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An examination of initial public offerings in the “high flying” internet industry

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AN ANALYSIS OF THE PERFORMANCE OF INITIAL PUBLIC OFFERINGS IN THE “HIGH FLYING” INTERNET INDUSTRY

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AN ANALYSIS OF THE PERFORMANCE OF INITIAL PUBLIC OFFERINGS IN THE “HIGH FLYING” INTERNET INDUSTRY

Abstract

This study fills a gap in previous research by examining whether underpricing occurs in the after-market for the entire population of Internet initial public offerings (IPOs). Results indicate that the mean first day and first week returns (excluding the first day) for an Internet firm was 80.5 percent and –1 percent. The first day market-adjusted returns using the NASDAQ and S&P 500 Indexes as benchmarks were 83.4% and 83.3%. The first week market-adjusted returns were -2% and -1%.
AN ANALYSIS OF THE PERFORMANCE OF INITIAL PUBLIC OFFERINGS
IN THE “HIGH FLYING” INTERNET INDUSTRY

The focus of this study is on the “high flying” Internet industry. The Internet industry has been receiving an enormous amount of publicity due to its dynamic growth. The amount of online-sales in 1998 was $8 billion, however Forrester Research, a research firm that focuses on the Internet industry, estimates that the amount of goods and services that will be sold over the Internet by 2001 will be $142 billion (Roth, 1999). The emerging Internet industry is having a dramatic effect on the competitive landscape of business today.

The Internet is part of electronic commerce (E-commerce). Kestenbaum and Straight (1996) define E-commerce as the integration of e-mail, electronic funds transfer, EDI (Electronic Data Interchange) and similar techniques into a comprehensive electronic-based system of business functions. Other authors (see Kalakota and Whinston, 1996) define E-commerce as a modern business methodology that addresses the needs of organizations, merchants, and consumers to cut costs while improving the quality of goods and services and increasing the speed of service delivery. Nath, Akmanligil, Hjem, Sakaguchi, and Schultz (1998) assert that E-commerce involves the buying and selling of information, products, and services via computer networks today and in the future via any one of the myriad of networks that make up the Information Superhighway.

The Internet is a global mix of interconnected computer networks using the Internet Protocol (IP) to communicate with each other (Margherio, Henry, Cooke, Montes, and Hughes, 1998). The Internet or Net is comprised of several data networks with hundreds of
applications such as the World Wide Web and e-mail that run through these networks.

The investment community realizes the unlimited potential of the industry. Evidence of this can be seen by the high amount of speculation that has been occurring in the after-market for Internet IPOs. For example, in 1998, Theglobe.com sold 3.1 million shares of common stock at $9.00/share, by the end of the first day of trading the company’s share price was $63.50 (606% increase). This indicates a loss of $169 million to the company.

When the stock price of a company such as Theglobe.com increases that dramatically in the after-market, it is termed underpricing. Underpricing occurs when the offering price for a stock is below the price for which the stock trades subsequently in the after-market (Bruton and Prasad, 1997). This area of research has been receiving increasing attention in the entrepreneurship literature (see Bruton and Prasad, 1997; and Prasad, Vozikis, Bruton, and Merikas, 1995).

The purpose of this study is to examine whether the phenomenon of underpricing exists within the Internet industry. Prior research has found evidence of underpricing for the general population of initial public offerings. However, little research has been performed on specific industries. This study will also examine the characteristics of Internet IPOs at the time of their initial offering (e.g. organizational age, net sales, net income, total assets and initial offering size).

The study fills a gap in previous research by focusing on the emerging Internet industry. Specifically, this study examines the underpricing phenomenon for the entire population of Internet firms that have made initial public offerings. The following research question will be
answered in the study: Does the underpricing phenomenon occur within the Internet industry?

