The NetLedger IPO:
A Case Study

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NetLedger: An Innovative Business Model

NetLedger is a major vendor of on-demand, Internet-based business software. The company's major products include Accounting/Enterprise Resource Planning (ERP) software, Customer Relationship Management (CRM) software and Ecommerce software. Founder and Chairman Evan Goldberg, a protégé of Oracle CEO Larry Ellison, started NetLedger after leaving Oracle. Backed by Ellison, Goldberg founded NetLedger at the height of the dot-com boom, when almost any company with the word "net" in its name could attract venture capital and quickly move to an initial public offering (IPO). NetLedger was founded in 1998, making it old by Silicon Valley startup standards. Ellison himself became a multi-billionaire when he took Oracle public during an earlier Silicon Valley market boom.

Goldberg and Ellison appeared to be on the fast track to generating more IPO billions with NetLedger, but their timing was off. Shortly after the founding of NetLedger, the dot-com boom turned into the dot-com bust. The dot-com crash erased $5 trillion of the market value of technology companies between March 2000 and October 2002. Well-funded by Ellison, NetLedger was largely insulated from the bust, but the vision of IPO billions had to be put on hold. There was nothing left to do but create a real company with real products and real revenues while waiting for the technology IPO market to rebound.

NetLedger's business model came out of a brief five-minute telephone conversation between Ellison and Goldberg. Since small firms cannot afford the hardware, software or technical support that comes with Oracle products, Ellison urged Goldberg to build easy-to-use, inexpensive database software to handle the financial accounting of small to medium size companies.

Goldberg fondly remembers Ellison saying, "That is the underpinning of [anyone's] business." However, that task turned out to be a considerably more difficult endeavor than simply organizing marketing leads in a database. Goldberg built the new company's databases on a nascent Active Service Provider (ASP) platform. The accounting software was designed to achieve levels of reliability, scalability and security

for customers that have typically only been available to large enterprises with substantial information technology resources

Since 2000, most large business enterprises have transitioned from custom integrations of multiple-point software applications to comprehensive, integrated business management suites, as their core business management platforms, such as those offered by Oracle or SAP. According to a 2006 data for the customer resource management (CRM) market and 2007 forecasts for supply chain management (SCM) markets from Gartner, Inc., companies in North America spent approximately $13.7 billion on CRM and SCM software applications in 2006; of which small and medium sized businesses (SMBs) accounted for $4.4 billion, or 32.0%. Gartner projects that SMB spending on these software applications should grow 8.7% annually from 2006 to 2010, compared to 5.7% for large businesses.

NetLedger'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. NetLedger's comprehensive business management application suite was designed to serve as a single system for managing a firm. All elements of the application suite shared the same customer and transaction data, enabling seamless, cross-departmental business process automation and real-time monitoring of core business metrics.

The integrated accounting software suite provides the functional capabilities necessary to automate fully the core operations of small- and medium-sized businesses. Integrated software suites enable firms to create cross-functional business processes by providing financial information in real time. Users access the web-based suite through user interfaces or dashboards that deliver specific tools and real-time information in formats familiar to the customers.

SaaS Model

Software-as-a-service (SaaS) is one of the most talked-about IT topics since the early 2000s. The adoption of SaaS applications has witnessed three waves namely – 'Early', 'Mainstream' and 'Ubiquitous Adoption'. Many believe that currently, SaaS has gone mainstream and is well poised for ubiquitous adoption in the future. Increasingly, SMBs are adopting the on-demand (SaaS) model. SaaS uses the Internet to deliver software applications from a centrally hosted computing facility to end users through an internet web browser. The fact that SaaS generally works very well for SMBs is yet another factor that will help its market growth. Today, approximately 80% of a typical SMB's IT budget is generally earmarked for maintenance and improving current software (Selip, 2006). This leaves companies with little money left over in their budgets to develop software internally.

The key drivers for adopting SaaS are its low-cost and ease of deployment and use. However, there are certain issues hampering the SMBs uptake of SaaS applications, the foremost of which is the problem of integrating SaaS applications with other on-premise applications, which, in turn, leads to interoperability issues. Security is also a major concern. As SaaS applications are distributed via the Internet, the chances of misuse are greatly magnified compared to traditional software delivery methods. This is one of the reasons that cause some SMBs to avoid SaaS despite the many cost benefits it provides. Many SMBs are sometimes reluctant to handing over their scarce

data to third parties. It is always well documented in the literature that using software from a hosted service provider does not mean that the enterprises is relieved of their responsibilities completely because they have to insure that the quality of service is in place.

