

Dutch Auction Or Dutch Uncle?

A Case Study Of The NetSuite IPO

Michael Adams, Jacksonville University, USA

Russell Baker, Jacksonville University, USA

Barry Thornton, Jacksonville University, USA

ABSTRACT

“Dutch uncle is a term for a person who issues frank, harsh, and severe comments and criticism to educate, encourage, or admonish someone. Thus, a Dutch uncle is a person who is rather the reverse of what is normally thought of as avuncular or uncle-like (which would be indulgent and permissive).” Wikipedia

Keywords: Dutch auction; NetSuite; Lawrence J. Ellison; SMBs; Salesforce.com; Evan Goldberg; ASP technology; SaaS; IPO mispricing; Winner’s curse

INTRODUCTION

It is 7:15 on a foggy evening April 6, 2007 and Evan Goldberg is racing down the 405 to reach Pier 38 by Fisherman’s wharf on San Francisco Bay. There Evan expected to find fellow company executives and a few of his key customers eagerly awaiting him at the pier. The party tonight had been arranged especially for a new start up company named NetSuite Inc. and its clients and executives. Glancing at the electronic clock in his black Mercedes 500, Evan knew that the boat had probably set sail at least an hour earlier. As he pulled up at the pier and put his car into park, a very attractive young crew member opened his car door and took his keys. Anxiously Evan asked how long ago the boat had set sail. The crewmember just smiled and informed him that a 38 foot Hatteras was standing by to ferry him to the party, regardless of what time he arrived. With that news, Evan smiled. “Oh, yeah,” he recalled thinking to himself, “I’m now in Larry’s world.”

“Larry” is Lawrence J. Ellison, the iconic multi-billionaire co-founder and CEO of Oracle Corp (ORCL). Larry has also been the largest Oracle shareholder since starting the company in 1977. L. Ellison is hosting the party since he is also the largest (54%) equity owner of the rapidly growing privately held San Mateo software company he co-founded along with Evan Goldberg. NetSuite offers accounting software targeting small to midsize companies (SMBs) and distributes it to customers over the Internet. Software users pay for the software via renewable subscriptions in contrast to the more conventional method of marketing enterprise software, where clients are charged huge up-front fees for regular support services to house the software on in-house servers. NetSuite’s software niche marketing strategy focuses on firms that are either too large for the off-the-shelf software such as QuickBooks or not large enough for the legacy enterprise software providers such as Oracle or SAP. NetSuite also pioneered L. Ellison’s idea of creating “dashboards” which are easy-to-read and provide readouts on key performance metrics such as sales growth or asset utilization in real time. NetSuite’s business model is also identical to the model employed by another L. Ellison’s spinoff start up tech that focuses on database management software that manages marketing data, named Salesforce.com ([CRM](http://www.salesforce.com)). The two firm’s similarities resulted in many on Wall Street as referring to the two companies as “Larry’s twins”.

NetSuite was founded in late 1998, making it old by most Silicon Valley standards. Evan Goldberg had been appointed both the chairman and chief technology officer of the startup technology firm. Goldberg, as an Oracle vice president, created a hosted accounting solution for use by small businesses. Since this was too small a market for Oracle, Goldberg launched the new company that would focus on the nascent Active Service Provider (ASP) application. Evan Goldberg provided the technical expertise and vision and Larry Ellison and a few venture

capital funds provided the necessary funds to start the company. Evan thought back to the late 1990s, when he and his Oracle co-worker, Mark Benioff were discussing how the internet would change the future delivery of business software. From those conversations, an idea was born to create database programs that could organize CRM for the marketing function of the firm. After leaving Oracle, Marc 42, became chairman and CEO of another San Francisco start-up company. In 2005, Mark Benioff's startup company had just completed its IPO with his new company based on ASP technology, calling it Salesforce.com.