The results of this study will assist Internet entrepreneurs in their quest for an IPO for several reasons. First, the Internet industry is a young emerging industry (most are under 15 years old) (Kazanjian and Drazin, 1990) where companies like Yahoo and Netscape are playing a key role in the economic development of the United States. Internet entrepreneurs will be able to take the results from this study to examine if any irregular patterns exist in the after-markets. Oftentimes patterns exist in the after-markets that may cause companies to lose capital that might have been useful to the long-term survival of the firm. In the example above, Theglobe.com lost $169 million in potential revenue that might have assisted in the growth and survival of the company. If the CEO of Theglobe.com and other Internet entrepreneurs understood the underpricing phenomenon in the after-market, they might be able to proactively respond by changing their capital structure (Schiller, 1990).

THEORETICAL BACKGROUND

A variety of methodologies have been used to study the underpricing of IPOs (for a review see Prasad, Vozikis, Bruton, and Merikas, 1995). Bruton and Prasad (1997) and Aggarwal, Leal, and Hernandez (1993) have published reviews of studies that have focused on underpricing. Streams of research also exist on the underpricing of IPOs for one day, one week, one month, and up to three years after a firm goes public.

The most popular research stream has focused on first day returns. One of the first researchers to investigate the underpricing of IPOs after the first day of trading was Logue’s (1973) study that found the average IPO to be underpriced by 30%. In a follow-up study,
Ritter (1984) analyzed 1028 IPOs from 1977-1982 and found the average first day return to be 26.5%.

Examining 545 IPOs from 1981-1982 Beatty and Ritter (1986) found the mean first day return to be 14.1%. Miller and Reilly (1987) found the average first day return for 510 IPOs from 1982-1983 to be 9.87%. From 1975-1982 Chalk and Peavy (1987) examined 649 IPOs and found the mean first day return to be 9.87%. More recently, Aggarwal and Rivoli (1990) found the average first day return for a population of 1598 IPOs from 1977-1987 to be 10.67%. Finally, Ritter (1991) examined 1526 IPOs from 1975-1984 and found the mean first day return to be 14.06%.

Another area that has received attention in the underpricing literature is the returns of IPOs one-week after going public. One of the first studies to examine this was Reilly and Hatfield’s (1969) study of 53 IPOS from 1963-1969. They found the first week returns for their sample to be nine percent. First week returns for a sample of 142 IPOs in 969 was 28.5% (see McDonald and Fisher, 1972). In 1974, Neuberger and Hammond examined 816 IPOs and found the average first week return to be 17.1%. Other researchers (see Reilly, 1977; Block and Stanley, 1980; and Nueberger and LaChapelle, 1983) calculated one week returns of 10.9%, 5.96%, and 27.7%.

Overall, previous research indicates that underpricing does occur in the after-market. This leads to our two hypotheses:

Hypothesis 1: The mean price of the stock at the end of the first day of trading for the entire population of Internet IPOs will be significantly higher than the mean initial offering price.
Hypothesis 2: The mean one week return for the entire population of Internet IPOs, excluding the first day, will significantly underperform the NASDAQ and S&P 500 Indexes.

DATA AND METHODOLOGY

Sample

This study utilized the entire population of Internet IPOs that went public up to 4/19/99. The total number of IPOs during this time frame was 112, however the final sample size was 109. The data from three companies was thrown out due to a lack of reliability. The sample consisted of firms that offered common stock only and had an investment banker that took them public.

Information on the initial offering size, total assets, net sales, net profit, organizational age and the firms’ stock prices were obtained from each firm's prospectus, Disclosure Inc. and Standard and Poor’s Daily Stock Price Record.

Similar to other studies (Deeds, DeCarolis, and Coombs, 1997; Finkle, 1998) the initial offering size (IOS) was calculated by subtracting the underwriter’s fees from the total value of capital raised during a firm’s IPO. IOS was controlled for inflation using the Consumer Price Index.

Table 1 shows the descriptive characteristics of the sample. The first Internet IPO was America Online in 1992. The largest number of initial offerings occurred in 1998, 31. However, 27 firms have already gone public as of April 19, 1999 with several other Internet companies making offerings every week.
Results of Table 1 also indicate that the average age of a firm was 4.5 years. The mean amount of money raised during an IPO was $48.2 million and the total amount of money raised for the sample was $5.25 billion. The mean amount of net sales, net income and total assets at the time of an IPO was $20.4, -$10.9 and $23.9 million. The findings indicate that the average Internet firm was losing a significant amount of money at the time of their offering.