The acceptance and uptake of SaaS applications have increased in almost all geographical regions. Currently, the US is the largest SaaS market in the world, followed by Europe, and Asia-Pacific. Apart from the regular SaaS applications such as CRM, HR, and web conferencing, there are certain other newer segments where the SaaS model is gradually gaining acceptance. SMBs spent $3.2 billion on SaaS applications in 2007, compared to $5.3 billion on packaged software; by the end of 2008, more than 55 percent of businesses based in North America will have deployed at least one SaaS application, with Europe close behind at more than 40 percent; and the SaaS market in Asia will reach $1.6 billion by 2010. According to IDC estimates, worldwide on-demand enterprise software vendor revenues were approximately $3.7 billion in 2006 and should grow 32% annually through 2011 to $14.8 billion (Vass, 2008).

Offering integrated software solutions over the Internet is a key component of NetLedger's business model. The major benefits of web-based, on-demand integrated software suites include:

- Reducing the need for customers to buy and maintain on-premise hardware and software;
- Eliminating the front-end costs of integrating disparate applications for different vendors;
- Reducing the time and risk associated with implementation; and
- Eliminating the costs of on-site maintenance and software upgrades.

NetLedger defined small and medium businesses as those employing up to 1,000 employees. These smaller firms tend to be less capable than large businesses of installing and integrating costly, complex software products provided by different vendors. As a result, these smaller businesses can benefit from a comprehensive business suite. However, integrated platforms designed for large enterprises generally are not well suited to smaller businesses because of the cost and complexity of such applications.

Pricing an Initial Public Offering: The Dutch auction Approach

In early November 2006 the NetLedger executive team listened to presentations from several investment bankers in both New York City and San Francisco. They learned that since the early 1990s, the traditional approach used by investment bankers to underwrite an IPO was a process called 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 's expressed sentiment.

A Dutch auction is based on a pricing system originally 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 sometimes referred to as a descending price auction and employs a structured bidding process to efficiently determine the optimal market clearing price regardless of the type of commodity that is being auctioned. In essence, this equilibrium price represents the minimum price a seller can dispose of all of the items that is being offered for sale. In the case of an IPO, this auction procedure can be employed by an IPO issuing company to ascertain the price at which it can sell all of the shares being available 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 NetLedger'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.

If the initial offering price discovery is ascertained using a Dutch auction platform, it should provide information about the potential market demand for the stock at commencement of the IPO. However, it should be clearly noted that the price information obtained in the auction might bear little, if any relationship to the actual market demand in the secondary market for the NetLedger's stock once trading commences. The bidding process will yield a potential market clearing price which represents the greatest price in which all of the available shares can be sold, including any shares that are subject to the standard over-allotment provision granted the underwriters. In addition, the auction process itself may create greater stock price volatility or a stock price decline after the initial offering. Any of those outcomes could lead to expensive, time-consuming and distracting litigation.

NetLedger and its underwriters also have the right to make multiple offering price revisions during the auction process. Any increases in the stated offering price range or the number of shares offered may result in a situation where limited demand for the shares exist at or above the price offered in the IPO. Any excess market demand will be "soaked up" and thus it is unlikely that the stock will appreciate in the near term. It is important to note that the NetLedger has the option to peg the initial public offering price at a market price actually below the auction-determined price. The company and underwriters might attempt to do this: (1) to ensure a more broadly distributed stock offering (which would be expected to occur because at a lower offering price there should be a larger number of successful bids) or to potentially limit a decline in the market price of the stock in the period immediately after the IPO. This might be reasonably expected if the price was set in a more traditional book building process. However, setting the IPO price below the clearing price determined by the auction may

not achieve the desired results. If the IPO price is set below the actual equilibrium-clearing price, the future price of the common stock could still trade significantly lower post the close of the public offering. In addition, setting the public offering price below the clearing price may result in a broader distribution of the firm's shares. However, such a strategy may not actually result in changing the relative allocation of share to certain groups of investors, such as professional and/or institutional investors. That is because there can be no assurance that investors of one group would submit bids at different prices than investors of other types, and so broadening the number of successful bids would not necessarily change the proportion of successful bids attributable to any one type of investor.