Later that evening, Evan Goldberg, and several of NetSuite's executive management team stood on the deck of the luxurious "Ronin," Ellison's smaller yacht, looking at the golden gate bridge. Evan couldn't help to think how far he has come in the ten years since he graduated from Harvard. Evan's current base salary of \$375K, with a bonus of \$125k would not, however, allow him to live as wealthy a lifestyle as his mentor Larry Ellison, whose net worth was estimated at over \$26 billion; Larry had amassed his fortune over the past 30 years while building Oracle into one of the most successful software makers in the world. Evan, sipping his gin and tonic, couldn't help but wonder when he would be able to afford to buy a yacht like Larry's or even this one because he once asked Larry "how many yachts can you ski behind at a time?" "Rising Sun," Larry's other mega yacht was estimated to cost over \$200 million, with 82 rooms and it even had space leftover for an on-board private submarine. Albeit, it was originally designed to be only 370 feet long, Larry abruptly changed his mind mid way through the construction stage and decided that it should be 454 feet long instead. To put this into perspective, the length is approximately 1 ½ football fields from bow to stern. Even though Larry has never officially stated it anywhere, it has often been said that Larry just wanted to have a bigger boat than his friend Paul Allen (Microsoft) had. Paul's yacht, the "Octopus" was a mere 417 feet long.

Since 2000, many large enterprises have transitioned their core business management platforms from custom integrations of multiple point software applications to integrated business process software suites, such as those typically marketed to large enterprises by SAP and Oracle. However, small and medium sized businesses (SMBs) have software requirements that are in many ways similar to large businesses, since their core business process requirements are generally identical. North American companies spent approximately \$13.7 billion on CRM and SCM software applications in 2006. SMB's market share was \$4.4 billion, accounting for 32.0% of the market. SMB spending on these software applications is projected to "grow 8.7% annually from 2006 to 2010, compared to 5.7% for large businesses". (Gartner, 2007).

SMBs are commonly defined as businesses employing up to 1,000 employees. These small businesses have limited resources to perform the often costly time-consuming integration of multiple point products from multiple vendors. Recently, SMBs have begun to benefit from the development of the on-demand software-as-a-service (SaaS) model. SaaS allows SMBs to significantly reduce the costs associated with the installation and maintenance of programs within the customer's IT infrastructure. As a result, SaaS results in substantially required capital investment in software, hardware and implementation. This makes SaaS more affordable for SMBs.

A NetSuite IPO also would highlight L. Ellison's venture capital role in helping to create several new software startups in the San Francisco bay area. Larry had been an initial sponsor and financial backer of Salesforce.com CRM), a start up that had a very successful 2004 IPO and presently has a \$4.5 billion market capitalization. CRM's stock has risen over 250% in aftermarket trading since going public. Adding to the complex nature of the relationship between NetSuite and Larry Ellison, Evan had to realistically consider Oracle both as a potential acquirer future of NetSuite, in addition to a future possible direct competitor. Salesforce (Larry's other startup) would also have to be considered as a potential competitor or a possible future potential acquirer.

In an attempt to reduce any investor apprehension relative to a potential conflict of interest issues, L. Ellison agreed to transfer his 32 million NetSuite voting shares he holds into a limited liability company (LLC) "lockbox," which would effectively remove his voting rights for electing NetSuite's board of directors (BOD). Before starting NetSuite, Evan had previously worked at Oracle Corporation as a vice president of technology, and had been charged with making complex database technology more easily accessible to end-users. However, as a result of a short five minute telephone conversation with Larry Ellison, Goldberg's took a different approach to designing databases. L. Ellison convinced Evan to focus on building easy, inexpensive database software to manage

small companies' financial accounting function, which turned out to be a considerably more difficult endeavor. "That is the underpinning of [anyone's] business," Goldberg fondly remembers L. Ellison saying.

NETSUITE'S BUSINESS MODEL

NetSuite has evolved into a premier supplier of on-demand integrated accounting software for SMBs. NetSuite's database software allows clients to organize their critical back-office, front-office and web operations in a single application. The software suite is to deliver functionality and levels of reliability, scalability and security that have in the past been only available to large enterprises. The suite is distributed on a subscription rental basis using the software-as-a-service (SaaS) or an on-demand model that relies on a cloud computing concept. NetSuite's revenue has grown from \$17.7 million in 2004 to \$67.2 million in 2006. For the nine months ended September 30, 2007, NetSuite had revenue of \$76.8 million and over 5,400 active customers; however it has not produced a profit to date.

