Going Public—Microsoft, 1986

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Abstract

The case takes the reader through the IPO process using the Microsoft 1986 public offering as an illustration. It reveals the motivations of the corporate participants and investment bankers, the interaction between the market and firm's fundamentals, and the negotiation process in setting the offer price. It begins with Microsoft executives' internal discussion and reasons for considering an IPO, continues with the process of selecting underwriters, and goes on to trace the events of the road show process. Ultimately, it reveals how the final offer price and the underwriting fees were negotiated.

Keywords: offer price, syndicate, prospectus, road show, institutional investor, the book

Introduction

On March 13, 1986, Microsoft had a highly successful initial public offering (IPO) at an *offer price* of $21. By the end of the day, the stock price had risen to $35.50, and Bill Gates made the headlines as the wealthy owner of 45 percent of the corporation's stock. The actual public offering occurred at the end of an arduous 5-month process during which underwriters were selected, numerous legal and regulatory issues were hammered out, potential investors were courted, and the expected terms of the offering changed dramatically. At various points during the process, the expected offer price varied from $15, to a range of $16-$19 suggested by Bill Gates even as the underwriters were suggesting $17-$20, to a range of $20-$22. More than most firms, Microsoft took a hands-on approach to the IPO process rather than deferring to Wall Street underwriters to the extent most firms do. (*Fortune*, 1986)

Founded in 1975, Microsoft was in 1986 the oldest major producer of software for personal computers, its largest products being the nonmenu driven PC-DOS and MS-DOS operating systems, which ran the operating systems of the IBM computers and clones. Microsoft also sold applications programs such as spreadsheets and word processing software for IBM and Apple personal computers. It is noteworthy that these packages gave the company a broader product line than some of its competitors. In addition, the firm was somewhat late in offering its stock publicly as compared with other software companies. The relative lateness of Microsoft's IPO derived in part from the desire of Bill Gates to maintain control and the fact that Microsoft was not dominated by *venture capitalists* eager to harvest their gains (only one venture capitalist, with a 6.2 percent share of the company). In addition, Microsoft had no real need for capital, with pretax profits running as high as 34 percent of revenues (*Fortune*, 1986). However, Gates had been selling shares and granting stock options to talented managers and cutting-edge programmers, and projections indicated that by 1987, the firm would have over 500 shareholders, so Microsoft would have to register with the SEC. Once registered, the firm would be for all practical purposes publicly traded but would have a very narrow market. So in fall 1985, Gates reluctantly agreed in an internal corporate meeting to go public in order to gain broader ownership, but reserved the right to back out of the decision at any time before the stockholders' meeting of October, 1985. (*Fortune*, 1986)

The Decision to Go Public

At the October stockholders' meeting, Gates made the commitment to begin the IPO process. The chief financial officer (CFO) accepted the task of finding underwriters to handle the IPO. Finding an underwriter was easy, since investment bankers had been courting him heavily, the smell of hefty fees in the air. He decided that he would select a first rank firm as the lead underwriter, with a "*boutique*" firm to co-manage the offering, thus enhancing Microsoft's appeal to investors with a specific interest in technology stocks. Some of the larger firms such as Merrill Lynch and Shearson Lehman were immediately ruled out, as they had too little experience with technology firms. Eventually, the participants put together a *syndicate*, a group of investment bankers sharing the risk of underwriting this huge stock offering, which finally came to number 114 firms (*Fortune*, 1986). Beginning with a small group of possible firms to serve as lead underwriters and to co-manage the offering, Microsoft narrowed the field to two, Goldman Sachs and Alex. Brown, neither of which had yet taken the step of going public

themselves, although Brown was preparing to do so. (*Forbes*, 1986) The original pool of candidates was selected systematically, and it was understood that any of these firms had the technical capability to carry the deal to completion. Ultimately, the final choices came down to personal chemistry—how well their representative got along with Gates, the CFO, and the rest of the Micro team. The following quote indicates how subjective the decisions were: Following an expensive dinner with Goldman Sachs, Gates said, "Well, they didn't spill their food, and they seemed like nice guys." Similar judgments were rendered regarding Alex. Brown. Microsoft's board accepted this logic and quickly approved Goldman and Brown. (*Fortune*, 1986)

