Got IPO Fever? Take Two Aspirin and Proceed with Caution

The recent high-profile IPOs of Lyft and Uber have rekindled IPO fever. But prospective investors should look beyond the hype and be aware of access and other issues unique to IPOs.

Uber's disappointing IPO serves as a lesson in the risks of IPO investing.

Initial public offerings (IPOs) are on a roll. Recent months have seen several high-profile companies go public -- including Uber, Lyft, and Pinterest. Others, such as Slack, WeWork and Palantir, are expected to follow.

For investors looking for a "ground floor" opportunity, IPOs can be appealing. Consider Alphabet (formerly Google), whose shares went public in 2004 at an offering price of $85 per share. Taking into consideration stock splits since then, an investment in one share would be worth over $2,000 today.

But more IPOs end up going the way of eToys or Groupon. eToys saw its shares more than triple in price the first day of trading, but ended up in liquidation less than two years later. Groupon went public at a price of $20, and shares later opened for public trading at $28 per share. But less than 13 months later, shares traded for less than $5 each.

Then there's Facebook, which went public in May 2012, at an initial offering price of $38 per share. Although share prices subsequently tumbled to less than half that amount by year's end, they went on to recover, and today trade at over $180.

As Facebook's -- and more recently, Uber's -- experience aptly demonstrates, not all IPOs skyrocket in price after their debut. In fact, investors considering IPOs will want to think long-term, and do some homework first, starting with how to get hold of shares.

Accessing IPO Shares

Access to a popular IPO depends largely on your relationship with your broker. You'll need to have an account with a broker that has access to that deal, meaning one of the investment banks that are part of the selling syndicate. Large IPOs will typically have a lead underwriter as well as a host of secondary underwriters that are allocated a certain number of shares through distribution alliances.

If you have an account with one of the brokerage firms involved in the offering, you'll need to contact them to see if shares are available. Availability of shares will depend upon the size of the deal, how large an allocation your brokerage is getting, how big your account is, how long you've been a client and how much trading you do. And not all brokers get access to IPO shares -- access to "hot" issues may be reserved for certain parties.

Another option to getting a piece of a popular IPO is to purchase shares of a mutual fund that owns it. Some funds focus on IPOs as part of their core investing strategy, while others buy IPOs as part of a general growth objective. Check with your advisor to see what funds might own shares.

What to Look For in an IPO

If you do decide to invest in an IPO, look for the following:

Strong fundamentals. Just like you would with any investment, look for IPOs with solid performance, in terms of sales and earnings, as well as a strong balance sheet. Also look for a proven business model, a solid growth strategy and experienced management. Much of this information can be found in the company's prospectus, which is available to the public.

A unique business model or competitive position. Where earnings are elusive, look for companies that may have a unique advantage over their peers. Does the company have a new, unique product or service? Is it a thought leader in its industry? Are there competitive walls -- patents, trademarks -- that protect the business? These factors can lead to outperformance over time.

A committed underwriting syndicate. Look at the underwriting syndicate. Are they a reputable group? Are they engaged on a firm commitment or best-efforts basis? A firm commitment means that the bank has sufficient confidence in the company to risk owning the shares itself.

Lock-up restrictions on insider trades. IPOs typically have lock-up periods during which company insiders are prohibited from selling any of their shares. This is done to protect initial investors from getting hit by an onslaught of additional shares of stock sold by insiders. A typical lock-up period lasts between 90 and 180 days.

Dos and Don'ts of IPO Investing

DO…

> **Think long term**. Even successful IPOs can take a while for their shares to rise above their IPO price. It can also take a while for the stock to recover from large early sellers. So don't go into an IPO with expectations of immediate gain. Also keep in mind where IPO investors in the likes of Microsoft or Wal-Mart made their biggest gains: by holding these investments over long periods of time.
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> **Expect volatile trading**, especially in the first few months. Successful IPOs tend to follow a typical pattern where prices rise at the outset, then dip (especially when lock-up periods expire-the so-called IPO hangover), but then recover later.
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> **Use caution**. Remember that IPOs are inherently riskier than established companies because of their lack of a track record. An allocation to IPOs should comprise only a limited portion of a diversified portfolio.

Don't…

> **Invest on rumors**. If your best friend's brother-in-law tells you how much money you can make by sinking your savings into a hot IPO, step back and ask yourself if this is really a viable investment. Check out the prospectus and see what is real and what is rumor.
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> **Get caught up in the hype**. It's easy to get carried away with the buzz that frequently accompanies larger IPOs. Instead, pay attention to price, performance, and the fundamentals.
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> **Go it alone**. Understanding all the ins and outs of IPOs takes expertise and experience. Work with a seasoned professional before investing in any IPO.

Remember, more investors lose money than make money on IPOs -- so think before you invest.