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The Evolution of Online Investment Banking

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Introduction

In the past few years there has been a growth in Internet markets where companies and investors can buy and sell initial public offerings (IPOs) of corporate stock. In fact, by early 1999, the mechanics of Internet IPOs had quickly progressed from the first phase, a partial distribution of IPO shares directly to investors via the Internet, to the actual determination of the offer price and the allocation of shares through an online auction process.

Internet-based investment banks provide companies with a choice of whether to use a traditional investment bank, or one that provides the new online services to distribute some portion of their IPO. When companies are considering an IPO they must first evaluate the financial issues to decide whether it is a viable financing option, and second they must identify which channel(s) they wish to use to distribute the IPO. In this article we focus on the second decision. This is an important topic because it potentially affects all public companies, or companies considering going public, the investment banking industry, and all stock investors. The importance is also indicated by the fact that in 1999 a record $74 billion was raised through 511 initial public stock offerings with new issues posting an average first-day gain of 68.3 percent [Kapadia 2000].

Traditional IPO Process

The traditional IPO process involves the issuing firm, an investment bank that acts as an intermediary between the seller and buyers, and a select group of typically larger investors. The investment bank provides services such as pricing the stock, forming syndicates of investment banks and their brokerage arms to distribute shares, providing access to a select group of large investors to facilitate distribution and, if need be, supporting prices in the IPO after-market by placing its own buy orders for the stock. Prior to the offer, the investment bank contacts its buying clientele and explains the details of the offer and the selling company. During this time the investment bank assesses interest in the IPO and takes preliminary subscriptions for shares. The bank then uses this information to determine the price and the number of shares to sell. Because many IPOs are over-subscribed, the bank pro-rates the shares during the final distribution based on the original subscriptions. This service comes at a price, however, as the investment bank receives a commission -- typically based on the amount of money raised in the IPO.

This process has been used for IPOs for well over a century, but some questionable activities have evolved during that time. There is the practice of spinning, where the investment bank allocates shares to favored or potential customers in hopes of winning future business. One could argue that by spinning, investment banks preclude the average investor from some potentially attractive IPOs. There is also underpricing. The stock price run-up of the average IPO on the first day of trading is so great, that it appears that investment banks are often setting the offer price too low. Theories have emerged to explain the existence and magnitude of underpricing and defend it as an efficient way to clear the IPO market. However, there is still a real possibility that many companies are being sold too cheap.

Consider the case of Theglobe.com, a Website builder that debuted in February 1999. Theglobe's bankers, Bear Stearns and Volpe Brown Whelan, underwrote its shares for $9, raising $27.9 million in capital. On the first day of trading, the price rose to $63.50. Had Theglobe sold the IPO for $63.50, rather than $9, the company would have collected not $27.9 million but $197 million - seven times the money to build the brand and develop new products [Tully 1999]. Given these transaction costs and a less than open IPO market, a new information technology enabled IPO may offer a solution.

Online Investment Banks and the Changing Role of Intermediaries

The primary difference between the traditional and online IPO process is the role of the intermediary. Bakos (1998) identified eight functions of a market that are facilitated through intermediaries. They include determination of product offerings, search, price discovery, logistics, settlement, trust, legal, and regulatory. The differences in the anticipated phases in the diffusion of online IPO processes can be described using these intermediary roles. The phases occur as the participants in the process search for greater market efficiency (reduced transaction costs).

The roles of intermediaries in Phase I, partial share distribution via the Internet, include providing market access and IPO information (search), IPO share offer price information (price discovery), as well as informing the investor that the intermediary feels that the selling company is reputable (trust). For Phase II, price determination via the Internet, the search and trust roles are similar, but the share price is determined not by an offer price but through an auction or negotiation mechanism. The future may bring a Phase III, disintermediation, where the IPO process intermediary is no longer necessary. This phase will only take place when the trust between the share buyer and seller can be facilitated without an intermediary firm.

Each form of online IPO involves the same seller, but a different form of intermediary. The online investment bank provides an Internet-based IPO offering a more open IPO market with access to a larger number of smaller investors. Bob Lessin, CEO of Wit Capital, identified this as a primary goal: to level the Wall Street playing field by giving the little guy, individual investors, a chance to invest in a company when it first offers shares to the public and before the stock actually begins trading in the markets [Dorsey 1998]. An example of a phase I online IPO process is Wit Capital. It allows the investor to subscribe to shares at the offer price via the Internet, using Wit Capital's homepage to peruse pertinent documents concerning the issuing firm. While only a small portion of shares is now allocated to those online investment banks in the distributing syndicate, it appears to be expanding.

The next phase of the online IPO process has been developed by William Hambrecht, owner of W. R. Hambrecht & Co. Using Mr. Hambrecht's plan, dubbed OpenIPO, investors submit bids for the number of shares they would take and at what price. After a few weeks of taking bids, the offering price is set at the lowest price at which all shares can be sold. Those bidding above the offering price will get all the shares they asked for at the offering price; those bidding at the offering price will get a portion of their bid; and those bidding less than the offer price will not get any shares. No more than ten per cent of the shares sold can go to a single bidder, and Hambrecht reserves the right to limit the purchase of anyone seeking to buy more than one per cent [Bransten and Wingfield 1999].

As of the end of 1999 there has not been a significant amount of IPO share sales directly from companies to investors without any intermediary. But, the potential savings in fees and commissions for both the offering company and the investors may be large enough to move toward a disintermeidated process.

Summary and Conclusions

Raising equity in public markets involves many choices for the issuing firms. Among these choices is how much stock to offer and at what price. They must also decide whether to use an investment bank to underwrite the issue and, if so, which investment bank. Traditionally, the underwriter pre-sells the entire offer to its clients - thus determining an optimal offer price and the demand for the issue. However, this traditional method has led to some questions as to some of the practices of the underwriter. For example, is the offer price discounted in an effort to satisfy the underwriter's preferred customers? While there are theories describing deep discounting as an equilibrium market clearing process, the practice suggests that the firm may not have received an optimal price for its stock.

Recently, the IPO process has experienced some significant changes involving the Internet In the first phase, a portion of the issue was distributed via the Internet. A preliminary analysis suggests there has been no fundamental changes in the underlying mechanics of the IPO. In the second phase, both the offer price and the investors are determined through an online auction mechanism. This may result in a more efficient offer price for a company's IPO and certainly implies a gradual disintermediation process as the need for brokerage and other solicitation activities of investment banks is mitigated. However, if deep discounting is required to clear IPO markets, an analysis may uncover the same phenomenon regardless of the price discovery and distribution mechanism.

In the future, when firms are deciding how to distribute their shares, they must compare the risks associated with using a new, relatively untested, online investment bank to distribute a portion of an IPO versus the potential increase in capital received resulting from this new process.

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