NetSuite's comprehensive business management application suite is designed to serve as a single system for managing a firm. All elements of the application suite share the same customer and transaction data, enabling seamless, cross-departmental business process automation and real-time monitoring of core business metrics. The key advantages of the NetSuite application suite to customers are:

- **One Integrated System.** The integrated accounting software suite provides the functional capabilities necessary to fully automate the core operations of SMBs, enabling firms to create cross-functional business processes by providing financial information in real time. Users access the suite through user interfaces or dashboards that deliver specific application functionality and information in a real time format familiar to the customers.
- **On-Demand Delivery Model.** Since the software is distributed over the Internet, customers are not required to buy and maintain on-premise hardware and software. The software is designed to achieve levels of reliability, scalability and security for customers that have previously only been available to large firms that had substantial information technology resources available. NetSuite's comprehensive on-demand suite eliminates the front-end costs typically associated with efforts to integrate disparate applications. This significantly reduces system implementation costs and virtually eliminates most of the onsite maintenance and continuing upgrade costs.
- **Implementation.** The comprehensive software suite significantly reduces the time and risk associated with the implementation by fully integrating multiple point products and price points. Moreover, the software can be tailored to the specific needs of selected industries to more rapidly meet their distinct business requirements. The user friendly software tools are designed to enable easy configuration by end-users, who often may lack the necessary software programming expertise as well as customization potential desired by more sophisticated users. As new updated versions of the suite become available, each customer's existing customizations and configurations are maintained with little or no additional effort or expense.

If the long awaited NetSuite IPO was as successful as Evan had hoped, he would have come a long way from the small cramped San Mateo condo that functioned as NetSuite's first office nearly a decade ago. The brief phone call from L. Ellison would fundamentally change the way Evan would approach designing databases in the future. The network-centric computing model proposed by Ellison played to Oracle's strength as a database provider, since the content and billing were managed by the same kind of application program.

Evan reflected on his decision to adopt the ASP business model. While the majority of ASPs based start-ups had failed, NetSuite had made some missteps and encountered technological challenges but had emerged as one of the more mature hosted applications vendors. In 2002, Zach Nelson was brought on board as CEO. Zach holds both a B.S. and M.A. degrees from Stanford. Under his watch NetSuite had undergone a meaningful maturation, albeit it had not yet reached profitability. NetSuite's labor force had expanded to 500 employees, and its installed customer base had grown to over a thousand firms in North American, Europe and Asia. Under Nelson's watch, top line revenue has shown a 10 fold increase since 2002. Prior to joining NetSuite, Nelson was a driving force at McAfee/Network Associates, Oracle, and Sun Microsystems (where he worked for the other larger than life

technology CEO billionaire, Scott Mc Neely). For the past twenty years Zack Nelson had held a host of executive positions in the hi-tech industry that spanned marketing, sales and product development functions.

TIMING THE IPO

For the past 18 months, Evan and the CEO had viewed NetSuite as having the potential to be the next great hi-tech stock IPO. NetSuite's 2006 sales revenues had reached almost \$70 million, and the company had achieved the ideal size to consider going public to raise additional capital, develop company stock currency for acquisitions, and allow the founding investors to diversify their personal stock holdings. However, the lack of profitability was a major concern. But Evan and the executive team wanted to strike while the IPO market was "hot". Although today's IPO market isn't as frothy as it was in 2000 when NetSuite was formed, it was clear that hot technology IPOs still could deliver massive returns as soon as their stocks begin trading, regardless of the method chosen for setting the final offering price. For example, the shares of business software maker VMware Inc., soared 76 percent in their debut in the second quarter of 2007 while those of Salesforce.com Inc., climbed 56 percent when they hit the market 3 1/2 years ago. George Rathmann, the CEO of Amgen was quoted by The Wall Street Journal on May 20, 2004 as saying: He drew an analogy between deciding whether or not to IPO and deciding whether or not to accept hors d'oeuvres when the tray comes around at a party." His advice? "Take the hors d'oeuvres when the tray comes around, *whether* you are hungry or not."