Even if the IPO price is set near or equal to the "auction equilibrium clearing price," the actual price of the offering may not bear a relationship to and may even be significantly greater than the price that otherwise would be ascertained employing a conventional indicator of a stock's overall value. These conventional measures would include such things as: future prospects of the industry, sales, earnings and other *proforma* financials and other key performance metrics. The professional investors usually apply multiples of revenue, earnings, operating cash flows and risk characteristics together with the market prices of securities of publicly traded companies engaged in activities similar to the company conducting the IPO are also compared to come up with a final IPO offering price.

In a typical IPO, the shares are usually distributed to professional investors who typically possess significant investment experience and expertise in determining a stock's value. These professional investors usually have the ability to access and subsequently perform their own independent research and subsequent analysis. Less sophisticated investors (usually small retail) typically have only limited access to this level of research and analysis. As a result of the auction process and the leveling of the playing field, these less price sensitive investors could end up exerting a larger influence in determining the initial offering price of the IPO. They may also participate to a much greater degree in the offering than what would normally be expected in a more traditional initial public offering. Successful IPO investors in a Dutch auction face a classic behavioral problem of the winner's curse. When an IPO is extremely "hot" both sophisticated and unsophisticated investors will demand shares, and the issue will be heavily oversubscribed. In these deals, investors will be rationed receiving only a fraction of the shares they requested. However when the deal or book making is weak these unsophisticated investors receive much greater allocations of the IPOs. The on-going debate is whether the book building method favored by most investment bankers results in more efficient pricing of IPOs than the Dutch auction method.

Timing the IPO

For the past 18 months, Goldberg and other NetLedger executives had viewed the company as having the potential to be the next great hi-tech stock IPO, a smaller Google. NetLedger's 2006 sales revenues had reached almost $70 million, and 2007 revenues were on track to exceed $100 million. In other words, 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. The lack of firm profitability was a major concern, however Larry Ellison was the largest shareholder, holding 54% of the outstanding stock and he wanted to harvest the value of his investment through an IPO.

Ellison, Goldberg and the NetLedger executive team wanted to go public while the IPO market was still "hot". Although today's IPO market is not as frothy as it was in 2000, it was clear that hot technology IPO's still could deliver massive returns as soon as their stocks begin trading, regardless of the method chosen for setting the final offering price. 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. NetLedger's IPO now finally could actually finally materialize. After a quick trip to NY to meet with investment bankers, the NetLedger executive team was discussing the NYC presentation of Hambrech and CSFB. These investment bankers had suggested that NetLedger employ the rare tech IPO Dutch auction to ascertain the final offering price of the stock. Less than 2% of the IPO's issued in 2007 employed the Dutch auction IPO method. The CSFB and Hambrech bankers forcefully argued that if executed correctly, the Dutch auction provides a more efficient mechanism to determine endogenously an equilibrium share price that would equate supply and demand. These investment bankers suggested that the greatest benefit to the company for using the Dutch auction would be the minimization of the increase between the offer price and the opening price of the IPO. From NetLedger's perspective, this price increase represents "money left on the table" and therefore, money that NetLedger could not appropriate for the company and the selling shareholders.

The executive team was tasked with picking a pair of investment bankers to market the NetLedger 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), made the best presentation to the NetLedger's board. As a result, they became the front-runners to get the IPO. However, Goldberg had reservations about the approach suggested by these investment bankers since they had urged NetLedger to employ a rare tech IPO Dutch auction to ascertain the final offering price of the stock.

By structuring their IPO as a Dutch auction, NetLedger invited smaller investors to take "a seat at the table." In addition, NetLedger could give itself a chance to become a smaller version of the 2004 Google (GOOG) Dutch auction blockbuster IPO. Evan Goldberg and the other executives all agreed that they would get back together in a week to come up with a recommendation of how to proceed with the IPO to the board of directors.

Questions

1. *Comment* on the SaaS business model of NetLedger. Would the continuing revenue business model (software as a service SaaS model) reduce cash burn rate and make early round financing for tech startups easier to arrange?

2. Would you advise NetLedger to conduct 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. The Dutch auction process used to establish NetLedger's final offering price may result in a market phenomenon often referred to as the "winner's curse". This "curse" could cause investors to experience large future stock losses. *Explain*.

