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HEARD ON THE STREET

Why IPOs Still Use the Old Way

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When Morningstar Inc.'s executives asked investment bankers from **Morgan Stanley** last fall about using an unusual electronic "auction" method to sell shares in Morningstar's initial public offering, two top executives of the Chicago investment-research firm recall, the initial response was open-minded.

After all, Morgan Stanley had just led a high-profile IPO for **Google Inc.** using the auction format in August 2004. "Their attitude initially was, 'You're the client. We do what the client wants to do,' " says Joe Mansueto, Morningstar's chief executive.


But when **Morningstar** got serious about the idea, he and the firm's chief financial officer say, a Morgan Stanley capital-markets executive, Jon Anda, flew to Chicago to warn Morningstar executives that an auction carried a high risk of an "adverse outcome." When Morningstar persisted, Mr. Anda and a fellow banker warned two outside Morningstar directors that Morgan Stanley might withdraw from the IPO. And when Mr. Mansueto, backed by the directors, stuck by the auction idea, the New York securities firm did resign as lead underwriter.

Morgan Stanley's tactics in resisting use of an auction-style IPO, first offered by W.R. Hambrecht & Co. in 1999, provide a glimpse at how Wall Street firms have sought to discourage some corporate clients from selling shares in this nontraditional fashion. The approach is a form of a Dutch auction, named for a method in the Netherlands for selling tulips. In such an auction, the price is set based on the bids made by investors; the highest price that will fill all the orders is picked, though the bankers and a company may agree on a discount.

Despite the warnings from Morgan Stanley, the Morningstar IPO auction May 2 went smoothly. The stock rose 8.4% on its first day of trading and kept rising steadily, finishing yesterday up 55% from the offer price. At \$162 million, it was the largest auction IPO out of just a dozen led by Hambrecht in six years.

A Morgan Stanley spokeswoman said the firm wouldn't comment on the Morningstar executives' account of the meetings. However, detractors of the auction approach don't believe the smooth sailing of the Morningstar IPO disproves the risks cited by the bankers. They note that Wall Street's biggest clients, the buyout firms that repeatedly take companies public, aren't pressing for auctions, either. Last year, three of 251 U.S. IPOs used the auction method.

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FINDING NETHERLANDS

See a [graphic](#)⁰ explaining the Dutch method of selling shares in an initial public offering.

Wall Street bankers compare auction IPOs with selling fine art on eBay instead of at Sotheby's. The big Wall Street firms have good reason to defend the traditional model. Known as "book building," it entails gauging the interest of hedge funds and mutual funds in an offering. With fees of 7% of capital raised for most deals, it is lucrative. Book building also enables the Wall Street firms to dole out IPO stock at bargain prices to their best customers, which can be a boon if the IPO soars on its first day of trading.

The Hambrecht model takes that perk away by offering stock equally to all bidders -- at a discounted fee of 3% to 4%. Although fees didn't drive its decision, Morningstar paid only 2%, partly because Morgan Stanley had done early work on the deal, for which it ended up unpaid.

"The auction system takes a bit of the power away from the underwriters," says David Menlow, president of IPOfinancial.com, an IPO-research concern in Millburn, N.J.

For example, Boston mutual-fund titan Fidelity Investments often receives large IPO allocations, based partly on its status as a big customer. Fidelity, which submitted a bid of \$17.50 a share for 2.2 million Morningstar shares, received zero shares, according to people familiar with the IPO. That is because Morningstar, which sold 8.75 million shares, received bids from other investors for 13.4 million shares at prices at or above \$18.50.

The auction detractors argue that because winning bidders in the Morningstar auction received only 65% of the number of shares they bid for, Hambrecht set the IPO price low enough to ensure the stock price would rise once trading began -- just as big Wall Street firms attempt to do.

Mr. Mansueto says the auction's prospect of "fairer pricing and equal access to allocations" appealed to Morningstar, which itself aims to level the playing field for average investors by offering research on stocks and mutual funds.

Other executives say other Wall Street firms similarly have steered them from auctions. Patrick Byrne, chief executive of online retailer Overstock.com Inc., recalls bankers saying he would be "a pariah on Wall Street" if he used an auction. Undeterred, Overstock.com went public in a Hambrecht auction in May 2002.

