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Lessons from Google's IPO

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After more than more than three months of filings with the Securities and Exchange Commission, public miscues, pricing changes and enough legalese to make a lawyer dizzy, Google's initial public offering is one for the record books.

Experts at Wharton and elsewhere say Google's IPO, on the surface, seems to be a success, but they note it's too early to issue a verdict. After all, Google did raise $1.67 billion by going public at $85 a share - but that's down from the $135 a share top target, or $3.6 billion, that the company was hoping for. And Google raised its capital largely thumbing its nose at Wall Street's typical method of going public, opting instead to use a Dutch auction that in theory would put shares in retail investors' hands and cut down on commissions to investment bankers.

"The jury is still out on whether the IPO is a success or not," says Wharton management professor Raffi Amit. "The fact that Google did a Dutch auction is a good thing. The company managed to float an offering when 10 deals were cancelled in the two weeks before. Google managed an IPO in a soft tech market."

Wharton marketing professor Peter Fader agrees, to a point. He says the way individual investors chased Google like lovelorn puppies the first day of trading is a sign that some folks will never learn. But if they can't remember lessons from the dot-com boom, maybe they can pick up a few in the aftermath. Here are some lessons from Google's IPO.

Going Dutch Isn't Easy

Amit is a supporter of Dutch auctions, where investors bid on an initial public offering before it goes public. The benefits are clear. In theory, a fair market price is set and the company reaps more cash. In traditional IPOs, prices are set low to ensure a big first day run for investment banks and their clients.

Google said in its regulatory filings that it wanted to make the IPO process more democratic. "Many companies going public have suffered from unreasonable speculation, small initial share float, and stock price volatility that hurt them and their investors in the long run," said Google's documents. "We believe that our auction-based IPO will minimize these problems, though there is no guarantee that it will."

The trouble was that Google initially scared individual investors with a price range topping out at $135. "The goal was to get a different mix of shareholders that wouldn't flip the IPO," says Amit. "Instead, it scared off retail investors and got mostly institutional buyers on the first day. Most individual investors couldn't afford 100 shares." To compound matters, institutional buyers didn't go for the auction system. Scare off retail investors with a high price tag and annoy Wall Street, and you get an auction below your initial price range. "The auction wasn't at the market clearing price," says Amit, referring to Google's first day 15% pop. If the auction had been a complete success, there wouldn't have been a first-day gain.

Fader believes the Google IPO proves the auction system can work on a large scale, but he doubts such offerings will become the norm. For one thing, most companies don't have the clout to force investment banks into doing a Dutch auction. Meanwhile, the fact that Google's auction didn't set a perfect price means doubters will remain. "I do feel the Dutch auction is the way to go because it's more transparent," says Fader. "But I don't see it emerging as a popular method."

Exuberance Persists

The press and adulation of Google leading up to its IPO shows that investors can still go gaga over a new stock just like they did during the dot-com bubble. That fact irks Fader. "I'm skeptical about the IPO process in general," says Fader. "Ego and the hope for a quick buck drive these new stocks."

To Fader, it's clear that many investors chased Google just to get the stock certificate. Such investors want to be involved in a big IPO; that longing is one reason that they will chase a stock even when it's likely it will come down from first-day highs. According to press reports, some investors who bought Google have never bought an individual stock before. "You shouldn't want to buy a stock for a gift," says Fader. "The IPO process brings out the worst in the stock buying. It's gambling. No matter what the ultimate number Google trades at, it has nothing to do with the value of the firm."

Nevertheless, there was a lot of enthusiasm for Google. For instance, Jeffries, a Wall Street firm with no underwriting ties to Google, started research coverage of the company just a day after its IPO. Typically, underwriters are the first out of the gate with coverage. In a research note, Jeffries analyst Youssef H. Squali said Google was worth $115 a share based on his estimates and relative standing to Yahoo and eBay. According to Squali, Google's strength is that it has a network of sites feeding it traffic and ad revenues. "With roughly 50% of all paid clicks derived from third party web sites in the second quarter, we find that growth (and therefore value) is increasingly in the Google network, not in Google's proprietary sites."

Keep It Simple

Amit doesn't mind reading SEC filings. And Google's prospectus was an interesting read for a few pages, but the company made things excessively complicated. Much of the prospectus documents Google's Class A, Class B share structure. Class B shares were offered in the IPO, but Class A shares, which were retained by insiders, kept all the voting power. "It was extremely complicated," says Amit. "It's clear that the owners didn't want to lose control."

And then there were the pages explaining its auction process and how the company worked. Included in the text were gems such as, "We provide many unusual benefits for our employees, including meals free of charge, doctors and washing machines. We are careful to consider the long-term advantages to the company of these benefits." Apart from such explanations, there were also a lot of moving parts, notably shares that are available to be sold shortly after Google's IPO. Analysts say it's likely those early lock-up expirations will pressure shares in upcoming weeks.

The prospectus included a long Warren Buffett-style letter outlining why Google is special, adding significantly to the page count. "It was in plain English, but there was too much of it," says Amit.

IPOs Can Hurt the Brand

Before it went public, Google's appeal was that it had great search technology, made for good copy and seemed above the money-grubbing big payday fray. "The Google brand needs no introduction," says Squali. "The name, which has become a verb, represents the top destination for searching online, and one of the top destinations on the web overall." Will that perception last? Once Google's business was detailed for the world to see and it became clear many of the company's employees would become paper millionaires — not to mention real ones since they are allowed to cash out shortly after the IPO — the company's image took a hit, says Fader.

Squali adds that stock lock-ups will float many more shares onto the market shortly as insiders and employees cash out. According to Google, 4.6 million shares can be sold after 15 days of the IPO, an additional 39.1 million after 90 days and a total of 260 million 180 days after pricing. "Do-gooders can't get any better by going public," says Fader. "Whenever there's an IPO, people wonder if you are selling out. You can't escape that perception."

It didn't help that Google's two founders — Larry Page and Sergey Brin — would become billionaires even at the company's lowering offering price. Usually, such profits wouldn't be a big deal. But Google claims to be different. In the letter in its prospectus, one of Google's chief tenets is to "Do No Evil."

Wanted: Seasoned Management

Anyone who spends some time with Google's regulatory filings will see that the company has a bulls-eye on its back. Microsoft and Yahoo are doing most of the aiming. How Google copes with this competition remains to be seen, but the way the IPO was handled raises questions about the company's management.

The IPO was almost held up by an interview with *Playboy* magazine before the pricing. Before that, Google disclosed that it mistakenly issued shares and had to offer to buy them back. And then there was the settlement of a patent dispute with Yahoo, which owns rival Overture. Overture, which pioneered matching search words with advertising, sued Google over the algorithm patent that provides contextual ads. Google issued shares to settle with Yahoo.

In addition, Google didn't provide institutional investors with much of an outlook for future growth and earnings. Squali says it's likely Google shares could see volatility due to its lack of financial guidance. Amit notes that Google executives have come off as "a little naïve."

These pre-IPO flubs raised a few eyebrows, especially in light of the onslaught of competition that Google is about to face. Wall Street has seen too many so-called next Microsofts to not be wary. "Although Google enjoys faster growth and higher profitability, we see several risks to its valuation, which may mean the stock ultimately trades at a discount to its peers," says Susquehanna Financial Group analyst Marianne Wolk. Google's IPO may come down to faith in the founders and management team they put in place. "Ultimately success or failure resides with management," says Fader. "You have to put a great deal of faith in their ability to create and execute."