Preparation for the Public Offering

On December 17, the offering got under way with a huge formal meeting at Microsoft headquarters, involving Microsoft's managers, its auditors, both managing underwriters, and their attorneys—always, the lawyers. A high priority for Microsoft was making its *preliminary prospectus*, or *red herring*, "*jury proof*." This term means that the prospectus is so carefully phrased that no investor could sue based on the claim that s/he was misled. The task was to make the preliminary version of the prospectus conservative enough that the SEC would not require heavy revisions while also avoiding making it so conservative that it failed to attract investors. During the promotional period, Microsoft would be limited to touting the stock based solely on information in the prospectus, as any claims made that were not covered by the prospectus could be grounds for a lawsuit. The attorneys spent weeks working on this document, and then the principals to the IPO met again to discuss its content. They discussed scenario upon scenario regarding what could go right or wrong. It was not until February 3 of the following year that copies of the final prospectus were sent to the regulators and the waiting process for the review by the SEC began. (*Fortune*, 1986)

As for the stock's offer price, Microsoft's expectation at this point was that it would sell the shares for $15. This offer price was intended to land Microsoft's PE ratio near the midrange of the PE ratios of other firms with recent IPOs—higher than those of that of Lotus Development Corporation and Ashton-Tate, which had narrower product lines than Microsoft, but lower than those of companies that create software for mainframes because they generally had longer track records and more stable earnings than Microsoft. Gates imposed an informal rule that no one should sell more than 10 percent of stock holdings—a total of 600,000 shares, compared with the company's expected sale of 2,000,000 shares. (*Fortune*, 1986)

By late January, the question of what stock price to expect had evolved a bit. A bull market had been in progress during this time, and now the underwriters were suggesting a price range of $17-$20 per share, but the preliminary prospectus indicated a possible offer price of $16-$19 per share. (*New York Times*, 1986) In an unusual move for corporate executives, Gates insisted on and got the lower price range. He felt secure with a minimum price of $16, believing that at this price, there was little risk of having to lower it, and he was uncomfortable with the $20 price because it would push Microsoft's market value above a half billion dollars, which he believed was too high. No decision was necessary at this point because the public offering would not occur for another two months or so, but the pricing issue continued to change and evolve with the market. (*Fortune*, 1986)

The next major step was the *road show*—a 10-day tour of eight cities by Microsoft executives and the underwriters, during which they would explain the offering to stockbrokers and *institutional investors*. The show began in Phoenix and ended with stops in Edinburgh and

London. Told that his entire presentation must be limited to the content of the prospectus, Gates complained that they were essentially taping his mouth, and asked, "You mean I'm supposed to say boring things in an exciting way?" Nevertheless, the road show went well. Gates and company successfully touted the upward trend, however uneven, of the firm's profits and Microsoft's freedom from long-term debt. In the terminology of corporate finance, the firm used no financial leverage. (*BusinessWeek*, 1986) Every stop played to a packed house, and many big institutional investors indicated they would buy as much stock as they were allowed to. In addition, the Dow continued to surge as the road show progressed. *The book*—the list of buy orders from institutional investors—was filled with orders and at favorable prices. Given how hot the offering was and the behavior of the market environment, Goldman Sachs told Microsoft they would have to consider raising the offer price from the $16-$19 range. (*Fortune*, 1986)

The principals to the IPO were raring to go with the offering as soon as possible, but control now lay entirely with the SEC. Finally, around March 4, an SEC reviewer called with the commission's comments on the preliminary prospectus, with numerous detailed questions: how Microsoft accounted for returned merchandise, whether Gates had an employment contract (answer: No), and most importantly, for assurance that Microsoft would allocate shares widely enough to make the offering truly public and not just a windfall for a few favored investors. Although nitpicky and calling for detailed responses, the lack of serious exceptions in the report came as a relief. Two days later Microsoft's attorneys and auditors called the SEC to negotiate changes. Soon after, the final prospective was inked. (*Fortune*, 1986)

After the negotiations and rewrites were completed, Microsoft was ready to make the offering. Goldman said that the book was the best they had ever seen. Further communication with large potential investors indicated that an offer price in the $20-$21 range would fly. Gates, now thinking more aggressively about the price to expect, called a private conference with key executives and discussed whether this range was too low. The result of the meeting was a price range of $20-$22. (*Fortune*, 1986) There seemed to be suspicion on his part that the big clients of Goldman would buy the stock from Microsoft too cheap and turn a quick profit. Goldman, however, expressed deep concern about such a high price, arguing that overpricing the stock by $1 would drive big investors away, taking the luster off the stock offering. Microsoft expressed concern that, in attempting to balance the interests of the institutional investors who were their ongoing clients against those of Microsoft, Goldman might be leaning too far in favor of the investors, with whom they would deal in future public offerings. They negotiated and ultimately compromised, agreeing to demand a price of $21. (*Fortune*, 1986)

