Evaluating an IPO Prospectus - Double Assignment

Following this sheet are two assignments, one labeled **Reading an IPO Prospectus - background information**, followed by a form, and another more general assignment labeled **Reading the Netscape Prospectus**, a three-page assignment, tailored toward evaluating IPOs using the famous Netscape IPO as a case study.

A number of copies of the original Netscape Prospectus have been placed on 2-hour reserve at the Honnold Library under this class.

Using the Netscape Prospectus, I want you to work on these two projects simultaneously. First read the cover page for the **Reading an IPO Prospectus - background information** assignment. Then switch to the **Reading the Netscape Prospectus** assignment and start following the instructions there. As you complete that detailed and difficult assignment, try to fill in information on the **IPO Evaluation** sheet as you encounter it. If this becomes too confusing, set the **IPO Evaluation** sheet aside and complete it after you have completed the **Reading the Netscape Prospectus** assignment.

Bring the results to class at the due date below.

Due date: March 30

d:\handout\ipo.wpd

Reading an IPO Prospectus - background information

This assignment requires a separate sheet labeled **IPO Evaluation**. You are to take an assigned prospectus for an IPO and find the information in the prospectus that is required to fill out the sheet.

The evaluation sheet does not cover all of the issues that should be considered when evaluating an IPO. The evaluation sheet mostly considers **Dilution** and **Capitalization**, and such important issues as concentrations of stock ownership.

In addition to the issues covered by the evaluation worksheet, a systematic review of an IPO would also take into account:

Management and Organization: An old business adage says that it is "better to have an **A** team with a **C** product than a **C** team and an **A** product" ... and better yet to have an **A** team *and* an **A** product. Who are these people? What are their credentials? Is this an *experienced* and *balanced* team? Do you recognize any of the names? Who funded the private placement (if applicable)? Who are the underwriters? Does the organizational structure look sound (is everything; marketing, finance, operations, et. al., well represented)? Does anyone here have any experience building organizations?

Description of the Market (and the product fit): This, of course, is entirely a judgment call. You might likely know nothing about this market at all. Does it appear that these people do? At one level, here, you must use common sense.

Risk: In an IPO, that there is risk is self-evident - that's why it's listed last here rather than first. In reading their appraisal of risk (which should be read carefully), see if you can spot anything that might raise a red flag.

The Books: Though less revealing on an IPO than one might think (many of these companies have little operating history, and what little they have often ceases to be relevant after an IPO), at least glance at the income statement to see how they've done so far - though if they've never made a profit, that's *not* necessarily a drawback. The books will at least tell you how big they are, and might give some indication of such important indicators as market share.

The **IPO Evaluation** primarily itself concerns itself with two things, *capitalization* and *dilution*. These are explained further here:

Capitalization: From the corporation's standpoint, this is why the company is going public. Any prospectus is required to have a section on capitalization, which will offer a summary of how much money is projected to be raised by the IPO, and how. Remember, the corporation receives only the amount of money raised on the initial issue of stock. If the stock triples in value the second day, this has no direct benefit to the company.

Dilution: Technically, dilution is equal to [IPO price per share - Book value per share]. From the assignment, see if you can figure out why dilution is so important.

IPO Evaluation

Company name / stock symbol:	
Number of shares **authorized** by charter . . . . ? (look under **Capitalization**)	
Number of shares to be sold in **IPO** . . . . ?	
Number of shares **outstanding** *after* IPO . . . . ? (look under **Dilution**)	
What percentage of stock outstanding will be owned by the public after the IPO? . . . . ?	
What percentage of **Total Consideration Paid** was paid by the public? . . . . ?	
How much capital will be raised by this IPO? (Subtract actual from "as adjusted.") . . . . ?	
What percentage of stock outstanding will be held by the primary shareholder . . . . ?	
What percentage of stock outstanding will be held by major private placement (if applicable) . . . . ?	
What is the projected **IPO** price . . . . ?	
What is the Pro forma net tangible book value per share of the **IPO** offering (see **Dilution**) . . . . ?	
What is the **Dilution per share to investors** . . . . . . ?	
What is the **Dilution Ratio** (equal to [Dilution per share / IPO price]) . . . . ?	

When evaluating answers to the questions above, ignore stock options, warrants, options to underwriters (to issue more shares, etc.), possibilities of later issues, etc.

IPO Evaluation

Company name / stock symbol:	
Number of shares **authorized** by charter . . . . ? (look under **Capitalization**)	
Number of shares to be sold in **IPO** . . . . ?	
Number of shares **outstanding** *after* IPO . . . . ? (look under **Dilution**)	
What percentage of stock outstanding will be owned by the public after the IPO? . . . . ?	
What percentage of **Total Consideration Paid** was paid by the public? . . . . ?	
How much capital will be raised by this IPO? (Subtract actual from "as adjusted.") . . . . ?	
What percentage of stock outstanding will be held by the primary shareholder . . . . ?	
What percentage of stock outstanding will be held by major private placement (if applicable) . . . . ?	
What is the projected **IPO** price . . . . ?	
What is the Pro forma net tangible book value per share of the **IPO** offering (see **Dilution**) . . . . ?	
What is the **Dilution per share to investors** . . . . . . ?	
What is the **Dilution Ratio** (equal to [Dilution per share / IPO price]) . . . . ?	

