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Firms and Markets
Mini-Case

Auctioning IPOs at WR Hambrecht + Co

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William Hambrecht, one of founding partners of Hambrecht and Quist (now part of JP Morgan Chase), started WR Hambrecht + Co in 1998 with a new idea: use an internet auction to connect new companies directly with investors. If it worked, it would give small investors direct access to the lucrative IPO market and challenge the hold of traditional underwriters on this market.

Traditional IPO Underwriting

An IPO is an initial public offering: the first issue by a company of publicly-traded equity. (Top IPO underwriters are listed in Exhibit 1.) In a typical US IPO, the company hires an investment bank to serve as lead underwriter and manager of the public distribution of shares. The two functions are different. As underwriter, the bank guarantees the issuer that it will purchase an agreed number of shares at an agreed price, thereby assuming the market risk of the issue. As distributor, the bank organizes the selling effort to develop demand for the stock among investors, both institutional and retail. The lead manager helps the issuer to prepare the information and documents required by the Securities and Exchange Commission, including a preliminary "prospectus" that contains information about the company (including financial information) that may be used in offering the securities. To register the securities with the SEC, the company must declare an expected price range. The filings may be amended. The lead manager also puts together a syndicate of investment banks to underwrite the offering. The company and underwriters then market the deal to potential investors.

In marketing the issue, the lead manager queries potential investors about their interest and uses this information to prepare a book of preliminary orders for the shares. Investors' responses are not binding, but they allow the syndicate to estimate demand for the issue. The manager and its syndicate partners use this information and other factors affecting the markets to estimate a price for the offering, which the company may attempt to raise by negotiation.

Offerings are made at a fixed price. Typically the price is set about 10 percent below the estimated market-clearing price to make sure all the shares are sold. The night before the issue, the company and lead manager agree on a price and prepare a "final" prospectus, which is submitted to the SEC the next morning as an amendment to the registration statement. When the SEC approves issue, the syndicate allocates shares to interested investors. The lead manager often allocates more than the available shares and offers to purchase shares sold by investors in the "aftermarket" to stabilize the price.

Since issues are typically underpriced, investors often express interest in more shares than are available. The syndicate has considerable discretion over which of these investors get the shares, often allocating them to favored clients. Or worse: In early 2002, CSFB settled a complaint by the SEC that it had charged excessive commissions on new issues, which some observers interpreted as kickbacks.

Hambrecht's OpenIPO

Particularly during the dot-com boom, when many IPO issues experienced sharp price increases immediately after they hit the market, small investors expressed interest in getting greater access to these securities. Hambrecht's OpenIPO system allocates shares to anyone who is interested using an internet auction.

Hambrecht's OpenIPO includes the following steps:

- The company, with Hambrecht's assistance, files a registration statement with the SEC, naming an offering size and expected price range.
- Hambrecht notifies potential bidders of the auction, and vets the credit of interested bidders.
- Bids take place for 3-5 weeks prior to the effective date of the offering. Each bid consists of a price and a number of shares. Bids may be changed or cancelled any time up to the close of the auction. (??Do bidders see other bids (or totals)?)
- After the close of the auction, the issuing firm reviews the bids and sets an offer price. The offer price is at or below the highest price at which bids equal or exceed the number of shares to be issued. Shares are allocated to everyone who bid the offer price or above. If bids exceed the size of the issue, shares are allocated proportionately.

An example illustrates the allocation process. Consider a firm that wants to do an IPO of 1 million shares, expected to sell between $8 and $14 a share. At the close of the auction, the bids are:

Price	Shares	Cumulative
14	280,000	280,000
13	340,000	620,000
12	410,000	1,030,000
11	260,000	1,290,000
10	320,000	1,610,000
9	210,000	1,820,000
8	130,000	1,950,000

The second column of the table lists the total number of shares bid at each price (here round dollar amounts between 8 and 14). The third column lists the number of shares bid *at or above* the given price. For example, at $13, the total bid is 620,000 shares: 340,00 at $13 plus 280,00 at $14. To sell a million shares, the firm can choose a price of $12 or below. If it makes the offering at $12, there are more than 1 million shares bid for. The shares would be allocated proportionately to all the bids at $12 or above. Thus an investor who bid for 50,000 shares at $13 would be allocated

$$50{,}000 \times (1{,}000{,}000/1{,}030{,}000) = 48{,}544 \text{ shares.}$$

Typically this is rounded to the nearest 100 shares (48,500).