The final decisions and the offering

When the $21 price was announced to the major investors, several indeed threatened to withdraw. Complicating matters, the market closed flat that day, and Sun Microsystems' stock, which had gone public just days before, had already fallen by nearly 10 percent. The following day, however, the Dow soared 43 points, a one-day gain of roughly 2.5 percent (*Economic Report of the President*, 1988), and Microsoft sent representatives to Goldman's New York office to negotiate the final offer price. As they negotiated, the Dow rose another 14 points, Oracle Systems had a successful public offering, and roughly half the investors threatening to withdraw agreed to stay in the game. The two sides easily agreed to finalize the $21 offer price. (*Fortune*, 1986)

Everything was now in place: the prospectus written, SEC approval given, investors at the ready, the market rallying, and the offer price set. It was obvious that the next step would be to proceed with the public offering, right? Wrong. There was the little matter of the underwriters' fee, or "*spread*." And truly, it was a comparatively little matter. Whereas the expected offer price had risen from an initial $15 to a final value of $21, the two sides now disputed whether underwriters' fee would be $1.30 as Microsoft wanted or $1.33 as Goldman wanted—a difference of $.03. Viewed from another perspective, the two were squabbling over whether the $4 million fee would vary by $93,000. Ultimately, they settled on $1.31, a half cent closer to Gates's proposal than to Goldman's. A done deal at last! (*Fortune*, 1986)

When the market opened the next morning, the SEC had Microsoft's filing package, and at 9:15 am Eastern time, the commission gave approval to trade. Twenty minutes later, the stock traded over the counter at $25.75, and by the end of the very first day, the price had risen to $27.75. This price compared to an expected price of $25, not anticipated to be reached until weeks after the offering. One of the most successful and lucrative IPOs in history had resulted in a highly successful launch for Microsoft, and Bill Gates owned what seemed a staggering $350 million of Microsoft stock plus $1.6 million in cash for the shares he sold. As a result, he would soon be the world's youngest billionaire, (*The Financial Post*, 1988) and in the years to come, the company would produce enormous returns to its investors, raising Gates's net worth to legendary levels. (*Forbes Asia*, 2008)

Concepts for discussion:

1. Several specialized terms are used in this case. Explain the meaning of the terms offer price, venture capitalist, boutique investment banker, syndicate, preliminary prospectus (red herring) vs. prospectus, jury proof, road show, institutional investors, the book, and, in the context of and IPO, the spread.
2. Most firms go public to raise capital, but Microsoft had no particular need for capital. Why, then, did it go public? What are the disadvantages of being a public rather than a private, or closely held, corporation?
3. Describe the steps in the IPO process. What features of the process account for the length of the period (5 months) from Microsoft's decision to go public until the offering occurred?
4. Why did Microsoft choose Goldman Sachs and Alex. Brown as its lead underwriters?
5. Which corporations' stocks did Microsoft use as comparables in setting its offer price, and why did it choose these firms? What data did it use from these comparables to set its offer price, and how might a risk factor such as breadth of product line have entered into the pricing decision? Why would the method used to set the offer price not have worked for a company operating at a loss? How might a company operating at a loss have priced its stock?
6. Explain what forces brought the anticipated offer price rose from $15 to $21 over time. What role did the attitudes of Gates and Goldman Sachs, on the one hand, and the stock market on the other, play in determining the ultimate price? What role did the book play?
7. Gates seemed concerned that Goldman Sachs might be underpricing the stock as the IPO approached. What motivation might Goldman have for doing this?
8. Who received the cash raised in the IPO?

