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INITIAL PUBLIC OFFERING UNDER-PRICING: A CASE STUDY OF TWITTER IPO

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ABSTRACT

This study is conducted to analyse the under-pricing phenomenon in Initial Public Offering (IPO) by Twitter, the most popular and fast growing online social networking and micro blogging service provider. On November 7, 2013, the first day of trading on the NYSE, Twitter shares opened at $26.00 and closed at US$44.90, giving the company a valuation of around US$31 billion. This was $18.90 above the initial offering price and Twitter ended with a market capitalization of $24.46 billion. Goldman Sachs, investment banker was the book runner. Twitter is backed by Union Square Ventures, Digital Garage, Spark Capital, and Bezos Expeditions. The issue netted about $1.8 billion through the sale of 70 million shares. Twitter is yet to make profits. Twitter was the most actively traded stock in the US on the issue day; more than 117.3 million shares had exchanged hands by the end of the day. From the analyses it is very clear that the Twitter IPO is under-priced. Since the closing price of the stock was $44.90 it was up by 73% on its first day. So Twitter potentially left about $1.25 billion on the table when they set the price of $26 a share. Twitter priced its initial public offering Wednesday night at $26 a share. The stock debuted at 10:49 a.m. ET on Thursday on the New York Stock Exchange, and the first trade came in at a price of $45.10 per share. Twitter isn't yet profitable: Twitter raised about $1.8 billion through the sale of 70 million shares Wednesday evening (6th November) at $26 a share. The offering's underwriters also have the option to buy another 10.5 million shares from Twitter. By comparison with the Facebook (FB) raised $16 billion in its IPO. The study has proven the presence of under-pricing in Twitter IPO.

KEYWORDS
under-pricing, investment bank, NYSE.

INTRODUCTION

The first public issue that is made by a company is referred to as an Initial Public Offering (IPO) or an unseasoned new issue. IPO is among the riskiest equity investments in the stock market. The firm generally has only a short earnings history and no history of public valuation. Thus, both principal agent and information asymmetry problems are likely to be very severe for IPO firms. A typical IPO firm is very young and has often taken a highly speculative position in a nascent industry. Firms that choose to go public generally hire an investment banking firm to underwrite the offering. The underwriter assists the firm in all legal procedures, and negotiates with potential public investors regarding the offer price. The underwriter tries to mitigate principal-agent problems by structuring the deal and recommending certain financial structures within the firm. The Investment Bank acts as an intermediary role and can be effective in mitigating information asymmetry problems associated with an IPO.

An additional motive for going public is to reduce debt. Firms that go public generally use a substantial portion of the IPO proceeds to pay off debt obligations. By issuing new shares in the IPO, the firm's entrepreneurs and management can dilute the voting power. Venture Capitalists that have partially financed a successful venture play several important roles in the IPO process. The VC has not only had substantial financial stake in the firm, but has participated in its development. VCs generally participates in negotiations about the offer price and the firm's post-IPO financial and ownership structures. Lerner (1994) examined the ability of VCs to time IPOs. VCs are anxious to liquidate their investment. Some analysts have argued that VCs are too aggressive in bringing their firms public quickly, perhaps even prematurely.

An IPO often results in substantial changes in the firm's ownership structure, management, governance structure and capital structure. For instance, an IPO firm's insiders generally dominate the ownership of the firm's shares just before the offering. IPO firms generally raise funds for the firm in the primary portion of the offering, which increases the firm's equity base and therefore reduces leverage. The reduction in leverage is more substantial if the proceeds of the primary portion of the offering are used to pay down debt. Both the primary and secondary portions of the offering bring in new shareholders to the firm. An IPO imposes substantial administrative burdens on the focal firm's management. These include time for preparing the registration statement and prospectus, and consulting with legal counsel, accountants, consultants and underwriters. Another substantial burden involves efforts to market the issue.

WHY ARE IPO's UNDER-PRICED?

The various reasons behind the under-pricing of the IPO according to the Researchers have been provided a number of explanations of which some of them are mentioned below:

LITIGATION RISK

As observed underwriter plays an intermediary role between the issuer and the capital market and makes pricing decisions that maximize his own welfare. Underwriter sets the issue price knowing that he will be sued in the future if there is evidence that the courts will judge as indicative of overpricing of the issue. There is a perfect sequential equilibrium in which some issues are overpriced, some are under-priced, there is under-pricing on average, and there exists a positive probability of successful litigation against the underwriter.