The challenge for Hambrecht is to attract investors and issuers. The sales pitch to investors: rather than depend on your relationship with the syndicate's partners, you can bid directly on new issues. In the words of Hambrecht's web site:

> OpenIPO is a new way to take companies public. It allows individual and institutional investors to bid online for shares of an IPO. It's not who you know – any qualified investor can open an account and place a bid. The auction treats all bids equally. A bid for one hundred shares by an individual investor has the same standing as a bid for one hundred thousand shares by an institution. Your allocation is based on what you are willing to pay rather than on the preferential treatment. This creates a market driven by supply and demand rather than influence or artificial demand.

The pitch to issuers: Hambrecht's fees are generally lower (3-6%). And since investors have direct access to the issue, the price will more accurately reflect the firm's value (in other words, be higher). Moreover, at the higher price the stock would be more likely to attract long-term investors, rather than investors looking to "flip" the stock for a quick profit.

Early Experience

As of January 2002, Hambrecht had been lead manager on 9 IPOs and participated in CSFB's Instinet IPO (see Exhibit 2). Nevertheless, it remained small player in the IPO market. Observers expressed mixed opinions. Hambrecht pointed to the success of Ravenswood Winery, which was purchased by Constellation Brands for about $150 million in July 2001. Others were puzzled that some early issues (Ravenswood and Andover.net) experienced the same first-day run-up in price seen in many traditional IPOs. Still others expressed doubt that the idea would ever catch on: "Auctions are fine for commodities like treasury bills, which everyone understands. But every company has its own story, and you can't expect investors to value them intelligently from the information in a prospectus." Hambrecht suggested that the approach might work best for visible consumer-based companies like Ravenswood and Instinet, which had strong name recognition among retail investors. Hambrecht's corporate debt service, OpenBook, took this approach, issuing $300 in corporate debt for manufacturing giant Dow Chemical in August 2000. Hambrecht was reported to be looking to license its technology to traditional investment banks, and signed a similar agreement with federal mortgage agency Freddie Mac in late 2000.

In short, the future role of auctions in equity and debt issues remains unresolved.

Questions for Analysis

(a) Where are the sources of value-added in the IPO process?
(b) What are the advantages of OpenIPO for issuers compared to traditional methods of IPO underwriting? Disadvantages?
(c) What are the advantages of OpenIPO for investors compared to traditional methods of IPO underwriting? Disadvantages?
(d) What features of the auction mitigate the impact of the winner's curse?
(e) What role do you see auctions playing in the IPO market in the future?

Additional Information Sources

- W.R. Hambrecht's website: http://www.wrhambrecht.com/
- Tim Jenkinson and Alexander Ljungqvist, *Going Public (Second Edition)*, New York: Oxford University Press, 2001.
- Roy Smith and Ingo Walter, *Global Banking*, New York: Oxford University Press, 1997, ch 11.

Notes

This case was prepared by Mariagiovanna Baccara, David Backus, and Luís Cabral for the purpose of class discussion rather than to illustrate either effective or ineffective handling of an administrative situation. The authors thank Iftekhar Hasan, Alexander Ljungqvist, Ingo Walter, David Yermack, and especially Roy Smith for useful comments and advice.

Exhibit 1
Major Players in the Global IPO Market, 2001

Lead Manager	Total Value of IPOs (millions)
Merrill Lynch	11,586
UBS Warburg	11,319
Goldman Sachs	10,554
Morgan Stanley	7,973
Credit Suisse First Boston	6,970
Citigroup/Salomon Smith Barney	4,984
Deutsche Bank	4,131
Societe General	2,930
Lehman Brothers	2,785
ABN Amro	2,090

Source: Constructed from data supplied by SDC Platinum, Thomson Financial Services.

Exhibit 2
WR Hambrecht + Co: IPOs to Date

Company	Date	Size (millions)	Comments
Ravenswood Winery	April 9, 1999	$11.55	Lead manager
Salon.com	June 22, 1999	$27.3	Lead manager
Andover.net	December 8, 1999	$82.8	Lead manager
Nogatech	May 17, 2000	$42.0	Lead manager
Peet's Coffee & Tea	January 25, 2001	$26.4	Lead manager
Briazz	May 2, 2001	$16.0	Lead manager
Instinet	May 23, 2001	$464	17% of CSFB deal
Smith & Wollensky	May 23, 2001	$45	Lead manager
Plato Learning	May 23, 2001	$50	Follow-on
InterCept Group	August 7, 2001	$124	Follow-on

Source: WR Hambrecht + Co web site.