After nearly every quarterly board meeting CEO Nelson would end his executive staff meeting with a power point slide on the impending IPO that always appeared to be only one quarter away. NetSuite's IPO now finally could materialize. After a quick trip to NY to meet with investment bankers, Goldberg, Nelson, and CFO Jim McGeever, who holds a B. Sc. From the London School of Economics, were discussing the NYC presentation. They all agreed that they would get back together in a week to come up with a recommendation to the board of directors. On Nov. 20, 2006 the executive team also heard presentations from several investment banks in San Mateo. Evan felt that he might be in over his head and his B.A. (Summa Cum Laude) degree in Applied Mathematics from Harvard University hadn't adequately prepared him to plan and execute an IPO for his company.

The executive team was tasked with picking a pair of investment bankers to market the NetSuite IPO offering in late 2007. The two investment banks, the small boutique San Francisco investment banking firm W.R. Hambrecht & Co. and the much larger Credit Suisse First Boston (CSR), and had made the best presentation to the NetSuite's board. These investment bankers had suggested that NetSuite employ a rare tech IPO Dutch auction to ascertain the final offering price of the stock. And if the IPO was structured as a Dutch auction which would give the small investor "a seat at the table", the IPO could end up being a much smaller version of the Google (GOOG) 2004 blockbuster IPO.

L. Ellison and some of the other NetSuite's board members were smoking Cuban cigars on the ship's deck; when one board member speculated that a NetSuite IPO that could possibly raise as much as \$100 million while giving up only 10% of ownership. They hoped to profit from the robust performance of the Salesforce IPO, whom many considered to be a twin of NetSuite (same business model and technology and Larry Ellison, the father figure). *"We're hoping to see something in the ballpark of what Salesforce got in terms of valuation," said CEO Zach Nelson. "Those are the two most similar companies in terms of the way we offer product in the market," said NetSuite CFO Jim McGeever. "Their high stock valuations certainly put a company like us in a high demand. Every single bank on the planet has probably called here."* Instead of a few large investment bankers selling the firm's shares to large institutional investors and their wealthy clients, in theory anyone would be able to access the Internet along side of the institutional investors and make a conditional order to purchase the shares when distributed. The investment banker selected would still be responsible for preparing the prospectus, conducting the road show, managing the auction process, and allocating the shares of the offering. CEO Zach Nelson stated that "We're an Internet company, and the whole thing is that the Internet changes everything. Why not change the IPO distribution business?" Evan wanted to learn more about the Dutch auction process and in particular the Google experience. Why did Google choose this method of going public?

Evan also realized that if the IPO was as successful as Google's, there was a good probability that the offering would be oversubscribed and that would yield an opportunity to cash out of some of his NetSuite's shares, provided the underwriters exercised their oversubscription option. Ethan was holding 150,000 shares he could sell immediately post the IPO worth about \$3.7 million, which would make a nice down payment on a future yacht. The question forefront on Ethan's mind was whether or not the Dutch auction system was the best platform for NetSuite's IPO offering? Evan was determined to learn all he could about the Dutch auction system before he had to make a final decision. Evan started making notes of what he learned. From his halcyon days in the business school at Stanford, Zach had learned that the company's cultural ethos required that the upcoming IPO be done in a manner congruent with NetSuite's business model. However Jim McGeever, the CFO suggested that in order to raise the full amount of capital needed, the traditional method of IPO would serve the best interest of the company, and "the company ethos be damned". Evan agreed with Zack that the mission statement of NetSuite dictated that they should price their IPO via the Dutch auction.

