IPOs: Land of opportunity or risky wager?

Some highly anticipated IPOs may be ahead. They can be enticing, but exercise caution.

Following a strong multiyear run, the initial public offering (IPO) market has been weak over the past two years. In 2016, the number of IPOs hit its lowest level since 2009, and those deals raised the lowest dollar value since 2003 (see IPO activity slowed again in 2016 chart). Among the contributing factors: market weakness early in the year, and uncertainty surrounding Brexit and the U.S. elections.

Despite the recent IPO activity recession, returns rebounded in a big way last year, and several signs suggest 2017 could be a turnaround year for IPO activity.

IPO activity slowed again in 2016.
IPO activity ramping up

Already, several high profile companies have filed for, retained underwriters, or taken initial steps targeting a 2017 IPO. Among the largest potential deals by proceeds to be raised are smartphone app transportation service provider Uber, rental website operator Airbnb, cloud storage provider Dropbox, photo sharing app designer Snap, photo sharing website Pinterest, music-sharing firm Spotify, and analytics platform Palantir.¹

Overall, Renaissance Capital—which tracks IPO activity—is forecasting 150 to 200 IPO offerings this year, up from 105 in 2016, raising anticipated proceeds in the range of $30 to $50 billion, up from $18.8 billion in 2016.

2016 in review

Although 2016 marked the second consecutive relatively weaker year for IPOs, by both the number and total proceeds, several notable companies debuted last year. The top 10 IPOs by size were ZTO Express (ZTO), Athene Holding (ATH), MGM Growth Properties (MGP), U.S. Foods Holding (USFD), LINE (LN), Valvoline (VVV), Extraction Oil & Gas (XOG), Patheon (PTHN), Red Rock Resorts (RRR), and First Hawaiian (FHB).²

More important, investors were generally rewarded by IPOs; the average total return of all IPOs last year was up 23.1% from the offer price, the best performance in three years (see U.S. IPO return statistics table). That was led by tech-sector IPOs, which gained 40% on average last year, versus a 2% drop in 2015.¹ Moreover, a majority of IPOs finished 2016 above their offering price, compared with only 43% in 2015.¹

Renaissance Capital asserts that a low number of IPO offerings has oftentimes resulted in relatively stronger short-term returns, as those that do make it to market in a low issuance period tend to be brought at more attractive valuations.

Average returns for IPOs can vary widely.

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<tbody>
<tr>
<td>Average Total Return</td>
<td>-9.8%</td>
<td>20.5%</td>
<td>40.8%</td>
<td>21.0%</td>
<td>-2.1%</td>
<td>23.1%</td>
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<td>Average First-Day Return</td>
<td>10.5%</td>
<td>14.1%</td>
<td>17.3%</td>
<td>13.5%</td>
<td>14.3%</td>
<td>11.4%</td>
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<tr>
<td>Average Aftermarket Return</td>
<td>-17.5%</td>
<td>5.6%</td>
<td>20.3%</td>
<td>7.2%</td>
<td>-13.5%</td>
<td>-11.0%</td>
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<tr>
<td>% Trading Above Issue at Year-End</td>
<td>59.2%</td>
<td>38.3%</td>
<td>21.6%</td>
<td>40.7%</td>
<td>51.1%</td>
<td>70.2%</td>
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<td>% Deals with Negative First-Day Return</td>
<td>32.8%</td>
<td>18.8%</td>
<td>26.6%</td>
<td>27.3%</td>
<td>27.1%</td>
<td>25.4%</td>
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<td>% Deals Priced Below the Range</td>
<td>34.4%</td>
<td>39.8%</td>
<td>28.8%</td>
<td>40.0%</td>
<td>32.9%</td>
<td>32.3%</td>
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Source: Renaissance Capital. Includes IPOs with a market cap of at least $50 million, and excludes closed-end funds and SPACs. Data through 12/31/16.
Caution is warranted

IPOs can generate buzz among investors, particularly for so-called “hot issues” that garner a lot of interest. But beware of getting caught up in the hype: IPO investing can be complex, and may be suitable only for experienced investors. Be sure to consider any opportunities within the constraints of your unique investment goals and risk tolerance.

There are unique considerations to keep in mind when it comes to investing in IPOs. For instance, the stock of an IPO can be particularly unpredictable on its first day—and also the first few months—of trading. For every AT&T (T), Google (GOOG), and Visa (V) that had successful IPOs and are now entrenched leaders in their respective industries, there is a long history of initial public offerings that have not performed well.

Moreover, extracting value out of IPOs, even successful ones, can be tricky for a retail investor. For example, suppose you identify an IPO that you find attractive as a long-term investment, and the price at which it begins trading on the IPO date is $20. If you were to buy the shares at around this price, and by the end of the IPO day the stock price had risen to $30, you might think, “I’ve hit the jackpot!”

But take a step back. This means that the company and its underwriters (a financial group, typically a bank that is responsible for determining the market price of an IPO) underestimated demand for the company’s stock. Therefore, the company lost out on the opportunity to raise more money to grow its business, because the IPO was mispriced (i.e., instead of receiving let’s say $30 a share from the public, it will have received only $20 a share).

In this scenario, if you were looking for short-term profits, great. If you are a long-term investor, however, a mispriced IPO may not be in your best interest.

Do your homework

Like any other investment, before making a decision regarding an IPO, you should review your investment goals and conduct a thorough analysis of the company, along with its growth prospects. Beyond the general risks associated with an individual investment opportunity, there are distinctive risks associated with IPO investing, each IPO is unique, and it needs to be evaluated independently to determine its investment potential.

IPOs and you

Individual Fidelity investors can sign up to participate in an upcoming IPO (login required and there are eligibility requirements).

For example, one of the primary difficulties that retail investors face when it comes to researching companies that have not yet become public is the extent to which there is access to information. Publicly traded companies in the U.S., for example, are required by the Securities and Exchange Commission to disseminate financial information quarterly. Private companies are not required to do the same.

Consequently, for the individual investor who does not have access to this information, it can be hard to fully assess the company’s merits as a sound investment. A key source of information for an IPO is the prospectus.

One way that you might be able to navigate the intricate IPO waters is to consider an actively-managed fund. Investing with a fund or manager can help you obtain the resources to do the necessary research for a thorough analysis. Large investors like Fidelity have the research capabilities and resources needed to invest in the pre-IPO stage, which most individual investors are not able to do.

If you are considering investing in an IPO, know the risks and be sure to do your homework.
Learn more

- Research the basics of IPOs.
- See how you can participate in an upcoming IPO (login required).
- Research stocks.

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