9. Did the market price at which Microsoft launched yield a gain for the syndicate of underwriters, or a loss?

References

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Concepts for discussion--solutions:

1. The following are central concepts in the IPO process:

a. The *offer price* is the price at which a corporation expects to sell newly issued shares of stock in a public offering. The underwriters guarantee the corporation the offer price, but the amount they in turn receive from the initial investors is the actual price the investors pay at the time the stock goes public. The actual price the investors pay may differ from the offer price, producing a loss for the underwriters if the actual price is below the offer price or a gain if it is higher.

b. A v*enture capitalist* is an individual or firm that invests in unproven companies and/or products, generally before their stock is marketable. The venture capitalist typically undertakes high risk investments, some of which yield enormous returns and some of which fail entirely. If a venture capitalist(s) has a great enough share in the equity of a closely held corporation, it may force the company to go public to render its investment in the company liquid enough to cash in on. As noted, Microsoft's lone venture capitalist held such a small amount of equity in the company that it lacked the power to do so.

c. A *boutique investment banker* is small and highly specialized firm, as opposed to larger firms such as Goldman Sachs that handle huge IPOs across a broader range of industries.

d. A *syndicate* is a group of investment bankers which jointly underwrite a public offering, sharing the risk as well as the fees. In the act of underwriting the offering, the syndicate guarantees the corporation a price (the offer price), thus placing themselves at risk, as explained above. Formation of a syndicate is a means of spreading the risk associated with a large public offering. This contrasts with a "best efforts" offering, in which the investment banker refuses to guarantee a price to the corporation, promising only to obtain the best price possible, with the understanding that if the actual price is lower than expected, the corporation and not the investment banker sustains the loss.

e. A *preliminary prospectus*, also known as a "red herring," is the first version of a key document drawn up in preparation for the IPO. This and its subsequent revisions include the corporation's financial data, descriptions of its products, information about its management team, assessments of its opportunities and risks, and the like. This version of the prospectus becomes the basis for the pitch to investors during the road show and

sets the boundaries of the claims the corporation can make, as any statements to the public or investors lying outside the information in the prospectus would subject the corporation to potential lawsuits.

f. The *prospectus* is a revision of the preliminary prospectus and must received SEC approval before the initial sale of stock to the public.
g. Corporations and their investment bankers strive to structure as optimistic a prospectus as possible but one which is conservative enough that it will not provide investors a basis for filing a successful lawsuit in the event they sustain losses. A prospectus which is not likely to expose these entities to such a lawsuit is said to be *jury proof*.
h. The *road show*, arranged by the investment bankers, is the process under which the key corporate executives travel to several financial centers pitching the stock to institutional investors. The purpose of the road show is to stimulate investor interest, determine how many shares investors are like to buy, and at what price they are likely to buy them.
i. *Institutional investors* are pension funds, mutual funds, insurance companies and other large financial institutions. They purchase most of the shares sold in a public offering, and some in turn offer them to small investors on a resale basis.
j. *The book* is a record maintained by the investment bankers in the course of the road show, tracking the numbers of shares the various institutional investors express interest in buying and at what prices. If, as the road show progresses, the number of orders in the book closely matches the number of shares the firm intends to sell publicly and in a price range which supports the intended offer price, this indicates that the public offering is likely to be successful. The names and numbers in the book, however, are not contractual, and in the event of unfavorable developments near the end of the road show, potential investors may decide not to follow through with their intentions as recorded in the book.
k. *The spread* is the net difference between the offer price and that received by the corporation. The difference, agreed upon between the corporation and underwriters before the actual public offering, becomes profit to the syndicate if the offer price is realized.

2. Not only did Microsoft not need the capital, but Bill Gates was reluctant to subject the firm to the public reporting and other requirements of being a publicly traded corporation. However, corporations with 500 shareholders must register with the SEC even if it does not trade publicly. Given that Microsoft's ownership was approaching 500 stockholders and was thus going to have to register, the management decided that it should take the step of going public and gain the accompanying benefits of a wider and more liquid market for its stock.
   The disadvantages of going public are the reporting and other compliance requirements. A publicly traded corporation must provide a range of reports to the SEC including not only its financials but occasional informational releases when, for example, the corporation is affected by a material event such as a major change in management. These reports are costly to provide and subject executives to disclosure and scrutiny which a closely held corporation avoids.
3. There are many time-consuming steps in the IPO process, which explains why nearly half a year passed between the decision to go public and the actual event. The executives must identify investment bankers deemed capable of handling the public offering, considering such factors as size and the nature of the industry in which the firm operates.