IPO PATH

Evan learned that few companies had taken the much less treaded path of IPO allocation through a process known as "Dutch Auction". Generally the sale of IPO shares uses one (or variants) of the following methods to establish an offering price and to allocate the shares:

1. Book Building
2. Auction Method

Since the early 1990s the traditional approach to an IPO used by investment bankers has been Book building. In a traditional IPO allocation process, investment bankers market the IPO by taking the IPO on a marketing "road show." Potential investors (usually the preferred institutional customers of the investment bank) are queried in order to gauge the potential demand in an effort to determine an appropriate price for the forthcoming IPO based upon investor's stated interest in the stock offering. As part of the standard *quid pro quo* arrangement between the bankers and clients, these large investors often are allocated the bulk of the available shares and ergo profit from the usual stock appreciation potential typically "imbued" in the final offering price. This market driven process of price discovery seeks to reward these sophisticated investors for disclosing their preferences. The initial price range for the company's stock is determined by looking at comparables of other recently issued securities and adjusting the final offering price based upon investor expressed sentiment.

A Dutch auction is based on a pricing system devised by William Vickrey, a Nobel prize winning economist, and got its name from the famous Dutch tulip bulb mania that occurred in Holland in the 17th century. A Dutch auction is also frequently known as a descending price auction and employs a structured bidding process to efficiently determine an optimal market clearing price for whatever commodity that is being sold. In essence, this equilibrium price represents the lowest price at which the seller can sell all of the items that is being offered for sale. In the case of IPO, this procedure can be used by an issuing company to determine the price at which it can sell all the available shares being offered for sale. A Dutch auction is a viable alternative to the traditional negotiated pricing process traditionally used by underwriters to set the final IPO price. Prior to NetSuite's IPO, this procedure was most recently employed by Google to price and distribute its IPO and is currently used for all US Treasury auctions. This auction methodology is even used by Ebay to facilitate trades on their on-line auction site.

The final offering price is the minimum price which would ensure the sale of all of the available shares. This method of price discovery minimizes the investment banker's role as a financial intermediary and consequently the large underwriting fees typically charged the firm. A strong proponent of the online process is Bill Hambrecht (Chairman of W.R. Hambrecht & Co.) who has pioneered the online Dutch auction method and whose firm is currently NetSuite's favorite among all the investment banks that made sales pitches, has argued that the full proceeds of the IPO flows directly to the issuing firm, instead of than to a few sweetheart customers of the investment banking firm. What stuck in Evan's mind was the statement by Bill Hambrecht, who argued that an opening day price "spike" of 10% or more, would mean that the IPO was ultimately a "bust".

In a Dutch auction process, the issuing company typically reveals the maximum amount of shares to be offered and a potential price range. Investors then enter a conditional order for the quantity of shares they wish to receive and the highest price they would be willing to pay. Once the equilibrium clearing price is determined, investors who bid at least that price are allocated shares in the offering. If more shares are bid for than shares available, allocation allotment are awarded on a pro-rata basis. This is in sharp contrast to the traditional IPO price setting process, whereby prices are set by underwriters using a negotiated book building pricing process. The auction process is designed to maximize the amount of money raised by the company issuing the shares, leaving less room for the IPO investors to profit in the secondary market. It is often argued that the Dutch auction process is more beneficial to the company going public and its venture investors, because bankers setting the offer price in a typical IPO usually favor their institutional clients, leaving “money on the table.” Since Google's high-profile Dutch auction in 2004, in which the underwriters were forced to lower the price range due to a lack of price discovery by unsophisticated investors, few companies have chosen this way to go public.

It is frequently posited that a Dutch auction provides an efficient and effective mechanism that endogenously determines an equilibrium share price where supply equals demand. Many advocates of the Dutch auction procedure argue that the first day stock price increase will be greatly reduced or eliminated. From the company going public perspective, the first day price appreciation is the value which the shareholders of the company did not appropriate. Evan had to present his proposal to the board of directors relative to the IPO method he recommended. Executed correctly, Evan argued that the Dutch auction provides the most efficient and effective mechanism to endogenously determine an equilibrium share price that perfectly equates supply and demand.