THE WINNER'S CURSE

Rock (1986) assumes the existence of both informed and uninformed traders while issuing the IPO and shows that under-pricing emerges to encourage participation by uninformed traders who would otherwise suffer the "winner curse" in trading with the informed traders. That means, uninformed investors realize that they tend to be more successful in obtaining shares of overpriced IPOs. In order to make them to participate, all IPOs must be discounted or under-priced. For the corporation, the implication is that the IPO will need to be significantly under-priced from what it believed to be its true value. This is the price of admission to the public market.

SIGNALLING MODELS

Several authors have provided the possible reason for under-pricing of the IPO. In these models, the intrinsically higher valued firms strategically under-price their stock in order to deter mimicking by lower valued competitors. High valued firms are under-priced in order to encourage information production by investors that will then be revealed in the secondary market price. These models involve firms dealing directly with investors, rather than through an investment banker. An

economic role for the underwriter as an intermediary also emerges in that risk-averse issuing firms may under-price in order to induce some investors to reveal information about market conditions. Under these circumstances, the existence of underwriters improves the economic efficiency of the IPO market.
Underwriters often reward valued customers with shares of under-priced IPOs. After receiving their allocation, these customers generally sell them quickly at a higher price in the secondary market, realizing a quick profit. This activity is called flipping. Many critics frown on flipping. However, it has to be realized that if none of the original purchasers of an IPO flipped, there would be no shares trading in the secondary market.

OBJECTIVES OF THE STUDY

1. To analyse IPO under-pricing for Twitter IPO.
2. To assess the extent of under-pricing.
3. To examine the reasons of under-pricing.
4. To understand the meaning of IPO under-pricing.

REVIEW OF LITERATURE

Timothy H. Lin (1996)
The author has made an attempt to investigate IPO under-pricing for the firms with and without VC backing. Also the study had made an attempt to examine the relation between VC reputation and underwriter spread. We can observe two contributions of this study which is: study has documented that the mean and median degree of IPO reduces because of VC backing and this backing also significantly lowers the underwriter spread charged by the investment banks. The other contribution is as large block shareholders, venture capitalists play an important role in certifying the value of a new equity offering. The incremental information which is not signalled by underwriter alone is provided by the quality of their reputation. The study shows that consistent with the certification hypothesis, VC reputation is able to reduce under-pricing of IPO and also the underwriting costs.
Raghuram Rajan and Henri Servaes (1997)
The authors have considered a sample of initial public offerings which was completed between the years 1975 to 1987 to make an observation so that how they related to the well documented IPO anomalies. The results of the study show that higher under-pricing leads to the increased analyst following. When the earnings potential and the long term growth prospects of the recent IPO's is considered analysts are overoptimistic about it and the study could see more firms complete IPO's when analysts are particularly optimistic about the growth prospects of recent IPO's. IPO's have better stock performance in the long run when analysts ascribe low growth potential rather than high growth potential. The results obtained from the study suggests that the anomalies may be partially driven by the over optimism of analyst.
Juseong Kim (1999)
The author has made an examination of capital market imperfections, such as information asymmetry, which increase the cost of external funds compared to that of the internal funds. This phenomenon creates financing constraints which limits the availability of external funds and making the corporate investment excessively sensitive to the cash flow. The study has concentrated on analysing the effect of financing constraints on the investment decisions by comparing the financial behaviour of Korean firms before and after their stocks is newly listed in the stock exchange. The results have suggested that the sensitivity of investment to the cash flow will be higher during the period before initial public offering (IPO) than after IPO. The study has also shown that the effect of financing constraints relaxation by IPO is more prominent in small than in large manufacturing firms.
Reena Aggarwal and Pat Conroy (2000)
The authors have examined the price discovery process of initial public offerings (IPO's) using a unique dataset. The initial quote entered by the lead underwriter in the five minutes of pre-opening window explains a large proportion of initial returns even for hot IPO's. The significant learning and price discovery continues to take place during these initial five minutes with hundreds of quotes being entered. The lead underwriters will observe the quoting behaviour of other market makers, particularly the wholesalers, and accordingly will revise the quotes. The study has shown that there is a strong positive relationship between initial returns and the time of the day when trading starts in an IPO.
Claire E. Crutchley, Jacqueline L. Garner and Beverly B. Marshall (2002)
The authors have made an attempt to investigate the long-term stock performance of the initial public offerings (IPOs). The study examines the stability of the board of directors affected by the past performance and how the subsequent performance of the IPO is affected by changes in board of directors. The study indicates that the IPO firms with poor initial performance experiences greater broad instability and the greater board stability is associated with the improvement in the leave subsequent performance of IPO. The study indicates that the board members leave the firms performing poorly rather than the shareholders replacing the ineffective boards. The continued success of IPO firms is associated with the retaining the boards which experience good initial performance.