When evaluating answers to the questions above, ignore stock options, warrants, options to underwriters (to issue more shares, etc.), possibilities of later issues, etc.

Reading the NetScape Prospectus

[Note to students: If this homework is done properly, it may require *two to three hours of your time*. Please take it as a matter of faith that it will be well worth the effort. Again, this is part of our *active* (rather than passive) approach to instruction. You will learn a lot (get a lot of knowledge-bang for your time-buck) and will *retain* most of it if you do it on your own rather than passively rely upon me to explain it to you.]

We are using the NetScape prospectus as an example of a prospectus associated with an IPO. NetScape, though, is not a typical IPO (if there is such a thing). The gamble here is on the company's phenomenal software (I use it, and it really is impressive) and the fact that they had a head-start in one of the most potentially explosive areas of growth in the near future, the Internet World Wide Web.

The intent in this assignment is to show you what kind of information is found in a **prospectus**. The **Table of Contents** on page 4 includes what is required by the SEC (and a little more). You do not need to read the whole prospectus (though it might be wise if you were mulling over dropping $500,000 into this company), but certain things you should look for.

This is not meant to be all-instructive nor comprehensive, but to provide first-time exposure to this all-important world of disclosure. Reviewing material like this gets to be an art - you learn from experience to assess risk and prospects for performance - a judgement that ultimately relies as much upon intuition as clear and objective criteria.

Of the more important areas in this prospectus,

1. Glance at the summary on page 3.

2. Peruse (quick scan-read) the *risk factors* beginning on page 6. Of these, read more carefully the following:

> *Limited Operating History ...*
> *Developing Market ...*
> ***Concentration of Stock Ownership ...***
> *Dilution* (also explained later)

3. Go to page 15, **Capitalization**. Read carefully the opening paragraph, then look at the spread below. Realize that the column labeled **as adjusted** represents how the company would look if the IPO had already happened as targeted (selling 3,500,000 shares at $13 per share). Note that the first paragraph is telling you that preferred stock currently outstanding will be converted to common at the ratio of 1-to-2 after the IPO. This means that those who currently own 100 shares (or some multiple) of preferred will (probably) be converting that to 200 shares common.

To be discussed in class (by you) - if you have time, please make some notes on this - you will get much, much more out of this if you figure this out on you own: What information can we glean from this?

4. Go to 16, **Dilution**. This is <u>very</u> important. Dilution is equal to

D = IPO price per share - Book value per share

Look carefully at the spread shown in the middle of this page 16.

To be discussed: What percentage of the company's issued stock will be owned by new (post-IPO) common stock investors? Given that $0.88 per share is the average price per share (for the common-stock equivalent) paid by existing stockholders, what percentage of the capital raised through the sale of stock was contributed by new investors? Do you see why I call this a "ten-for-60" dilution?

5. Look at the consolidated income statement on page 17 at least briefly. This company has no "good quarter," since it has run only losses. Clearly NetScape is a high-tech gamble (and in my judgement, a good gamble for the *principals*).

6. The section on **Management Discussion** and **Business** has general background info on the company - which would be important if you knew nothing of the company - but it doesn't have the meat. Glance at it to see what it is, then move on to ...

7. **Management -** This **is** an A-Team, no matter what else you may think of this prospectus. Look at this closely. at least up to the point of Sha. Ask yourself, "Why is any Underwriter even willing to look at this company - no profit, no nothing." The answer is found here.

Answer this in your own mind:

*(1) Who is James Clark? [To be answered later as you see more data] - How much has be personally pumped into this company. What are his **credentials**? [And answer this later when you encounter the data: what are his stakes?? what did he contribute financially?]*

(2) Who is Barksdale? What background? What is his operational importance?

(3) Maybe the most important question of all: [hint - look at ages and everything] Who is Andreeson? What is his role? What purpose did he play in the formation of this company? Is this guy important? Turn to page 50, read footnote 5, and figure out the implications. If you do, you are well on the way to understanding some of subtleties of this business.

Sub-question:

Is Andreeson smart to agree to all of this???

I'll give you the answer so we don't have to dwell on it:

Yes.

As a final thought on the "better an A-Team and a C-Product than a C-Team and an A-Product, " this, despite the problematic track record and high risk, is the classic example of an A++ team with an A product. This is the *only* reason the Underwriters said "go."

8. Though you've seen some of this before, read the first 2/3 of page 51 on **Description of Capital Stock** carefully - all 5 paragraphs. Some of it you may not understand, but some of it you will.

Answer this at least: How many shares were authorized for this company??

9. After glancing at the material in between, go the section called **Underwriters** on page 57 and read the whole thing.

Answer this: What have Morgan Stanley et. al. agreed to do here??

If you understand accounting and can read balance sheets, continue on to read the consolidated balance sheets that begin on page F-3. Regardless, since you have gone to the trouble of doing this much, fill out the table below [important]:

Questions:	
How many shares are authorized in this company's charter? (p. 51):	
How many share are to be sold in the IPO?:	
After the IPO, how many shares of common stock will be outstanding? (p. 3):	
... will be owned by James Clark? (p. 49/50):	
... by major private placement (Kleiner, et. al., Adobe) (p. 49/50):	
... by Andreeson? (p. 50, footnote 5 also):	
... by executive officers and directors as a group:	
How much will Clark's investment be worth if this goes out at 13?:	