4. It has been alleged by some that the auction process for NetLedger's IPO could cause a situation in which less price sensitive investors determine the final offering price by virtue of them constituting a greater portion of the investor pool. As a result, the stock's IPO price may not be able to be sustained after the stock starts trading in the secondary market. Moreover, the IPO price established by the auction process may bear little, if any, connection to the IPO offering price that would result if a more traditional valuation method had been used to establish the price. *Comment on the merits of this argument.*

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NetSuite Case Study: Teaching Note

This is a real case involving a real company. The name of the company was changed to prevent students from getting additional information about the case from the internet and gaining an unfair advantage. NetSuite was formally known as NetLedger prior to the IPO. The eight-year-old company will hold its first annual meeting as a public company May 29, 2008.

NetSuite attempted to reduce the odds of its stock first day stock price spiking by relying on a Dutch auction method to set its IPO price. In most IPOs, the investment bankers set the price after gauging the interest among institutional investors, who then receive most of the shares. Previous research findings (Adams, Thornton and Hall 2008) have suggested that investment bankers deliberately set the IPO price artificially low to increase the odds of a big payoff for the investors who first get the shares.

On December 19, 2007 NetSuite went public by offering 6.2 million shares on the NYSE, under the ticker "N". The company originally listed a price range of $13 to $16; however the underwriters raised the offer price twice the day of the offering. NetSuite's IPO offering floated about 10 percent of the company's outstanding shares, raising $161 million, at a price double the low end of an initial forecast range and $4 a share higher than the top of the final forecast of $19 to $22.

1. NetSuite is at the forefront of a gradual change in the way that more and more SMBs acquire software to help them analyze and manage the firm's day-to-day operations. To date, the SaaS model has been applied to various types of business software applications, including CRM, virus protection, accounting, and human resources management and has been broadly adopted by a wide variety of businesses. Customers do not have to make large upfront investments in technology infrastructure to install and maintain software on their own computers, as more of these companies are subscribing to service providers like NetSuite The software -on-demand concept, known as "software as a service," or "cloud computing," is gaining widespread acceptance by saving companies money while boosting employee productivity and measuring employee efficiency in real time. This change in selling software as an on-going service allows small technology startups to develop continuing revenue cash flow streams. This is very beneficial to these startups when they are seeking venture capital early round financing and subsequent IPOs and to help reduce cash burn rates.

2. Advantages of Dutch auction:

a. Minimization in "*Spike*"

The "spike" represents the difference between the final offer price and the opening price on the first day of trading. In the typical IPO distribution process, investment bankers determine the appropriate price by giving "*road shows*" to potential investors such as large wealthy clients and buy side analysts of large mutual funds. The investment bankers try to gauge the potential demand and price inflection points. As a result of disclosing their pricing preferences, these large institutional investors often are given the bulk of the initial allotment of shares; thereby benefiting from the usual first day price appreciation, which typically has averaged about 11%. This is an additional

cost to the company in addition to the underwriting fees typically charged by the investment banker of 7%. By employing the Dutch auction method the spike should be greatly reduced since at least in theory, the demand level has already been gauged and the price has been arrived at by the free market mechanisms of demand and supply.

b. Small investor participation:

The Dutch auction process enables small investors to participate on a level playing field with the institutional investor in the pricing by placing an conditional order indicating the maximum price that one is willing to pay and the total number of shares they are interested in buying. Ergo, it is designed to democratize the process of IPO share allocation.

c. Role of investment banks:

Since the investment banks' role is greatly diminished by virtue that they are not involved in the pricing of the IPO, the price is the minimum price at which all of the shares can be sold; it minimizes the influence of the bankers and thus making the whole IPO process more market driven. Moreover, any first day price appreciation will go to the investing public as opposed to the investment bankers favored client list.