This determination is followed by a selection process, in which corporate executives meet with representatives of the investment banking firms to discuss financial and other technical issues and to determine whether personal chemistry is such that the two sides can work together. In the event of a large offering such as Microsoft's, it may be necessary to solicit other underwriters to form a syndicate. Working together, the corporation and its lead underwriters (the members of the syndicate appearing at the top of the prospectus) draft the preliminary prospectus. A carefully revised version of the prospectus is sent to the SEC, which requires weeks to determine whether the prospectus is acceptable and if so, what revisions are required. In the meanwhile, the corporation and underwriters undertake the road show to stimulate and assess investor interest. (As the time required for all these activities passes, movements in the general stock market change expectations regarding the possible offer price and, in the event of a market crash, can kill a public offering entirely.) Once the SEC is satisfied with the revisions to the prospectus, the parties to the IPO are ready to go public, subject to final negotiations. The corporation and lead underwriters must agree on the spread, and just prior to the initial sale of stock, the offer price is finally set. The offer price is generally set at the last minute in order to minimize risk. If a major market fluctuation occurs between the determination of the offer price and the date of the offering, the underwriter may sustain a huge monetary loss or the corporation an opportunity loss.

4. The apparent reasons for Microsoft's choice of Goldman Sachs were its size, prestige, and experience in handling offerings of firms in the area of technology. Alex. Brown, a boutique firm, was chosen to co-manage the offering because its focus on technology stocks was expected to enhance the stock's appeal to the class of investors in technology stocks, who would have a special interest in firms such as Microsoft.
5. The offer price was based largely on price-earnings ratios. Microsoft and its investment bankers set the offer price so that its PE ratio would lie in the range of the market multiples of similar firms with recent IPOs. In particular, the goal was to have a higher PE than Lotus Development Corporation and Ashton-Tate, which had narrower product lines than Microsoft, but lower than the PE ratios enjoyed by producers of mainframe computers, a long established product which provided greater earnings stability. In general, a broad product line, stable earnings, and long firm history are associated with higher stock prices relative to earnings.
   This method would have failed for a company with negative profits because application of any multiplier to negative earnings per share would indicate a negative price. Companies sustaining losses would price their stocks on other metrics such as book value per share (from the equity section of the balance sheet) or sales per share.
6. As plans for the IPO progressed, the general stock market rallied, carrying all stock prices including Microsoft's higher. IPOs do not incur in a vacuum, with its own internal finances and prospects as sole determinants of price. IPOs have succeeded or failed depending upon whether the stock market rose or fell during the process. In this IPO, Goldman initially strove for a higher price than Bill Gates was comfortable with, but in the end was less aggressive. Bill Gates began cautiously, concerned that too high a price per share would imply an unrealistically high value for the firm as a whole. Over time, however, he became increasingly demanding, ultimately arguing for a price near the high end of the probable range. The book served as a gauge of the progress and probable success of the offering and provided those on the selling side confirmation of the

realization of the success they expected. Indeed, it at some points indicated that the offering would surpass their expectations and later indicated that the offering could unravel as institutional investors threatened to withdraw, when the offer price was set at $21, higher than their expectations.

7. Goldman could have been motivated to underprice the stock so that its institutional investors would be pleased with their realized returns and consequently be receptive to its future offerings of the stocks of other corporations. Corporations selling stock through underwriters are acutely aware that these financial institutions return to the market and to investors repeatedly, and that they have keen interests in ensuring the satisfaction of their repeat customers by setting offer prices low enough to provide them high returns.
8. It is interesting to note that, contrary to the typical textbook presentation, the proceeds of an IPO accrue not only to the corporation but also to those who hold stock in the company prior to the public offering and choose to harvest gains by selling some of their shares in the initial offering. Recall Gates's specification that no existing shareholder would sell more than 10 percent of shares owned. This limited the maximum total sale by existing shareholders to only 60,000 as compared with 2,000,000 by the corporation. Thus, the lion's share but not all of the funds raised in the offering accrued to the corporation. A larger sale by shareholders might have depressed the initial price somewhat but not a great deal, given the relative size of their holdings and the number of shares sold by Microsoft.
9. Clearly, the $21 offer price yielded a huge gain for the members of the syndicate. The haggling over the spread was a struggle to determine the relative sizes of the gains to be shared between sellers and underwriters and, it appears, a battle of egos. Because the market sustained the offer price, the underwriters' gains were enormous, but had the price fallen sufficiently below the offer price, they could have sustained significant losses, as occasionally occurs, especially when the general market declines after the offer price is set. The practice of setting the offer price just before the actual event is intended to minimize this risk. Consider that in this case, the process lasted nearly three months from the time Microsoft and its underwriters began, but the price was agreed upon just one day before the offering occurred.