keeping personal servants on the company payroll, having the company guarantee personal loans, loaning company money to their other businesses, and giving themselves inordinate levels of compensation. Stopping these practices can be quite difficult for an owner, whose overall level of compensation may drop substantially as a result.

- *Show 25 percent annual growth.* Potential investors want to invest in companies with a record of strong growth, preferably at least 25 percent for each of the last few years. To create a business in line with these expectations, the business owner must close down or sell off those portions of the business that have no reasonable near-term prospect for growth, or (worse) those areas that are not only *not* growing, but which also require substantial cash infusions that could be better applied to higher-growth business segments.
- *At least show breakeven profitability.* Investors understand that extra expenses must be incurred in order to ramp up sales, so they are not looking for inordinate profit levels in addition to high sales growth rates. However, there should be no losses appearing on the income statement for the past few years, since this would imply an inability by management to control costs, which brings into question the viability of the entire business model. This may also require a business to switch away from some tax reduction strategies that it may have pursued as a private company in order to reduce its tax liability, in favor of ensuring that some degree of profitability appears in the financial statements. Another alternative for ensuring some profitability is a tighter focus on cost controls, perhaps through the use of benchmarking or best practices implementations that are recommended by consultants.
- *Fill the product pipeline.* Investors want to see a company that has established a clear competitive differentiation in the marketplace. This can be done through the advance funding of research and development projects that lead to the creation of a stream of new products. Since it takes a long time to create new products, the investment in this activity should begin far in advance of the IPO. It is particularly important not to appear like a "one-hit wonder," with only a single winning product—be sure to create a process that reliably generates a continuing stream of products.
- *Achieve critical mass.* In order to attract the attention of institutional investors, a company must have a market capitalization of at least $100 million. At this point, investors' participation will yield an active market for the stock, which can help to drive up the stock price. To reach this capitalization level, a company requires substantial revenue volume. Though roughly one-quarter of all public companies have revenues of less than $10 million, a much higher level is required to reach the crucial $100 million capitalization level. In order to do this, company management may need to concentrate on making acquisitions in the years leading up to the IPO, with the objective of building enough critical mass for the IPO.
- *Expand high-growth segments.* Investors want to see a high rate of growth in areas where other public companies have been rewarded

with high price-earnings multiples. To do this, the management team should be aware of P/E multiples for all companies in its market segment and allocate funding to those areas of the business that will reward the company with a high P/E multiple when it goes public. This capital allocation process is a difficult one, for the market can increase or decrease P/E multiples in a very short time period, depending on its perception of how "hot" a market segment may be.

- *Pick an independent board.* Investors want a majority of the Board of Directors to be independent from the management team, in order to place investor interests ahead of those of the management team. Although this group can be selected just prior to the IPO, it is better to do so at least a year in advance, in order to give this group time to settle into their roles and learn about company operations.
- *Protect owner wealth.* The owner of a company that has just gone public, and who has sold some proportion of his or her shares to the public, should expect to be paying a large amount of taxes. To reduce this tax burden, the owner can spend the previous few years gifting company stock to heirs, which can be given tax-free in blocks of $10,000 per year to each recipient (or $20,000 if the owner is married). In addition, if there are potential capital losses on any investments, this is the year in which they should be recognized in order to offset the gains from the IPO.

The main point of this section is to point out the need for advance planning for an IPO, preferably beginning a minimum of three years prior to it. Only by taking this long view to going public can a company position itself properly to achieve the maximum value for its shareholders, while minimizing the tax impact for its original owners.

Finding an Underwriter

The process of becoming a public company begins with the search for a qualified underwriter who can lead the company through the maze of steps needed to go public. An underwriter is an entity that sells company shares either directly to individual investors or to institutional buyers, such as mutual fund managers. The largest underwriters operate on an international scale, while others have a regional focus or only concentrate their attention on specific market niches in which they have built up a considerable degree of expertise. A major underwriter may have built up a large retail brokerage operation, as well as having significant institutional sales capacity, though some of these underwriters have elected to focus more on one of the two sales channels over the other.