GOOGLE'S IPO

Google's 2004 IPO generated great investor awareness, not only due to its global name recognition, but also because it was the first major tech company to employ the unusual Dutch auction method to price and distribute its huge stock offering. Google's IPO was viewed by most investors as a huge triumph given the fact that the firm's stock price today is hovering around \$500; however, a closer inspection of Google's IPO raises serious questions concerning the alleged “benefits” of a Dutch auction. Evan reasoned that a Dutch auction method of IPO allocation could potentially create an instant financial windfall for both the insiders and the company by virtue of the fact that such a method would result in actual market demand being encapsulated into the offering price determination.

However, one of the supposed advantages of a Dutch auction method of minimizing the price spike did not materialize in the case of Google's initial public offering which took place in the fourth quarter of 2004. Nineteen and one half million shares were offered at a price of eighty five (\$85) per share. Although the sale raised a staggering \$1.67 billion, the “pop” (the disparity between on the first day close and the issue's offering price) was much greater than for an IPO during that time period. Google's final offer price was set at \$85, but the stock actually began trading at \$100, which represents a sharp 17.6% increase. Evan concluded Google's decision to commence its much heralded IPO by means of a Dutch auction process had mixed results. Google's shares soared on the open and continue to trade higher. Evan questioned whether Google represented a special case? He questioned whether some hi-tech IPOs would fare much better than others in an auction?

The performance of Google's stock offering in late 2004, however, does not appear to lend support to the contention that the online auction process did in fact serve as a very efficient pricing mechanism. Google's first day price appreciation was much larger than the first day price increase for all IPOs done the traditional book building method. The reduction in Google's price range (\$85 per share) may have given the appearance to some investors that Google's stock was “on sale”. As a result, this may have resulted in increased upward market pressure on the stock price. Between January and November 2004, eighty three (83%) percent of all IPOs coming to market saw less of an increase in the first trading day than Google. Moreover, Google's first day return was greater than that of other IPOs in its peer group. For example, excluding Google, other IPOs issued in 2004 in the Internet search space demonstrated a mean price appreciation (the difference between the offer price and the stock's opening price of ten (10%) percent. Moreover, Google's final \$85 to \$95 target price range represented a significant reduction in the initial target price range of the \$108–\$135 range projected by the company in the later part of July. At that time, several security analysts on Wall Street opined that the prior Google price range had been seriously overpriced;

however, Google's stock price actually exceeded the upper end of that price range after just 32 days in the secondary market and sold at the lower end of the range after just 18 days.

Google's large increase in the stock price, particularly given the void in any substantive news, further indicates the use of the Dutch auction method failed to efficiently price for Google's stock. By the early part of December 2004, Google's stock price appreciated nearly 80 percent (%) and was substantially greater than the mean price appreciation for almost 94 percent (%) of all IPOs issued in 2004. It is worthy to note however, Google's stock increase was about equal to other Internet search engine IPOs, which averaged a 73.3 percent (%) price appreciation. However, approximately one half of the Internet search engine IPOs came to market in the fourth quarter of 2004 after the Google offering; therefore their subsequent price rapid appreciation may have been influenced to a large degree by the post-Google surge in general investor enthusiasm.

Evan wanted to know what some of the possible explanations for the mispricing were. Perhaps one possible explanation was that the small retail investor, who is the primary focus in this type of auction, may often lack the ability to simply access sufficiently detailed company investment information sources to appropriately price the company's stock predicated on the stock's fundamentals, rather than purely on familiarity or general name recognition. The paucity of detailed company financial information disclosure required by the online process further contributes to the problem. A frequent criticism leveled at Google concerned the "secretive" nature on how Google would ultimately employ the capital it raised, and thus generally provided very little in the way of detailed information in their stock sales presentations.