To examine whether the phenomenon of underpricing existed in the after-market, we calculated the initial period return (after the first day of trading) and one week buy and hold returns. All returns were adjusted using two benchmarks, the NASDAQ and S&P 500 Index.

The first day adjusted return for stock $i$ was defined as the percentage change in price from the offering date to the close of at the first day of trading ($r_i$) subtracted by the change in the benchmark used ($r_m$).

$$ar_i = r_i - r_m$$

The first week adjusted return for stock $i$ was defined as the percentage change in price the close of the first day of trading to the close of the first week of trading ($r_{in}$) subtracted by the change in the benchmark used ($r_{mn}$). Thus, the change in price from trading days 2 through 5.

$$ar_{iw} = r_{in} - r_{mn}$$
RESULTS

First Day Returns

It was hypothesized (H1) that the mean stock price at the end of the first day of trading for an Internet IPO would be significantly higher than the mean initial offering price. This hypothesis is supported through the results in Table 2. After performing a t-test, we found a positive significant difference (.00 < p) between the mean initial offering price ($14.2) and the mean closing price at the end of the first day of trading ($27.15).

Table 3 reports the mean first day return for the entire sample of Internet IPOs was 80.5%. The mean adjusted returns utilizing the NASDAQ and S&P 500 Indexes were 80.7% and 80.6%. There was no significant difference between the Internet IPO first-day returns and the returns of the indexes. Furthermore, only 6.4% of the issues had negative returns after the first day of trading.

Table 4 examines the pattern of first day returns over time. The years 1993, 1998 and 1999 had the highest first day returns; 49.4%, 91.6% and 154.1%. The lowest return can be seen in 1994 at 1.2%. It appears that the amount of underpricing is increasing with time.
Cross-Sectional and Time-Series Patterns in the After-market Performance of IPOs

It was hypothesized (H2) that the mean one-week return for the entire population of Internet IPOs, excluding the first day, will significantly underperform the NASDAQ and S&P 500 Indexes. Results indicate that the mean raw return of the Internet IPOs was -1%. The mean adjusted returns for the NASDAQ and S&P 500 Indexes were -2% and -1%. Using a t-test to test Hypothesis 2, we found no significant differences between the raw return and the NASDAQ and S&P 500 indexes (p < .50 and p < .68).

Upon further examination of the one-week returns, the highest percentage increase was 2.3% in 1992 and 1999. In between these time frames, 1995 through 1998 had negative returns with 1996 having the largest negative return of 5%.

Table 6 provides further insight into the after-market performance of the IPOs by classifying the Internet returns by the size of their initial public offering. The findings indicate that 62% of the IPOs had offerings greater than $30 million. The largest first day returns, 107.2%, were associated with offerings of $30 million or more. Only 1.8% of the IPOs had offerings in the range of $1-5 million with the smallest first day returns, 4.7% in this group.
DISCUSSION & CONCLUSION

This study evaluated data on the entire population of Internet firms that made IPOs. The study fills a gap in IPO and entrepreneurship research by determining if the underpricing phenomenon occurs within the Internet industry. The findings partially support the major theoretical underpinnings of the study. Significant underpricing occurred after the first day of trading, however no significant underpricing was evident after the first week. The average first day return for the entire sample of Internet IPOs was 80.5% while the market-adjusted NASDAQ and S&P 500 returns were 80.7% and 80.6%.

Previously, the largest amount of underpricing that had been documented after the first day of trading was Logue’s (1973) study that found the average IPO to be underpriced by 30%. The findings indicate that the underpricing phenomenon is industry specific.

However, no support was found for underpricing for one-week after the IPO. The raw return for the sample of Internet IPOs was –1% while the NASDAQ and S&P 500 market-adjusted returns were –2% and –1%. These returns are significantly lower than previous studies that have shown returns from 5.96% (Block and Stanley, 1980) to 28.5% (McDonald and Fisher, 1972).