It is better to use underwriters with an established reputation, despite their higher cost, because investors tend to trust them more, which can result in a higher stock price. Conversely, using an underwriter with a poor reputation (i.e., for drumming up the price of stocks that later crash) is much more likely to result in unhappy investors, potential investor lawsuits, and a thinly traded stock. It is also important to use an underwriter with a strong research capability and a commitment to use this resource to distribute information about the company and its industry to investors. A good way to determine who has the best analyst coverage of an industry is to ask investors and other brokerage houses whose reports they feel are the most complete and accurate.

Underwriters have a tendency to sell shares to institutional investors, because these are sophisticated investors who buy in large volumes, thereby reducing the sales efforts of the underwriters. This can be a problem if a large percentage of the company's shares are being sold to the public, because institutional investors are much more likely to either gain control over the company or at least gain a formidable block of voting stock that can be used to influence the company's direction.

If an IPO is a small one, an underwriter may handle the entire issuance by itself. However, it more commonly leads a team of underwriters as the managing underwriter if there is a substantial amount of stock to be sold to the public. It creates this syndication not only to spread its own risk in the transaction, but also to ensure that shares are sold to a wide cross-section of the investing public, which is critical for creating a strong market for the company's stock.

A larger company with a strong track record will attract the attention of a number of underwriters who are eager to take it public. When selecting from among this group, one should look for a business with a strong reputation for successfully bringing new offerings to market, which can be easily discerned by reviewing the business press for the last few years. Another key factor should be its distribution capacity, since the company will want a broad range of investors, rather than a small number of powerful institutional investors. The underwriter should also be able to commit to the creation of a strong aftermarket in the company's stock, which can be verified by making reference calls to the CFOs of other companies that it has already taken public as the managing underwriter. These reference calls should include queries about the level of service provided, the level of underwriter expertise, the breadth of share placement among investors, and subsequent promotion through research reports. If the underwriter already employs an analyst for the company's industry, this is a strong indicator of the underwriter's commitment to an aftermarket. Further, one should ask if the analyst plans to issue regular research reports to the underwriter's clients about the company. Of particular concern should be the underwriter's history of bringing companies public as the *managing* underwriter, rather than as one of a large syndicate. If the underwriter has primarily been a syndicate member, this is a strong indication that it lacks experience in managing the IPO process.

Unfortunately, most companies are too small to attract a flurry of underwriter interest. Instead, they must work hard to attract the attention of just one or two. To do so, the owner should have already accomplished all of the long-range targets noted in the last section. In addition, the management team should construct a detailed business plan that dovetails with prior company results, while also showing exactly how it plans to use the cash received from the stock offering to achieve future growth and profitability. The plan should most certainly *not* describe any intent by management to sell off its shares, since this tells underwriters that they want to cash out of the company, potentially leaving investors to shift for themselves. This document should include a detailed description of all key members of the management team, since underwriters are well aware of the importance of a strong team. Further, the plan should itemize all risk areas and how the company plans to hedge those risks while pursuing its growth plans. Above all, the plan must present a compelling story that will attract a quality underwriter.

If an underwriter is sufficiently interested in the company, it will conduct an exhaustive due diligence process to verify that what the company says about itself is true. This is likely to include interviews throughout the company, a detailed analysis of all operations, company tours, and reference calls to company suppliers and customers. In particular, the underwriter will investigate the background of each key executive in detail, so be sure that executives' published resumes are accurate. The underwriter must conduct this level of detailed review in order to protect itself in case problems arise after the IPO that it should have seen prior to the stock offering. If there is even a hint of the company trying to mislead the underwriter about material issues, the underwriter will walk away, so be certain to verify all information in the business plan prior to releasing it to the underwriter.