INTRODUCTION TO TWITTER IPO

Twitter is an online social networking and micro blogging service that enables users to send and read "tweets", which are text messages limited to 140 characters. Registered users can read and post tweets, but unregistered users can only read them. Users access Twitter through the website interface, SMS, or mobile device app. Twitter Inc. is based in San Francisco and has offices in New York City, Boston, San Antonio and Detroit.
Twitter was created in March 2006 by Jack Dorsey, Evan Williams, Biz Stone and Noah Glass and by July 2006, the site was launched. The service rapidly gained worldwide popularity, with 500 million registered users in 2012, who posted 340 million tweets per day. The service also handled 1.6 billion search queries per day. Twitter is now one of the ten most-visited websites, and has been described as "the SMS of the Internet."
The seven-year-old social network company started offering shares on the New York Stock Exchange (NYSE) at 10:50 a.m. on Thursday, in the most anticipated tech IPO since Face book's in May 2012. The company, which set its initial IPO pricing at $26, saw the share price open at $45.10 due to strong investor demand. The initial surge in price gave the company a valuation above $24 billion when it began trading shares. Twitter seems confident about investor appetite for its stock; it boosted the initial share price by 30 percent in the days leading up to the IPO.

TWITTER IPO

In its first day as a publicly traded company, Twitter blew past everyone's expectations including its own. The seven-year-old social network saw its stock price soar from an initial public offering price of $26 to $44.90, a 73 percent increase. After one day of trading Twitter already has a greater valuation than currently hot tech companies like Netflix and LinkedIn. The high price means Twitter underestimated the value of its own stock and likely left money on the table. The company pocketed $1.8 billion when it priced its IPO at $26 Wednesday night, but clearly could have raised the price even higher. Still, the strong first-day increase makes Twitter's one of the most successful IPOs of the year. Out of 193 public offerings so far this year in US, Twitter's day-one jump was the 14th largest, according to Renaissance Capital, an investment firm that manages IPO funds.
"There's obviously a lot more optimism than even what we were thinking in terms of what the company's worth," says Rick Summer a senior equity analyst at Morningstar (Morningstar, Inc. is a leading provider of independent investment research in North America, Europe, Australia, and Asia). "It's clear that investors are clamoring for technology, they're clamoring for growth."
The $26 rate is what the Twitter IPO's underwriters -- including lead banker Goldman Sachs (GS) -- will use when selling shares to their clients. Those customers are mostly large are institutional investors, such as mutual funds and hedge funds. Shares will be released Wednesday night to those buyers, and the underwriters have the option to buy another 10.5 million shares from Twitter.

Calculation of Initial Returns of Twitter IPO: Twitter went public on Nov. 7, 2013, and ended its first trading day at $44.94 (up 72.84 percent).IPO under-pricing is calculated using the formula:

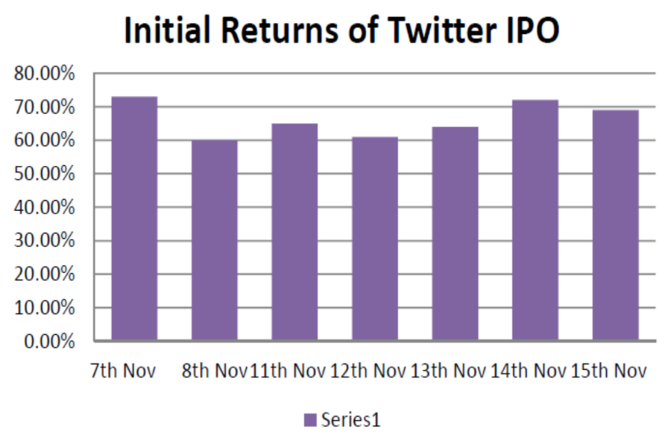
Under pricing = (First day closing price – offer price) / offer price * 100

Closing price and offer price is represented in terms of Dollars ($) because the social networking company (Twitter) is US based company.

