

## 93/03-IPOs Explained

**By Peter Lynch**

Every year, hundreds of new issues take their place on the ticker tapes. These financial newborns are called initial public offerings (IPOs), and how they are handled is one of the most fascinating stories on the Street.

Whereas for humans, life ends at the undertaker's, for common stocks, it begins at the underwriter's. Company X engages one of these Wall Street investment houses to peddle its first publicly traded shares, at a fixed price, to a group of initial buyers. Where to fix the price is a guessing game that puts the underwriter in a ticklish situation.

If the price is set too high, it will surely fall after the stock begins to trade freely, causing the initial buyers to lose money as well as any faith they may have had in the work of the underwriter. Since most of these buyers are big Wall Street institutions who do not take kindly to losing money, this result will not enhance the underwriter's popularity.

On the other hand, if the price is set too low, then the stock will soar in the market, making the initial buyers very happy-- but not so the company. Company X will realize it could have gotten much more for its shares had the underwriter set a higher price at the start. The next time it wants to do a deal, Company X will likely take its business elsewhere.

To satisfy both sides, the underwriter tries to price the new issue high enough so the company won't feel bamboozled, and low enough so the initial subscribers can make a bit of profit. In IPO circles this process is known as "leaving something on the table."

The underwriter, however, reserves the right to sell an additional amount of shares, usually about 10% of the offering shares, at the time of the offering. This is the "green shoe" allotment, named for the now-defunct Green Shoe Corp., for which the strategy of selling additional shares was invented. If all goes well, the stock price of the new issue will "lift" (another bit of IPO jargon) after it begins to trade freely on the open market. The green shoe shares can then be sold to add to the proceeds from the offering.

The deliberate pricing of deals slightly under the presumed market value is one reason IPOs do so well in the first three months of existence. In fact, if you'd bought shares in every IPO that appeared in the last ten years (I'm not counting penny stock IPOs here), held those shares for three months, then sold them and invested in the next batch of IPOs, you would have outperformed the S&P; 500 by a large margin.

Getting your hands on the shares of an attractive IPO is not easy. They are doled out by the underwriter to a who's who of pensions, mutual funds, and the like. Usually the best deals are oversubscribed. At Magellan, a constant frustration was getting excited about a new company and then discovering that I was allowed to buy only a piddling amount of stock.

If Magellan had this problem, you can imagine what chance the average investor has of participating in an attractive IPO. Brokerage houses get an allotment of shares, which they offer to their biggest and best clients. If you're not one of those and your broker offers to let you in on a "hot IPO," you ought to look this gift horse in the mouth. Why are the big investors avoiding this deal?

When Apple Computer went public in 1980, the state of Massachusetts, using the arcane Blue Sky laws, prohibited small investors from buying any shares. The idea was that Apple was such a risky venture that only professionals should participate. This ranks just behind the Boston Red Sox's decision to sell Babe Ruth as the worst ever made in my state. It was fortunate for me because it meant I got a big allotment in the Apple deal.

IPOs seem to come in waves, followed by calmer periods when there's relatively little action. There were waves in mid '81, between mid '83 and early '84, in 1987, and we're in the midst of one that began in late 1991. These waves correspond to peaks in the stock market when investors are euphoric and willing to pay top dollar for stocks. Companies wait for a giddy atmosphere in which to go public, which is why so many of them do it at the same time.

Some people argue that it's a mistake to buy IPOs in a giddy atmosphere, which may be true in general, but this is often when the best of the new issues make their debut. It was in July 1987 that a company called MBIA, Inc., was launched. This profitable insurer of municipal bonds came public at \$23.50 and promptly dropped half its value on Black Monday in October. It's a \$63 stock today.

#### Lessons From A Prospectus

If you miss out on an IPO, you can acquire as many shares as you want when the stock starts trading in the "aftermarket." I always search for bargains during the rare periods when the deals aren't lifting, as occurred in the summer of 1992, when 70% of the most recent 100 IPOs were selling at or below their original prices.

In looking through the list of new issues, I came across Taco Cabana, a chain of Tex-Mex restaurants. I got copies of all the relevant reports, one of which included a map of Texas covered with bright red chili peppers that represented each Taco Cabana outlet in the state, accompanied by the company billboard slogan toot if you like our borracho beans.

It's always a good idea to review the prospectuses. There are two of these. The first is called the red herring, named for the numerous warnings sprinkled throughout the text and printed in red. This is the provisional explanation of the deal, showing the range of prices at which the underwriter thinks the shares might be sold after the "road show," where investors are solicited. The final prospectus, with all the details worked out, is printed in black.

