GOING PUBLIC—MICROSOFT, 1986

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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 of *Fortune* magazine 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 Microsoft selected underwriters, 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.

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. 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.

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 these firms 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 and thus enhance Microsoft's appeal to investors specializing 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 group put together a syndicate which finally came to number 114 firms. Beginning with a small group of firms to underwrite and co-manage, Microsoft narrowed the field to two firms, Goldman Sachs and Alex. Brown. 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 Microsoft gang. 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.

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 the prospectus, and then the principals to the IPO met again to discuss its content. There, 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.

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 that 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 unload more than 10 percent of his holdings—a total of 600,000 shares, compared with the company's expected sale of 2,000,000 shares.

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. In an unusual move for corporate executives, Gates insisted on and got a lower range, $16-$19 per share. 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.

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 shut, and asked, "You mean I'm supposed to say boring things in an exciting way?" However, the road show went well. Gates and company successfully touted the upward trend, however uneven, of the firm's profits and Microsoft's lack of long-term debt. Otherwise stated, the firm used no financial leverage except some short-term borrowing. 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.

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 to Microsoft. Two days later Microsoft's attorneys and auditors called the SEC to negotiate changes. Eventually, a final prospective was written.

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. 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 on a price of $21.

When the $21 price was announced, several major investors 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 surged 43 points, 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, and Oracle Systems had a successful public offering. The two sides easily agreed on a price of $21.

Everything was now in place: the prospectus written, SEC approval given, investors in place, 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' proposal than to Goldman's. A done deal at last!

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 stock traded for $27.75. This price compared to an expected price of $25, not expected 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 now owned a staggering $350 million of Microsoft stock plus $1.6 million in cash for the shares he sold. In the years to come, the company would produce enormous returns to its investors, and Gates' net worth would rise to legendary levels.

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 process of an IPO. Why did it take 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 firms did Microsoft use as comparables in setting its offer price, and why did it choose these firms? What data did it use from these firms 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 how 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 would 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?

SOURCE: All information in this case was taken from *Fortune Magazine*, July 21, 1986, pp. 23-33