The calculations of returns for the initial days after the issue are mentioned below:

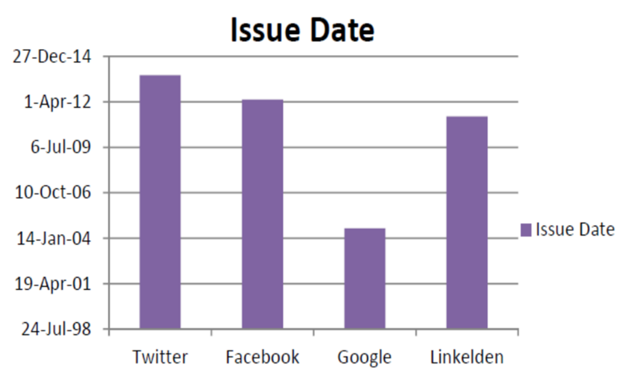
7th Nov = (44.90 – 26) / 26 *100 = 72.6%
8th Nov = (41.65 – 26) / 26 *100 = 60.19%
11th Nov = (42.90 - 26) / 26 * 100 = 65%
12th Nov = (41.90 - 26) / 26 * 100 = 61.15%
13th Nov = (42.60 - 26) / 26 * 100 = 63.84%
14th Nov = (44.69 - 26) / 26 * 100 = 71.88%
15th Nov = (43.98 – 26) / 26 * 100 = 69.15%

FIG. 1



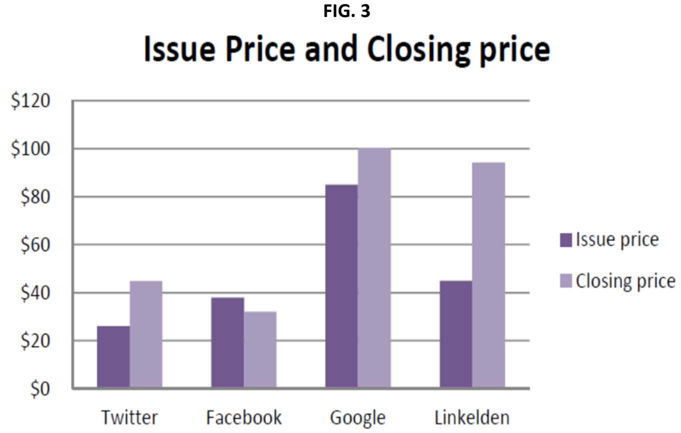
From the above diagram, we can analyse the returns of Twitter IPO from issue date till 15th of Nov and can observe the variations in the returns which represent increase in the price of the share after the issue, where the issue price is $26.

FIG. 2



From the above diagram, we can observe the IPO Listed date of different internet companies along with Twitter IPO.

FIG. 3

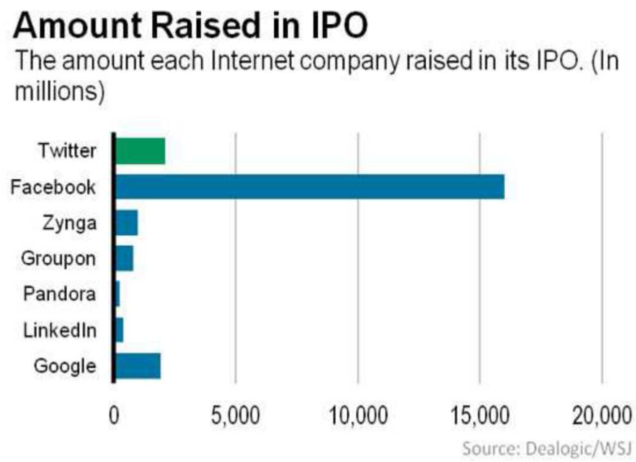


From the above diagram, we can analyse the difference between the issue price and the closing price. Except the Face Book all other companies closing price more than the issue price. This is with regard to first day (listed day) opening and closing price.

