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Morgan Stanley Was 'Driver' on Facebook's Wild IPO Ride

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The highly-anticipated Facebook IPO was plagued with problems, potentially costing thousands of dollars to many small investors and further damaging Wall Street's reputation on Main Street. A Wall Street Journal report.

In snaring the most coveted investment-banking assignment of the year, Morgan Stanley's Michael Grimes insisted to a senior Facebook Inc. executive that he be the "single driver" of the company's initial public offering, adding that if the deal soured, it would be his "throat to choke."

The Winners and Losers

From the firm and the funders who raised billions to the investors who lost billions, a look at some of the money made and lost on the Facebook IPO

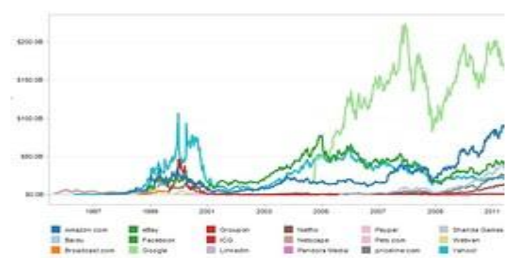
Faceplant

The Nasdaq Stock Market has been criticized for its handling of Facebook's initial public offering on May 18. Track events of the day.

Facebook IPO's Rocky Road

See some key events in the social network's IPO from the time the company filed to go public in February.

IPO: Go, No-Go?



Initial public offerings aren't always good investments. Here's a look at some highfliers and flame-outs of the past and present.

Mr. Grimes's audacious, successful pitch to minimize input from other underwriters put Morgan Stanley in a position to exert unusual control over the IPO and to scoop up a bigger share of its fees. But it also turned the veteran Silicon Valley investment banker and his firm into targets for criticism when Facebook's IPO swiftly turned bad for many investors.

Investment banker Michael Grimes's audacious, successful pitch to minimize input from other underwriters put Morgan Stanley in a position to exert unusual control over Facebook's IPO. Anupreeta Das has details on Markets Hub. Photo: Reuters.

In the wake of the botched offering—Facebook has shed $22 billion in market value since the May 18 deal—much of the focus has been on the chaotic first day of trading, which was marred by technical problems on the Nasdaq Stock Market. But interviews with Wall Street bankers, brokers, investors and Silicon Valley executives reveal that Mr. Grimes, his firm and Facebook made several decisions in the weeks leading up to the offering that contributed to the rocky ride.

Bloomberg News

Facebook CFO David Ebersman, center, worked on the deal.

Mr. Grimes and Morgan Stanley, in consultation with Facebook, made several unusual moves, say people involved in the process. They shut out the two other lead banks, J.P. Morgan Chase & Co. and Goldman Sachs Group Inc., from many meetings with prospective institutional buyers, making it harder for those bankers to judge demand for the shares, these people say. They supported increasing both the number of shares offered and the price range, a rarity, despite misgivings expressed by a Goldman executive, they say. And they allocated 26% of the IPO shares to individual investors, more than the typical 15% or so, and some small investors got shares they hadn't expected to get. Although Facebook shares rose 10% late last week, they are still down 21% from the offering price, the steepest-ever decline over the first month for an IPO of $1 billion or more of a U.S.-based company, according to Dealogic, leaving many investors sitting on big losses and regulators asking for explanations. The offering appears, at least for now, to have chilled the U.S. market for IPOs, with no new deals pricing since.

Morgan Stanley, designated the senior of the three lead underwriters, says it did its job for its clients, and that the fact that the stock traded above the $38 offering price on the first day meant that the deal was priced well. "The price and size of the transaction were consistent with the institutional order book of demand as indicated to the lead underwriters, and confirmed by the trading of the stock prior to the impact of the Nasdaq trading issues," said a spokeswoman.

Nasdaq officials concede they are to blame for some first-day trading problems, which left many investors unsure for hours whether their buy and sell orders had gone through, but not for the price decline since then. In an internal webcast 11 days after the offering, Morgan Stanley Chief Executive James Gorman told employees that Facebook Chief Operating Officer Sheryl Sandberg had called him after the offering and praised Morgan Stanley's work on the deal, say people who heard the webcast.

The deal was lucrative for the lead underwriters. In large IPOs, it is common for fees to be split relatively evenly between several lead underwriters. On the Facebook deal, Morgan Stanley stands to collect $68 million in fees—38.5% of $176 million slated to go to about 30 underwriters, public filings indicate. J.P. Morgan will get about 20%, and Goldman, 15%.

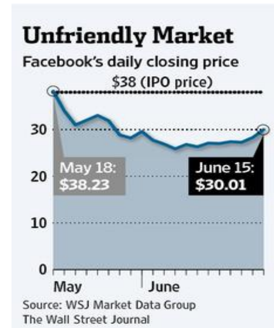
Morgan Stanley and the other banks made additional money through their attempts to buoy the faltering stock early on. Those efforts generated trading profits of about $125 million, according to bankers

Goldman Sachs

Goldman technology banker Andy Fisher

knowledgeable about the transactions. At Morgan Stanley, the gains are expected to be offset somewhat by reimbursements to clients who lost money because of technology snafus at the Nasdaq, one person familiar with the matter has said.
The 45-year-old Mr. Grimes, who made about $6 million last year, is likely to make more than that this year because of his role in the Facebook deal, says one person familiar with the firm's compensation.