However, some notable shortcomings in the Dutch auction process are:

a. Lack of information available to small investors:

Small retail investors, who are the primary participants in this type of IPO allocation method, may not have sufficient financial information to price the shares based on the stock's fundamentals. Moreover, the lack of a due diligence efforts on the part of the small investor may result in doing it on basis of name recognition (brand of the company). Conversely, in a traditional method of IPO allocation, the price range is arrived at by Ivy League educated investment bankers that have access to detailed information and who are experts in their respective fields. Moreover, contrary to the traditional method, the online auction method is not required by law to disclose as much information as required in the traditional IPO method

b. Potential Mispricing:

There happens to be a mismatch on the pricing front due to lack of rigorous scrutiny and due diligence efforts normally conducted by the investment bankers, Due to initial risk aversion by retail, many investors who lack financial knowledge could lead to under pricing of the initial offer price.

c. Minimum Price Spike:

The price spike, which happens in traditional IPO allocation methods, in fact, may bode well for the stock in the future. A large pop on the open typically imparts an aura of success to the stock offering, which in turn could boost the stock higher in the future leading to the capital gains for the investors. This doesn't generally happen in case of an auction method.

d. The absence of the large investment bank participation:

Since the role of the large investment banker is minimized, and consequently huge investment banking fees lost, there is generally a lack of price support from the investment bankers, typically offered to their traditional IPO clients

3. Successful bidders who were allocated shares in this IPO could logically infer that there could be limited upside potential demand for the shares at a price above or equal to the initial public offering price, once trading begins in the secondary market. This would result in successful bidders concluding that they probably over paid for the shares (the classic winner's curse) which would cause these investors to attempt to liquidate their holdings to limit any losses, both real and anticipated. In this situation, other investors who were not successful in submitting their bids may wait for the initial selling climax to be completed before purchasing the stock, which would result in reduced future demand for the common stock.

4. Investors who submit successful bids may experience a significant decrease in the market price of their equity holding after the offering is completed. This could cause the auction to price an issue higher than the price that most professional investors would be willing to pay. As a result, investors may experience declines in the stock price once trading of the common stock commences. Furthermore, if the offering price is set above the level that most knowledgeable investors ascertain is appropriate for the security investors are prohibited from shorting the stock for 30 days after the IPO. This action would result in increased downward pressure on the stock's future price.

Epilogue

NetSuite's IPO generated such strong demand that the San Mateo-based startup wound up selling 6.2 million shares at $26 per share. The IPO surged almost 37 percent in its market debut on December 20, 2007, a day after its initial public offering priced far higher than the price range contained in the prospectus. At the end of the first day of trading, the shares traded up $9.50 at $35.50, and turnover was high with nearly 16 million shares changing hands, or more than double the 6.2 million shares issued in the offering. NetSuite's IPO raised nearly $70 million *more* than the company envisioned. After paying expenses and IPO fees, the company expects to pocket $148.1 million from the IPO, according to documents filed in December 2007 with the Securities and Exchange Commission.

Valuation Comparable

	IPO Mrkt	Price /	Price /	Price /	Price /	%
Actual IPO offering price of $26	**Cap (mm)**	**Sales**	**Earnings**	**Book Value**	**Tangible BV**	**offered in IPO**
NetSuite (N)	$1,547	13.8	-214.9	23.7	25.3	10%
Salesforce.com (CRM)	$7,080	9.2	272.3	17.7	19.3	

But for NetSuite the stock's first day return begs the question: did they make a wise choice by forgoing the traditional method for the IPO pricing of shares? The answer appears to be enigma. The company did raise $70 million more than it anticipated. The IPO should be viewed as successful. NetSuite did however, leave an additional $58.9 million "on the table" with their market debut easily outstripping the average first-day gain of 10 percent among the previous 234 IPOs priced in 2007, (Renaissance Capital). More IPOs were completed in 2006 than any year since 2000, when 406 companies went public amid rabid demand. Bill Hambrecht, the chief proponent for Dutch auctions, has stated that an auction with a first-day pop of 10% or more should be considered a failure, thus according to that definition the offering would have to be considered a "bust". The enigma is what did the NetSuite IPO really mean? Two definitions come to mind: **I**ts **P**robably **O**verpriced and **I**nstant **P**rofit **O**pportunity! In the case of NetSuite both definitions equally apply.

Post Script

NetSuite's stock price (at the end of the 1st quarter of trading –March 24, 2008) is currently trading underwater (offering price = $26 per share). It is interesting to note that NetSuite is also still losing money.

Last Price (3/24/08)	$23.25
Offer Price	$26.00
52 week range	$18.31-$45.98
Market Cap	$354.47M
EPS	$-2.446

NetSuite Stock Price