TWITTER IPO: COMPARING IT WITH ITS INTERNET RIVALS

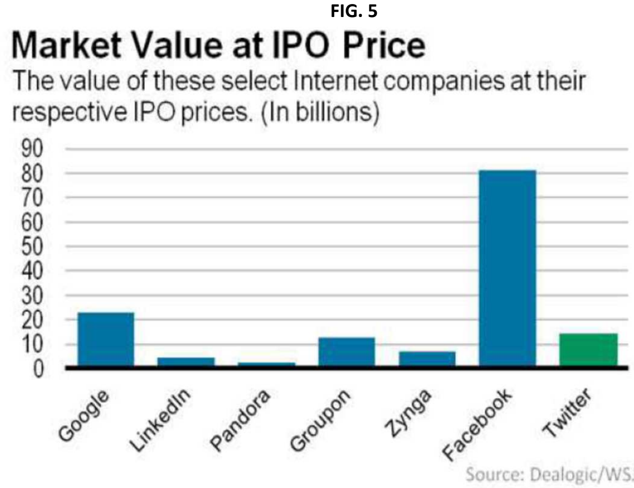
The IPO Funds: Twitter trails only Face book in the hall of giant Internet IPOs. The 140 character site raised $1.8 billion in its IPO, while Face book set the standard at $16 billion.

FIG. 4



Market Capitalization: At Twitter's $26 IPO price, Twitter was worth $14.4 billion, putting it far behind Face book's $81 billion, and Google's $23 billion, but ahead of Groupon's nearly $13billion.

FIG. 5

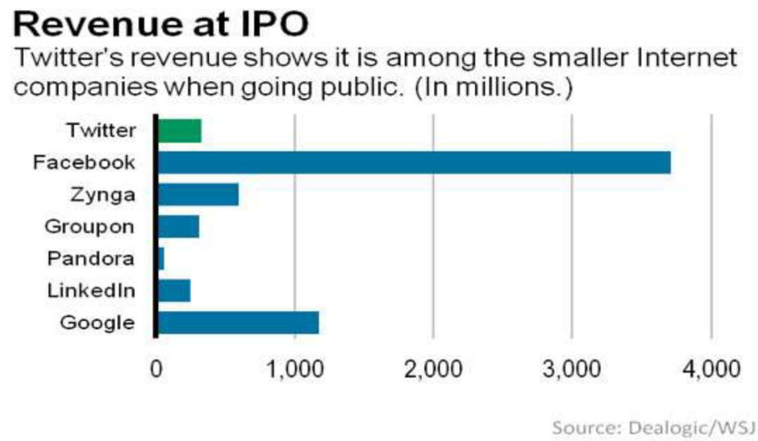


Market Cap at the end of the day: After getting that 73% bump, Twitter, at $25 billion, was much closer to Google which closed at $27.2 billion on its first day.

FIG. 6

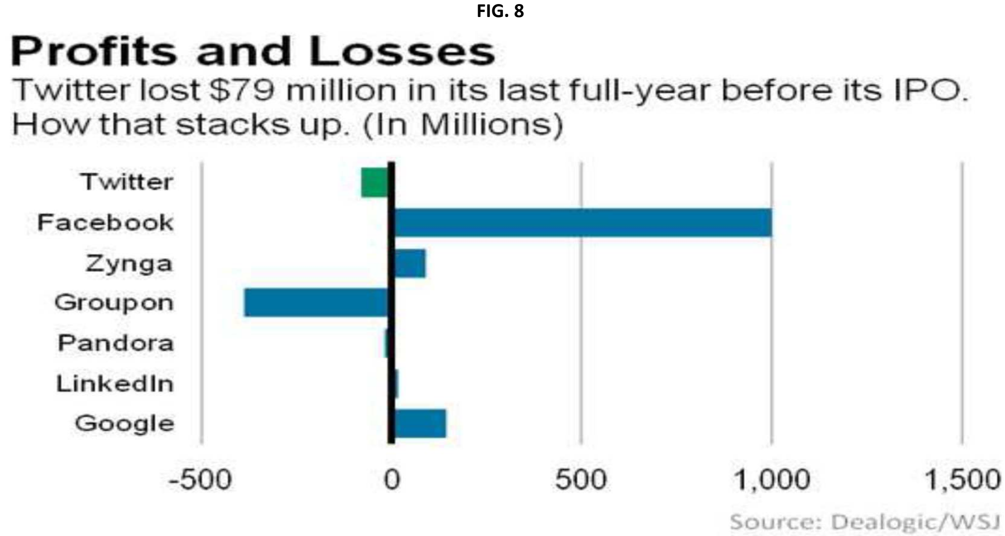
Revenue: Twitter's top line for the last full year before going public ranks toward the bottom of the group. Twitter brought in $317 million for 2012. Still, Twitter's revenue has been growing rapidly, as were the others when they went public, and for the first nine-months of this year already recorded $422.2 million.