By comparing one prospectus with the other, you can see whether the road show was a success and the underwriters got their expected price, or whether a lack of enthusiasm caused them to have to reduce it.

In the Taco Cabana red herring, the underwriter said the deal would be priced somewhere in a range of \$11 to \$13, but in October 1992 it came public at \$13.50. Obviously, investors were moderately excited about borracho beans.

A prospectus also tells you what happens to the money that was raised in the stock sale. The proceeds can go one of two places: into the corporate till (the best result) or into the pockets of the founders and directors who are selling their shares in the offering. Whenever I see insiders using the IPO as an excuse to cash out, I ask myself: If they have no faith in the future of their company, why should I?

In this instance, \$20 million was going into the corporate till and \$13 million to insiders. I also noted that 94 cents a share was going to the underwriters-- no wonder Wall Street firms love to handle IPOs. In the regular market, institutions make only three to five cents a share in commissions for doing stock trades.

Among the insiders, the chairman, who owned 2.046 million shares, was selling 754,500 of them to pocket a quick \$10 million or so. I would have preferred that he keep all his shares, but among the many gossipy details in the red herring, I found his age: 65. A 65-year-old, I figure, has a right to enjoy some of his money, and he'd retained more than half his holdings. Meanwhile, the Prudential Venture Partners II, one of the original bankrollers of Taco Cabana when it was private, owned 2.9 million shares and were not parting with any of them. This was a positive sign.

The next point to consider was how the company will use its share of the proceeds. The red herring informed me that Taco Cabana was planning to reduce its overall debt from \$10.4 million to \$2.5 million. In fledgling public companies, it's always reassuring to see a strong balance sheet. A company with no debt will have a hard time going bankrupt.

Did management know what it was doing? On page 20 of the report, I learned that Taco Cabana had opened its first "Mexican patio cafe" in 1978, and since then had added 40 more company-owned patio cafes, mostly in Central and South Texas. The chairman had 36 years' experience in the restaurant business in San Antonio. The president had been a vice president at Fuddrucker's, the vice president of operations was a vice president at Burger King, and a director was president and COO at Church's Fried Chicken. They knew their beef, their chicken, their beans.

Sales were on the increase and so were the earnings-- another good sign- - and the company was determined to put new chili peppers on the map, with 12 new company-owned patio cafes planned for 1993 and another 18 for 1994.

You discover a lot of interesting trivia in a prospectus, such as the fact that a Taco Cabana restaurant is painted vivid pink and open 24 hours a day, that the average check is \$4.63 per person, and that 40% of the business is drive-through. You imagine yourself going to a pink building at 4 am to eat borracho beans, and you marvel at the hearts, minds, and stomachs of Texans.

It says here that it cost \$900,000 to build a Taco Cabana and that each one is expected to bring in \$1.8 million in average annual sales. A general rule for investing in restaurants is that annual sales should exceed the cost of construction. A two-to-one margin is quite favorable.

Alcohol (beer, I guess) accounted for only 6% of sales. I'm skittish about owning stock in restaurants that make most of their money on liquor. Liquor tastes the same everywhere, and a restaurant that becomes a bar is likely to lose its customers to a trendier bar.

With the stock at \$13.50, Taco Cabana was selling for 18 times its estimated 1993 earnings of 75 cents. This was not an extravagant price tag for a fast-growing company in a stock market selling for 23 times earnings overall.

I'm not recommending that either of us buy shares in Taco Cabana. I'm using it to illustrate how much you can learn from reading prospectuses, and how it makes sense to investigate companies that have recently gone public.

New companies are routinely misunderstood and/or ignored by Wall Street, which makes these the perfect targets for individual investors who do independent research. There are several newsletters and advisory services that keep tabs on the latest IPOs. These include "Going Public/ The IPO Reporter," published by Investment Dealers' Digest in New York (\$990.00 per year; 212-227-1200); "New Issues Digest," published by National Corporate Sciences, White Plains, NY (\$425 per year; 914-421- 1500); and Standard & Poor's "Emerging & Special Situations," in New York (\$223.50 per year; 800-221-5277).

In the chart on page 38, you can see the results from a few of the most profitable IPOs of the past 12 years. Most are household names already.

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Peter Lynch retired in 1990 from managing the Magellan Fund, the best- performing of all mutual funds over a 15-year period. He is a trustee of the Fidelity Group of funds and his new book, *Beating the Street*, will be published this month by Simon & Schuster.

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