The results of this study will benefit Internet entrepreneurs contemplating an IPO. Clearly, this study indicates that the market does play a major factor in a firm’s ability to raise capital in the after-market. Firms are losing out on potential funding that could make or break a company. However, we are seeing Internet entrepreneurs adjusting the capitalization structure of their IPOs to make up for the potential loss of capital. For example,
Mpath Interactive, an online gaming company, raised their initial offering price from $10-$12 to $14-$16. The day they actually went public, the offering price was $18. This resulted in an increase of $31.2 million to the company.

Internet firms that plan on going public have the ability to negotiate with their investment bankers up-front to obtain the best possible IPO method and price. Generally, investment banks prefer the underwriting method. An underwritten issue guarantees that the entire issue of stock will be sold at the IPO price with the investment banker taking the risk for any unsold shares. Compensation to the investment banker may be in the form of cash (from the underwriting spread) and possibly a bonus in the form of an over-allotment option. This option gives the investment banker the right to purchase more stock at the new issue price. Unfortunately, these forms of compensation give the investment banker two different incentives to underprice the issue. First, underpricing encourages the issue to sell out quickly so that the investment banker is not “stuck” with unsold shares. Second, when underpricing encourages a quick rise in the after-market price, the over-allotment option then becomes valuable. Entrepreneurs should be cautious when negotiating an underwriting with the investment banker, realizing that the investment banker has incentives to underprice the issue.

An alternative to the underwritten IPO, though not that popular with investment bankers, is the “best efforts” offering. In a best efforts offering, the investment banker agrees to act as an agent to sell the shares for a commission only. While the best efforts method minimizes incentives to underprice for the investment banker, should the issue not sell completely, the company is limited by the entire amount of capital it planned on raising.
In conclusion, this study has confirmed the existence of underpricing within the Internet industry. Future research still needs to be performed in this area. For instance, a follow-up study should examine if underpricing occurs over the long-term in the Internet industry. Furthermore, replications of this study could be performed with other emerging industries (e.g. semiconductors and software) to check the validity of the findings. In addition, comparative studies should be performed, contrasting how underpricing occurs in other industries over different periods of time.
REFERENCES


Table 1

Characteristics of Internet IPOs, 1992-1999

<table>
<thead>
<tr>
<th>Year</th>
<th>No. of IPOs</th>
<th>Mean Age of Firm (Years)</th>
<th>Total Issued ($ millions)</th>
<th>Mean IOS ($ million)</th>
<th>Mean Net Sales</th>
<th>Mean Net Income</th>
<th>Mean Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>1</td>
<td>7</td>
<td>8.7</td>
<td>8.73</td>
<td>19.5</td>
<td>1.50</td>
<td>14.47</td>
</tr>
<tr>
<td>1993</td>
<td>2</td>
<td>7</td>
<td>23.6</td>
<td>11.8</td>
<td>11.9</td>
<td>.82</td>
<td>10.11</td>
</tr>
<tr>
<td>1994</td>
<td>2</td>
<td>9</td>
<td>11.6</td>
<td>5.82</td>
<td>14.3</td>
<td>1.7</td>
<td>8.6</td>
</tr>
<tr>
<td>1995</td>
<td>6</td>
<td>4.7</td>
<td>263.5</td>
<td>43.9</td>
<td>13.8</td>
<td>-2.8</td>
<td>12.1</td>
</tr>
<tr>
<td>1996</td>
<td>23</td>
<td>4.3</td>
<td>668.9</td>
<td>29.1</td>
<td>6.9</td>
<td>-2.7</td>
<td>8.8</td>
</tr>
<tr>
<td>1997</td>
<td>17</td>
<td>4.4</td>
<td>632.2</td>
<td>37.2</td>
<td>13.9</td>
<td>-20.3</td>
<td>28.9</td>
</tr>
<tr>
<td>1998</td>
<td>31</td>
<td>3.5</td>
<td>1490.2</td>
<td>48.1</td>
<td>10.5</td>
<td>-9</td>
<td>16.1</td>
</tr>
<tr>
<td>1999</td>
<td>27</td>
<td>5.2</td>
<td>2150.2</td>
<td>79.6</td>
<td>43.6</td>
<td>-19.2</td>
<td>47.3</td>
</tr>
</tbody>
</table>