FIG. 7



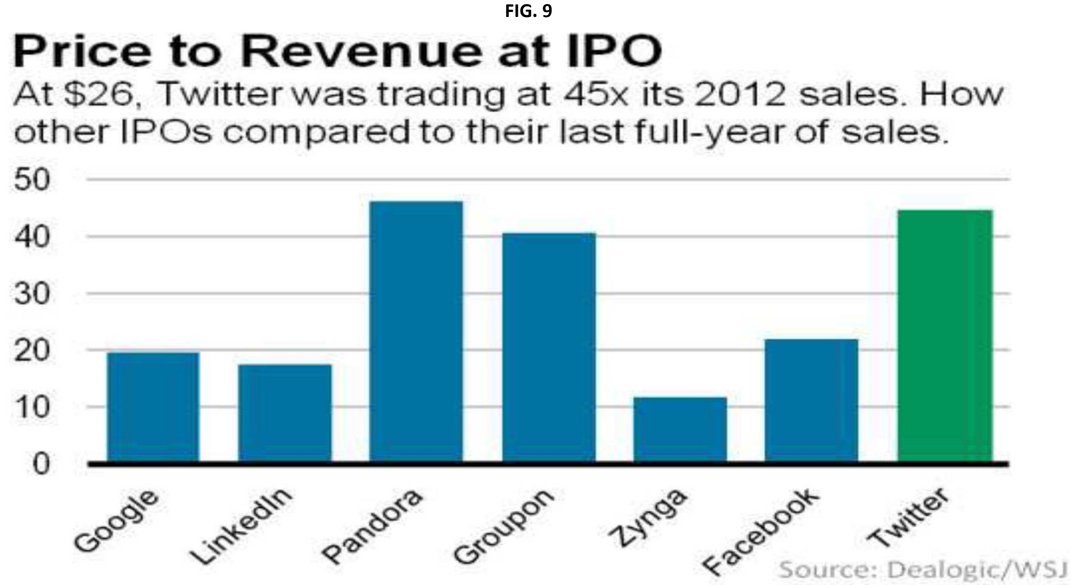
Bottom Line: Twitter lost $79 million in 2012, and losses have continued to pile up in the year (2013) also, in line with Pandora and Groupon which is yet-to-be-profitable at their IPO. Face book, by contrast, was the most mature in terms of earnings, making a $1 billion profit in the last full-year before it went public.

FIG. 8



Price to Revenue: Price to Revenue helps the investors to see how far sales would have to expand to bring it the market value of the company. By this metric, Twitter is expensive at its IPO price of $26 was at 45.7x its 2012 sales. That only slightly cheaper than Pandora, which was at 46.3x and more than double the 21.9x Face book went out at. Zynga was the cheapest at 11.7x.

FIG. 9



CONCLUSION

As per the observation made in the study, many reputed internet companies and also the social networking companies like Google, Face book, LinkedIn have issued the IPO and have raised the capital for the business purpose and the next turn was of the Twitter IPO which went to public on November 7, 2013. By analysing the initial returns it was clear that the Twitter IPO is under-priced, because issue price is $26 which was decided on the previous day of offering and first day closing price is $44.90. Sufficient amount of money is left on the table. Under pricing is obviously a cost to the issuing firm as the value been reduced in financial terms. The performance of Twitter IPO stocks is measured by the returns generated in very short term (i.e. the first and second week of IPO). The reason for under-pricing of Twitter IPO is we can relate it to the Winner's Curse phenomenon (it means the winner tend to overpay) investors have an optimistic view on the company's future performance. So with this positive optimism the investors have bought the stocks at the higher prices.

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