A second possible explanation for Google's mispricing perhaps can also be attributed to the less rigorous due diligence efforts performed by the investment bankers coupled with the consequent decline in information that is required by a Dutch auction conducted online. The auction protocol thus should be utilized more by firms that do not possess a clear purpose for the intended uses of the capital they are attempting to raise. Any initial risk aversion exhibited by potential investors could easily result in the discounting of the initial stock offer price. A possible final reason given for the apparent mispricing in Google's stock and the subsequent decrease in the suggested price range was attributable to the reluctance by some investors to embrace the integrity of the online auction process in general. Albeit, online IPO auctions have been employed since late 1999, relatively a hand full of hi-tech companies that have chosen this path. Additionally, subsequent purchases in the aftermarket by hedge fund managers who had boycotted the auction process in protest may have played a key role in the subsequent price spiral of the stock once it began trading in the secondary market. Evan was uncertain whether this effect would manifest itself in any subsequent IPOs.

IPO MISPRICING

Evan jotted down the following notes: IPO mispricing can result because of: (1) a general paucity of information received and processed by the average small investor; or (2) a general perception by many investors that the Dutch auction process is usually employed only by companies which generally wouldn't be successful using the more widely accepted standard route (a stigma). Evan reasoned the primary solution to these problems (either real or imagined) would be the company's full disclosure of very explicit information concerning the exact uses the company planned for the money raised, the actual corporate governance structure of NetSuite, and the NetSuite's rationale for employing the internet to price and distribute their IPO. Evan felt that this must be stressed at every sales presentation even if this is generally addressed in the red herring, it must be stressed at all of the IPO sales presentations. Evan thought this was necessary to eliminate any adverse selection problems that are common to online auctions, thus enabling investors to identify and more effectively sort out any "lemons."

This SEC ruling effectively gave large institutional investors an unfair advantage, since small investors were generally much less likely to actually attend a company sales presentation. The greater participation of the retail investor in online auctions could have further added to the informational asymmetry impact. Additionally, many lesser-known companies going public were impacted to a much larger degree than the better-known firms, by their inability to effectively utilize the media during the "quiet period" to hype and sustain general investor interest. However, in late 2004, the SEC reed to relax those guidelines by permitting firms to provide detailed financial

information directly to investors, both verbally and in written form, if that information is also filed promptly with the SEC. Moreover, the SEC recently approved a provision to allow IPO marketing "road shows" to be podcast over the internet. This fact alone would appear to make the Dutch auction method more congruent with NetSuite's ethos and culture.

Evan was very fascinated by which parties were most likely to gain from any IPO mispricing, should it materialize. In Google's case, the primary beneficiaries to the price appreciation appeared to be: (1) those individual investors who purchased the stock when it initially started trading in the secondary market and who did not flip the shares (quickly selling in the aftermarket); and (2) the chief executive and co-founders of Google in addition to (3) the venture capital (VCs) firms that provided the Google's early round financing. The VCs received long-term warrants, however, they were generally restricted for 180 days (standard lock-up period) from selling the stock. Evan concluded that an online auction process was a two edged sword. While the auction increases the small retail investor's participation, it also reduces the large institutional investor dominance. These customers typically also happen to be the large lucrative clients of the underwriting investment banker. It does however illuminate the fact that small retail investors may also lack the ability to perfectly price an IPO. This information gap could occur if these small investors either lack access to the same information sources that large investors possess or the fact that these investors often lack the required expertise to price the issue. Moreover, firms simply have not traditionally been expected to provide as much information in the online process vis-à-vis the traditional method of book building.

Investors could also discount the IPO price, when it is issued through the auction process, due to the general perception that the firm may not have performed poorly if it employed the traditional IPO issuance method. A decrease in the difference between the offer price and the open price spread would provide the issuing company with full value and is one of the principal benefits of the online auction process usually cited. This reduction did not materialize in the case of Google. It is not clear, however, if a lesser-known firm, once it experienced initial underpricing, would enjoy the same stock appreciation in the secondary market that Google has achieved.