Total 109 4.5 5248.9 48.2 20.4 -10.9 23.9
**Table 2**

*Initial Stock Price and Closing Stock Price after the First Day of Trading*

|                  | Initial Stock Price | Closing Price First-Day | T-Test
|------------------|----------------------|--------------------------|--------
| **Mean**         | 14.20                | 27.15                    | .00 < p |
| **Standard Deviation** | 5.16                | 19.04                    |        |
| **First Quartile %** | 9.75                | 11.56                    |        |
| **Median %**     | 15.00                | 21                       |        |
| **Third Quartile %** | 17.00               | 39.94                    |        |
Table 3

First Day Internet IPO Returns and NASDAQ & S&P 500 Index Returns, 1992-1999

Mean First Day Returns

<table>
<thead>
<tr>
<th></th>
<th>IPOs</th>
<th>NASDAQ</th>
<th>S&amp;P 500 Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mean</td>
<td>80.5</td>
<td>80.7</td>
<td>80.6</td>
</tr>
<tr>
<td>Standard Deviation</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>First Quartile %</td>
<td>16.6</td>
<td>17</td>
<td>17.2</td>
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<tr>
<td>Median %</td>
<td>44.2</td>
<td>43.9</td>
<td>43.4</td>
</tr>
<tr>
<td>Third Quartile %</td>
<td>124.8</td>
<td>124.7</td>
<td>125.2</td>
</tr>
<tr>
<td>% issues with negative first day returns</td>
<td>6.4</td>
<td>6.4</td>
<td>7.3</td>
</tr>
</tbody>
</table>
Table 4
First Day Returns by Year of Issuance for Internet IPOs and NASDAQ & S&P 500 Index, 1992-1999

Mean first day returns

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of IPOs</th>
<th>IPOs</th>
<th>IPO minus NASDAQ Index</th>
<th>IPO minus S&amp;P 500 Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>1</td>
<td>28.3</td>
<td>28.1</td>
<td>28.1</td>
</tr>
<tr>
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<td>29.3</td>
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<td>1997</td>
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<td>27</td>
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<td>1998</td>
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<td>27</td>
<td>154.1</td>
<td>157.4</td>
<td>157.7</td>
</tr>
<tr>
<td>Mean</td>
<td>109</td>
<td>80.5</td>
<td>80.7</td>
<td>80.6</td>
</tr>
<tr>
<td>Year</td>
<td>Number of IPOs</td>
<td>IPOs</td>
<td>IPO minus NASDAQ Index</td>
<td>IPO minus S&amp;P 500 Index</td>
</tr>
<tr>
<td>------</td>
<td>----------------</td>
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<td>1993</td>
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<td>1998</td>
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<td>2.3</td>
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<tr>
<td>Mean</td>
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<td>-1</td>
<td>-2</td>
<td>-1</td>
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Table 6
Internet IPO Mean Returns for One Week After the Initial Issue Date by Size of Issue, 1992-1999

Mean first day returns

<table>
<thead>
<tr>
<th>Issue Size</th>
<th>Number of IPOs</th>
<th>IPOs</th>
<th>IPO minus NASDAQ Index</th>
<th>IPO minus S&amp;P 500 Index</th>
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<tbody>
<tr>
<td>($ millions)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1 to 5</td>
<td>2</td>
<td>4.7</td>
<td>5.1</td>
<td>5.3</td>
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<td>5 to 10</td>
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<td>35.2</td>
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<td>10 to 15</td>
<td>7</td>
<td>17.3</td>
<td>17.6</td>
<td>17.4</td>
</tr>
<tr>
<td>15 to 20</td>
<td>7</td>
<td>36</td>
<td>34.5</td>
<td>34.2</td>
</tr>
<tr>
<td>20 to 25</td>
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<td>66.4</td>
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<tr>
<td>25 to 30</td>
<td>14</td>
<td>43.4</td>
<td>43.6</td>
<td>43.3</td>
</tr>
<tr>
<td>30 and up</td>
<td>67</td>
<td>107.2</td>
<td>106.9</td>
<td>106.8</td>
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<tr>
<td>Full Sample</td>
<td>109</td>
<td>80.5</td>
<td>80.7</td>
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</table>
Biographical Sketch of Authors