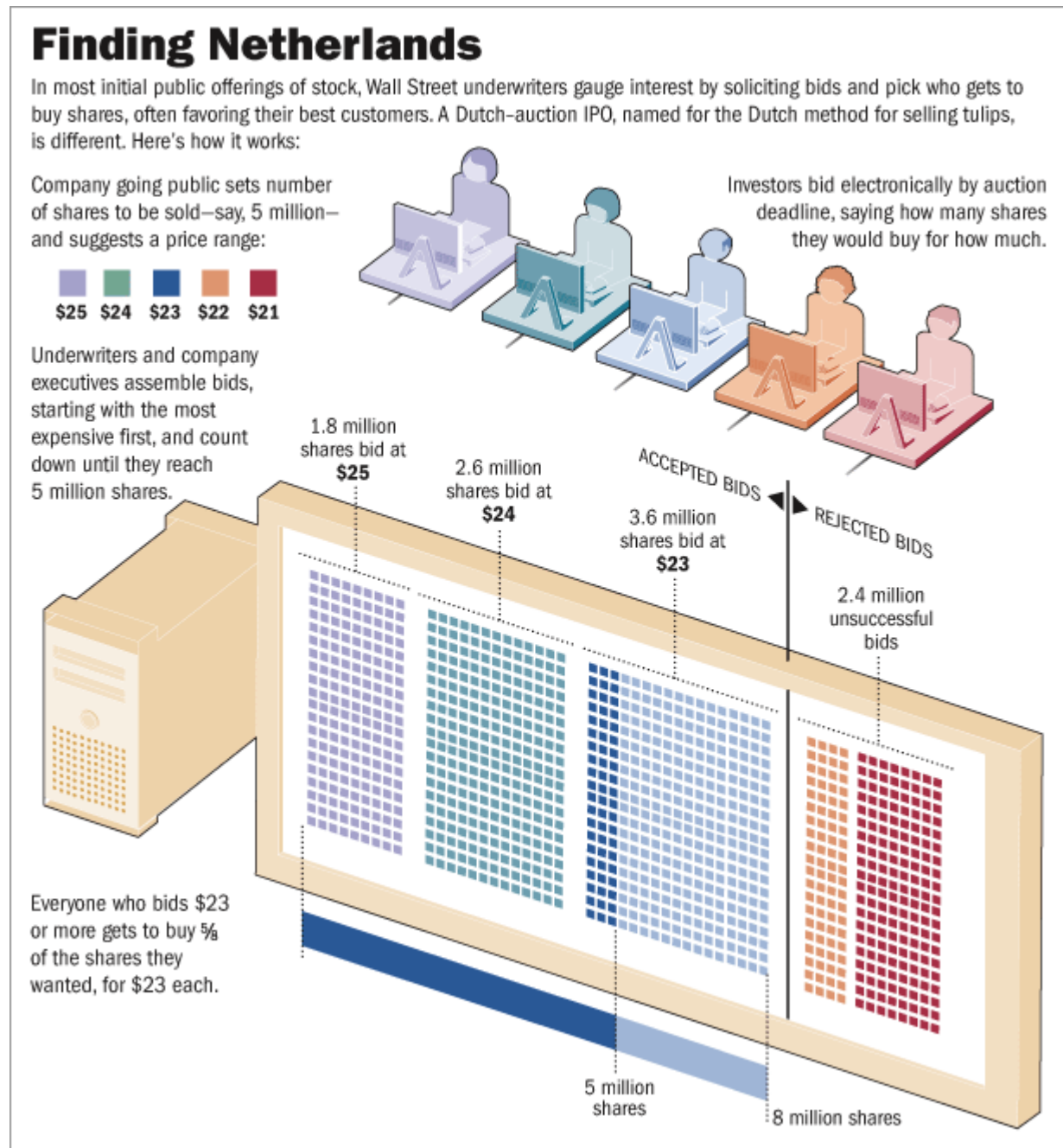
In Morningstar's instance, Mr. Mansueto says Morgan Stanley banker William Strong, after initially saying the firm would consider an auction, said the approach wouldn't make sense for Morningstar. He then helped set up a meeting with Mr. Anda, who had worked on the Google IPO. In that meeting, Mr. Mansueto and Morningstar Chief Financial Officer Martha Boudos recall, Mr. Anda warned that auctions were unproven and carried the "adverse outcome" risk. Translation: The bids might be insufficient, or overexuberant individual investors might overpay and then get burned.

"Price discovery" was more difficult in an auction, they recall the bankers warning. One Morgan Stanley banker noted that Morningstar's various operations -- in addition to stock and fund research for individuals as well as professional advisers, it has consulting and money-management services -- complicated its story. The banker also cited conservative accounting for stock options.

Mr. Anda later met in Chicago with director Steven Kaplan, a University of Chicago finance professor, with another director listening by phone. Mr. Kaplan subsequently consulted academics Jeremy Stein of Harvard and Jay Ritter of the University of Florida, who both urged an auction. Mr. Kaplan concluded that the standard Wall Street IPO price discounts, together with the 7% fee,

enabled underwriters and their customers collectively to keep as much as 20% or more off the top of every IPO.

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