If the underwriter remains interested in the company after the due diligence phase, it will sign a letter of intent with the company. This letter outlines the following issues:

- *Type of agreement.* The letter will state if the arrangement with the underwriter will be a "firm commitment" deal or a "best efforts" deal. The firm commitment approach is used by most large underwriters and requires them to purchase a fixed number of shares from the company at a fixed price, which is discounted from the price at which they will then sell the shares to investors. This is the preferred approach, since a company will be guaranteed a fixed amount of cash. The alternative is a best efforts deal, under which the underwriter merely tries to sell as many shares as it can and takes a commission on those shares it sells. This alternative does not guarantee a company any cash, while still requiring it to meet with the various requirements of being a publicly held entity, and so is much less preferable. A best efforts deal is most common when a company's prospects are considered sufficiently risky that the underwriter is uncomfortable purchasing the entire stock offering, thereby putting itself at risk of being unable to resell them.

- *Expenses.* The underwriter will outline the expenses it expects to charge the company. The largest portion of these costs will be a percentage of the stock offering. More information about this is listed in the earlier "Cost of an IPO" section. This is a good time for the CFO to consider swapping an issuance of warrants to the underwriter in exchange for a lower commission rate. Another significant cost listed in the agreement will be the legal expenses incurred by the underwriter for its legal counsel to review state "blue sky" laws to see how they apply to the offering. One should insist on a cap to these expenses, which can be substantial. The underwriter may also require the company to pay for any out-of-pocket expenses incurred by the underwriter if the company withdraws from the IPO—if so, be sure to insert a maximum expense cap in the agreement. There should be no expense reimbursement requirement if the underwriter is the party who withdraws from the offering.
- *Overallotment option.* This option is another manner in which the underwriter can profit from a potentially lucrative stock offering. It allows the underwriter to purchase additional shares from the company, up to a specified maximum amount, within a short time period following the IPO date. If the underwriter feels that it can sell additional shares at a high price, it will buy the extra shares from the company, sell them to investors, and pocket the difference. The overallotment option is usually acceptable to company management, unless the additional shares sold might potentially interfere with their control of the company.
- *Expected stock price.* The agreement will list a price at which the underwriter expects to sell the company's shares, though this is strictly a preliminary number that can vary considerably, depending on market fluctuations and the receptiveness of institutional investors to the proposed price during the subsequent road show.

During the period between when the company engages the services of an underwriter and 25 days after its securities begin trading, the company is in a so-called "quiet period," when it should not issue any marketing statements or materials that could be construed as an attempt to arouse investor interest in the securities to be offered. For example, no projections about expected company performance should be issued, nor should any communications include the name of the underwriter. However, the SEC's Rule 135 permits notice of the proposed offering as long as the notice only contains (1) a legend stating that it does not constitute a securities offering; (2) the company name; (3) the title, amount, and basic terms of the securities offered; (4) the amount of the offering; (5) the anticipated timing of the offering; and (6) a brief statement of the purpose of the offering. Also, the SEC's Rule 169 allows a company to issue factual business information that is provided as part of the company's ordinary business, such as product advertising; this Rule is limited to the types of information that a company has issued in the past. To avoid any chance of breaking the SEC's quiet period regulations, any company communications during this period should be cleared by legal counsel prior to release.

Once the letter of intent is signed by both parties, they jointly move forward into the IPO registration process, which is described in the next section.

Registering for and Completing the IPO

Registering for and completing the IPO process usually takes three to four months. The basic steps in the process are due diligence investigations of a company's operations and finances, followed by the creation of a registration statement, whose contents are then updated based on SEC comments. This is followed by a road show, final pricing of the stock, filing of the final prospectus with the SEC, and then closing the deal with the underwriter. The following discussion is based on a firm commitment deal with an underwriter. A best efforts deal differs from this discussion primarily in the length of time required to obtain payment from the underwriter, which may require two to three extra months following the registration effective date.