**Dr. Todd A. Finkle** is an Assistant Professor of Management and Fellow at the Fitzgerald Institute for Entrepreneurship at the University of Akron. He received his Ph.D. from the University of Nebraska-Lincoln. His teaching and research interests lie in the area of entrepreneurship, franchising, and small business management.

**Dr. Dan W. French** is a Professor of Finance at New Mexico State University. He received his Ph.D. from Louisiana Tech University. His teaching and research interests lie in the area of financial management, investments, and small business finance.
RESPONSE TO REVIEWERS’ 1 & 2

1. Suitability for the Journal of Business and Entrepreneurship:

Reviewer 1: We feel that the article makes a contribution to the entrepreneurship literature by reporting the reactions of stocks during certain periods in history. In this instance, we learn that due to the significant underpricing within the Internet industry (an emerging industry), companies are affected in their ability to raise capital, an important part of the entrepreneurial process.

2. Adequacy of Method and Analysis:

Reviewer 1: This study is unique because it focuses on a relatively new industry. Also, very few studies exist within the underpricing literature that focus on specific industries. Moreover, the results of the study indicate that the Internet industry is unique to the general population of IPOs. The average underpricing for an Internet IPO was 80%, whereas the average underpricing for an IPO in other studies was 14.3%.

3. Originality:

Reviewer 1: The paper as stated earlier is unique and original in the sense that no one has ever studied the underpricing effect of Internet initial public offerings.

We have defined the Internet on the opening page of the article in the second and third paragraphs.

We feel that the motivation for the study was addressed. On the third page of the manuscript we state the following paragraph:

The results of this study will assist Internet entrepreneurs in their quest for an IPO for several reasons. First, the Internet industry is a young emerging industry (most are under 15 years old) (Kazanjian and Drazin, 1990) where companies like Yahoo and Netscape are playing a key role in the economic development of the United States. Internet entrepreneurs will be able to take the results from this study to examine if any irregular patterns exist in the after-markets. Oftentimes patterns exist in the after-markets that may cause companies to lose capital that might have been useful to the long-term survival of the firm. In the example above, Theglobe.com lost $169 million in potential revenue that might have assisted in the growth and survival of the company. If the CEO of Theglobe.com and other Internet entrepreneurs understood the underpricing phenomenon in the after-market, they might be able to proactively respond by changing their capital structure (Schiller, 1990).

4. Presentation:

Reviewer 1: Please see response to reviewer number three.
5. Other:

Reviewer 1: While we realize that the sample size for these years is very low, we must note that we have collected data for the entire population. Therefore, in our opinion all of the data should be included in the study.

RESPONSE TO REVIEWER 3

- Why was the response rate only 97%? The total number of IPOs during this time frame was 112, however the final sample size was 109. We had to throw out three companies due to the unreliability of the data.

- How do we set a correct IPO price? How do we fix the problem?

  We added a section to the discussion section on pricing IPOs and a suggestion on how to resolve the problem. The following has been added:

  Internet firms that plan on going public have the ability to negotiate with their investment bankers up-front to obtain the best possible IPO price. Generally, investment banks prefer to underwrite where their compensation is stock and an over allotment option to purchase more stock. However, Internet companies may be able to increase their ability to raise money if they negotiate a “Best Efforts” deal with the investment bank.

  A “Best Efforts” contract guarantees that the entire amount of stock issued will be sold at the IPO price. If the issue doesn’t sell, the investment bank is required to purchase the remainder of the shares at the offering price. The investment bank is paid through a commission.