CONCLUSION

Evan was sure that almost all of NetSuite's online auction problems could be surmounted by NetSuite if they provided full disclosure to investors. Evan and his executive team decided that they should be very candid relative to: (1) the specific purposes for the funds raised; (2) the transparency of NetSuite's corporate governance structures (including the number of outside directors on the BOD); (3) the reasons why NetSuite had chosen to employ the online process; and (4) the nature of the NetSuite's relationship to Larry Ellison.

Ethan sat back in his chair to consider all he had learned about the Dutch auction process. He carefully reorganized his notes. He would meet with his executive team at 5:00 to finalize how they should proceed with the IPO. Foremost on his mind was what opening price range they suggest to the investment bankers for the IPO Dutch auction? Not only did Ethan have a lot riding personally on the successful IPO, but the future of the company could hang in the balance.

QUESTIONS

1. *Comment* on the business model of NetSuite. Would the continuing revenue business model reduce cash burn rate and make early round financing easier to arrange?
2. If you were advising Evan Goldberg, would you advise conducting their IPO by the traditional book building method or the Dutch auction method? *What are the pros and cons of this type of IPO methodology?*
3. *Explain* the analogy between a Dutch auction and a Dutch uncle.
4. What initial price range would you set to issue the shares in the IPO? (See Exhibit I).
5. Larry Ellison has invested the majority of the nearly \$100 million capital NetSuite has risen to date. It has been suggested by some critics of L. Ellison that "he is unfairly profiting personally from the growth opportunities that Oracle shareholders missed out on". *Comment on the ethics of this assertion.*

6. *Comment* on the following: “We believe allowing open participation in this offering through a technology-enabled auction process aligns with our corporate culture and business mission. In the same way that our software application suite allows companies of all sizes to benefit from capabilities previously only available to large organizations, we are conducting this offering through an auction process to open participation in our initial public offering to all investors, both individual and institutional”.
7. The Dutch auction process used to establish NetSuite’s final public offering price may result in a market phenomenon often referred to as the “winner’s curse”. This “curse” could result in investors experiencing significant future stock losses. *Explain*.
8. The IPO price established by the auction process may bear little, if any, relationship to the IPO offering price that would result if the traditional valuation method had been used to establish the price and as a result the initial public offering price may *not* be sustainable once the newly issued begins trading in the secondary market. *Comment on the merits of this argument*.
9. *Explain* what the CEO of Amgen meant when he stated that “When the hors d’oeuvres tray comes around, take some, whether you are hungry or not”.

AUTHOR INFORMATION

Michael Adams is an Associate Professor of Finance at Jacksonville University. Dr. Adams has published several articles in the area of IPO valuation, behavioral finance and entrepreneurial finance. Dr. Adams received his Ph.D. in finance from the University of Arkansas.

Russell Baker (Ph.D.) is an Associate Professor of Management at Jacksonville University. Dr. Baker has previously published in the areas of IT, and several pedagogical articles on instructional technology use in the classroom. Dr. Baker received his Ph.D. from the University of Sarasota.

Barry Thornton, (EE. D.) is an Associate Professor of Economics at Jacksonville University. Dr. Thornton has previously published articles in the area of behavioral economics, IPO valuation, and Statistics. Dr. Thornton received his EE. D from the University of North Florida.

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**Exhibit I
VALUATION RATIOS**

	IPO Mkt. Cap	Price / Sales	Price / Earnings	Price/ BV	Tangible BV per share	% offered in IPO
\$19-22 IPO price range:						
NetSuite (N)	\$1,220	10.9	-169.4	18.7	\$25.30	10%
Salesforce.com (CRM)	\$6,920	9.0	266.2	17.3	\$18.90	
\$16-19 IPO price range:						
NetSuite (N)	\$1,041	9.3	-144.6	21.7	\$33.80	10%
Salesforce.com (CRM)	\$6,920	9.0	266.2	17.3	\$18.90	
\$13-16 IPO price range:						
NetSuite (N)	\$863	7.7	-119.8	28.5	\$65.90	10%
Salesforce.com (CRM)	\$6,920	9.0	266.2	17.3	\$18.90	