The due diligence process is conducted by the underwriter and is a vastly expanded version of the due diligence it went through when it was initially investigating the company. In this case, it will require outside auditors to comb the company's financial records at a level of detail significantly greater than a standard audit, and then issue a *comfort letter* to the underwriter, stating the additional procedures it completed at the request of the underwriter. These procedures usually relate to unaudited financial information that is included in the registration statement. The auditors send the comfort letter to the underwriter once the initial registration statement has been filed. A comfort letter is not always required in a "best efforts" underwriting, since the investment banker's risk is reduced.

The registration statement is composed of a prospectus and additional information required by the SEC. The statement is the SEC's Form S-1. The prospectus portion of the statement is an overview of the company's operations and finances and is carefully designed to be a balance of marketing language intended to bolster the stock and a tedious itemization of every conceivable risk to which the company is or may be subject to, with the intent of avoiding liability in case the company's prospects sour after it goes public. It also includes all standard financial reports, such as the balance sheet, income statement, statement of cash flows, and shareholders' equity. It will also include interim financial statements if the registration statement is declared effective (more on that shortly) more than 134 days subsequent to the company's fiscal year end. The registration statement is a complex document, so one should expect 30 to 60 days to pass before the initial version is ready for review by the SEC.

The registration statement is then forwarded to the SEC, which usually takes about one month to review it, after which it issues a comment letter that contains required changes that must be added to the statement in order to bring it into compliance with SEC regulations. SEC comments can include such issues as an expansion of risk disclosures, cross-referencing information within the prospectus, questions about the use of certain accounting policies, and adding information to support claims made. Once these changes are made in an amended filing, the SEC has the right to continue reviewing the document until it declares the statement to be effective.

The company must also submit the registration statement to the Financial Industry Regulatory Authority (FINRA), which wants to ensure that the underwriter's compensation is not excessive. The statement must also be sent to each state in which the company plans to offer its shares for sale, so they can verify that the offering meets individual state reporting requirements.

The prospectus portion of the registration statement is then sent to prospective investors. This *red herring* version of the statement may not yet have been approved by the SEC and will not include a final stock price, but will list a range within which the final price will fall. This version is used to educate investors in advance about the offering, but is not used to solicit the sale of stock. It is also sent to the syndicate of other underwriters that the primary, or "managing," underwriter will assemble to help sell the stock.

After filing the registration statement and prior to its effective date, the CEO and CFO (sometimes accompanied by other members of management) go on a road show to visit a number of key institutional investors and analysts, where they make a sales pitch about the company, but do not attempt to sell any shares. Slide and video presentations are permissible during a road show, as long as the company does not provide investors with copies of the materials, since the copies could qualify as a prospectus.

The road show is a physically exhausting process that typically lasts about two weeks. As an example of just one day in a typical road show circuit, the CEO of a Silicon Valley company boarded a private jet in San

Francisco at 5 A.M. and flew to five cities across the United States, stopping for a one-hour presentation in each city (several being on the East Coast), before flying back to San Francisco—the same day. He did this for nine days in a two-week period. Preparing for the road show also requires long hours, frequently including training by speech coaches and even etiquette consultants.

The SEC also permits road shows over the Internet, which can be a great time savings for the management team. The SEC only stipulates that an Internet road show not exclude any material information, only one version is captured for subsequent Internet transmission, and the content of the road show is consistent with information contained within the prospectus.

While the management team is conducting the road show, its legal counsel will file an application with the stock exchange on which it wishes to be listed, while also selecting a registrar (who tracks all stock, pays out dividends of various types, and mails reports to shareholders) and a stock transfer agent (who handles the transfer of shares between parties) to handle subsequent stock-related issues. It will also submit filings in accordance with the securities laws of all states in which the company expects to sell shares.

