



5 Things Investors Need to Consider When Evaluating an IPO

Description

IPO's can be spectacularly lucrative opportunities, allowing investors to “get in on the ground floor” on an exciting new business venture.

Think for a second about those investors who had the foresight and were fortunate enough to get in the ground floor of a company like Canada's own **Shopify Inc** ([TSX:SHOP](#))([NYSE:SHOP](#)).

If you had been able to [snag up some SHOP stock](#) on the day it originally came to market, the value of a hypothetical \$10,000 then would be worth an estimated \$126,502 today.

Crazy, right?

But IPOs aren't exactly without their fair share of risks either.

Here are five things investors need to be on the lookout for when evaluating the prospects of any new Initial Public Offering (IPO) that's expected to come to market.

The company's operating history

This can sometimes be tricky if the company is at an earlier stage of development, but no matter what, an investor will want to do their own research and due diligence to gather a reasonable understanding of what it is the company does, how long it's been operating for, its were for the past 12 months and whether or not the company has been profitable.

Investors will want to avoid falling into the trap of chasing after the latest fashionable idea, especially if they don't have a firm grasp on exactly what it is the company does.

Risk considerations

As part of the public offering, firms are required to provide prospective investors with a prospectus document clearly outlining the conditions of the offering, along with a complete, fair and full disclosure

of any and all of the risks pertinent to the business.

This could include sensitivities to the business cycle, risks associated with the prices of raw materials used as inputs as well as any pending legal or regulator matters.

When in doubt, investors will want to make sure they've asked all the right questions about a prospective investment before, rather than after, making any major decisions.

Special voting rights

As part of the prospectus, the issuing company is also required to disclose any special conditions around the offering, including the presence of a dual-class share structure.

Sometimes the company's owners will elect to create two separate classes of share ownership, such as giving additional voting rights to the original company founders on issues like who is eligible to sit on its board of directors.

These types of special situations can sometimes present problems for shareholders down the road, particularly if they've only come to light after the fact.

The role of the investment bankers

Companies have various avenues available to them when coming to market with an IPO. Part of that decision-making process includes the relationship agreed to between the issuing firm and the investment banking team helping to bring the deal to market.

For example among the possible options, deals can either be structured on a "best efforts" basis, or alternatively by way of a "firm commitment."

In a best efforts offering, the investment bank is acting only as an agent, helping to find a buying market for the company's shares. In a firm commitment, the investment bank seeks to find a buyer, but also agrees to purchase the entire allotment of the offering if it's unable to secure a market for the issue.

Does the valuation make sense?

IPOs are often the best opportunity for a company's founders and early-stage private investors to "cash out" on their investment.

Investors will want to do their proper due diligence to ensure the valuation that's being marketed as part of the public offering is grounded in economic reality, and free of overly optimistic future projections and non-GAAP financial measures.

Foolish bottom line

IPO's are among the most exciting places in the markets and as evidenced by Shopify's recent

success can prove tremendously valuable for investors as well.

Keep these five factors in mind the next time you're [considering an investment in an IPO](#) coming to market and with a little luck, hopefully your fortunes will turn out just as bright.

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