Once the SEC is satisfied with all changes made to the registration statement, company management meets with the underwriter to set the final price of the stock. Price setting is part science and part art form. Ostensibly, the price should be based on a quantitative measure, such as the existing price/earnings multiple or price/revenue multiple for similar companies. Other operational issues may also be considered that will modify the price to some extent, such as backorder volume, sales trends, the proportion of expenses to sales, the quality of management, the outlook for the entire industry, the severity of current or potential competition, pending pollution issues, or the presence of valuable patents. However, the comments of institutional investors who were contacted during the road show will have a strong bearing on the final price. They are usually relied upon to purchase a significant proportion of the company's stock, and if they show resistance to purchasing stock at a specific price, then the underwriter will recommend a price reduction. In addition, the underwriter will underprice the issuance slightly in order to ensure a complete sale of all shares offered to the public, while also giving it some grounds for avoiding a lawsuit in case the stock price later declines and investors claim that the initial price was too high. The extent of the underpricing tends to be greater during the IPO in comparison to secondary offerings, so management may want to consider selling slightly fewer shares at this time in order to avoid dilution.

Underwriters like to price IPO shares in the range of $10 to $20, on the grounds that this avoids penny stock status (which is $5 or less), and the perception that investors will be less likely to buy shares priced above $25. To achieve this range, the company may have to conduct either a stock split or a reverse stock split. For example, if the underwriter decides that a company's total valuation is $50,000,000 and that the stock price will be $20, then there should be 2,500,000 shares outstanding in order to achieve the designated price per share. If the company actually has 10,000,000 shares outstanding, then it must conduct a four-for-one reverse stock split in order to bring the number of outstanding shares down to the required 2,500,000 level.

The underwriter will also want to sell in excess of one million shares during the IPO, not only to create an active trading market for the stock, but also to meet the minimum outstanding shares rules of the stock exchanges (as noted further in Chapter 3, "Listing on a Stock Exchange").

Once all parties agree to the stock price, this is included in the registration statement as an amendment, along with the net proceeds by the company resulting from the offering, and the underwriter's commission. The company then asks the SEC to declare the registration statement *effective*. This request is typically accompanied by a request to accelerate the SEC's standard twenty-day waiting period between the filing date of the last amendment and the date when the registration is declared effective, which the SEC generally agrees to as long as the prospectus has already been sufficiently widely circulated to prospective investors in its "red herring" format. After the registration is declared effective, the company issues the prospectus to the investors who previously received the "red herring," as well as any others who wish to review it.

The company can choose to use its Web site for delivery of the prospectus. If so, it must take precautions to ensure that only permissible material is included. Any hyperlinks within that portion of the Web site designated as part of the prospectus will be considered part of the prospectus, so the company must carefully investigate all posted materials.

During the post-effective period, the company is allowed to issue supplementary sales literature about the securities sale, which is known as *free writing*. In most cases, the prospectus must be delivered to prospective investors alongside the free writing materials. While there is no specific restriction on the types of information that can be issued as supplementary sales literature, the literature should avoid excessive optimism—otherwise, it may run afoul of the SEC's anti-fraud regulations.

Also during the post-effective period, the company must update the prospectus for any material events or change in earnings. These updates can be made by affixing stickers to the prospectus that contain the updated information. This saves the company the expense of reprinting the entire prospectus.

Finally, at a closing meeting that usually takes place about one week after the registration effective date, the underwriter hands over payment for all shares proffered under the IPO offering in exchange for the share certificates. This delay of a few days is needed for the underwriter to collect cash from its investors, who will then receive the stock from the underwriter. The company is now officially a public entity.

Summary

This chapter has described both the positive and negative factors associated with being a public company and has also addressed the basic process flow associated with the initial public offering. This is clearly an expensive and time-consuming process that will make great demands on the time of the management team. It is the cleanest way to go public and is generally the recommended approach. However, it is also possible to go public by acquiring a public shell company, which is described in the next chapter. This alternative has a lower initial cost, but the same ongoing expenses as would be incurred by a company following the more traditional IPO path.