Pricing an IPO is as much art as science. A lead underwriter like Morgan Stanley must balance the interests of the stock issuer and investors. Companies like Facebook want a high offering price so they can raise more money. Investors taking a risk on a new stock want a price low enough that it is likely to pop when trading begins.



In the weeks before the first trading day, underwriters build a "book" of orders by meeting with prospective investors, often large institutional clients like hedge funds, mutual funds and pension funds. Those investors tell banks what they think about a company's growth prospects, what price they would feel comfortable paying for shares and how many they want to own.

Bloomberg News

Morgan Stanley's Michael Grimes has urged companies about to go public to use a 'single driver' approach.

Getting the price right can be a challenge. Morgan Stanley underwrote the IPO of LinkedIn Corp. in May 2011. Its shares more than doubled on their first trading day, sparking criticism that they were priced too low. The firm also underwrote the Zynga Inc. IPO, whose share price languished after its December offering, leading to complaints about too rich a price. Zynga now trades 44% below its IPO price.

Thanks to Mr. Grimes, an energetic California native with a degree in electrical engineering and computer sciences, Morgan Stanley has been a tech-IPO powerhouse in recent years. The firm helped take public 14 of the 32 Internet companies that listed in the U.S. since last year, according to Dealogic.

Mr. Grimes favors flashy presentations, sometimes knocking on the doors of prospective clients' homes to pitch them.

Mr. Grimes's pitch to be Facebook's sole driver echoed what he had told other tech companies in recent years. A page of his pitch book to other companies, which he calls the "Driver/Navigator Model," shows a black sports car. A company about to go public, the pitch reads, must choose between a "single driver [who] operates the steering wheel, gas, brake and clutch," or the "two driver model, where the car literally has an extra steering wheel, gas, brake pedals and clutch for a second driver." Morgan Stanley, the pitch says, "favors the sole bookrunner approach."

As he sought the Facebook assignment, Mr. Grimes bet Chief Financial Officer David Ebersman, who lives in the same northern California town as Mr. Grimes, that the San Francisco 49ers would beat the New York Giants in the NFL playoffs. Mr. Grimes lost the bet, but won the Facebook deal.
After hiring Morgan Stanley, Mr. Ebersman told analysts at a meeting in March that he wanted the deal to be the most successful public offering in history, according to one attendee.

Morgan Stanley hosted all major group presentations on the "roadshow" to pitch big investors. Mr. Grimes introduced Facebook Chief Executive Mark Zuckerberg at the New York kickoff on May 7, and accompanied Mr. Ebersman and other executives to most meetings.

As the tour began, a banker on the underwriting team not at Morgan Stanley asked a Facebook executive whether his firm would attend the investor meetings. The banker recalls that the executive told him no, that Morgan Stanley wants to control the message.

Morgan Stanley emailed other lead underwriters its schedule of meetings the next day with big investors, including Fidelity Investments and Putnam Investments in Boston and T. Rowe Price in Baltimore. The other bankers weren't invited to the meetings.

Goldman and J.P. Morgan underwriters had access to the book of orders and spoke with some large investors, according to bankers involved in the process. But because they weren't included in any one-on-one roadshow meetings, they didn't hear firsthand how investors reacted to Facebook's story, these bankers say. Messrs. Ebersman and Grimes attended most of those meetings together.

The first outward sign of trouble came May 9, nine days before the IPO. Facebook disclosed in a regulatory filing that tepid growth for ads on its mobile site could "negatively affect" results. Over the next two days, Morgan Stanley and the other underwriters called their top institutional clients, including mutual-fund giants Fidelity and Capital Research and Management, saying their analysts had lowered Facebook's earnings and revenue estimates, according to people familiar with the matter.

Still, as the roadshow concluded early the following week, demand for Facebook IPO shares totaled more than five times the shares available for institutional investors, bank officials with knowledge of the deal say, strong demand for a deal of that size.

Morgan Stanley and Facebook wanted to raise the IPO price. On Monday, May 14, Goldman and J.P. Morgan bankers received separate calls from Mr. Ebersman asking what they thought of increasing the IPO range to $34 to $38 a share, from $28 to $35, according to bankers with knowledge of the calls.

J.P. Morgan Vice Chairman James B. Lee Jr. told Mr. Ebersman he remained "bullish" on the company, based on a successful $8 billion bank-financing J.P. Morgan had led for Facebook, as well as reports his firm was receiving of demand at a price as high as $41 a share, according to people familiar with the call.

On another call, senior Goldman technology banker Andy Fisher told Mr. Ebersman it wasn't clear how big investors would react to such a price increase, according to bankers knowledgeable about the call. He suggested that Facebook get clarity from those investors before moving ahead.

Mr. Ebersman told Mr. Fisher that increasing the range was the way to go based on investor interest in the roadshow, say people familiar with the call. Later that day, news broke of the IPO price-range boost.

That evening, after the last investor meeting, Messrs. Grimes and Ebersman shared a barbecue dinner in Kansas City, Mo., to celebrate, says one bank official.

The following day, The Wall Street Journal reported that General Motors would no longer buy advertisements on Facebook because the car maker believed paid ads on the site were ineffective. The story raised questions among some investors about the prospects for Facebook's ad-revenue model.

That evening, Mr. Ebersman, in consultation with Mr. Grimes, decided to increase the size of the offering after Mr. Grimes told him the order book was "dramatically oversubscribed," says a banker involved in the process. The underwriting teams at J.P. Morgan and Goldman were informed of the decision after it was made, the bankers say, although one Goldman banker involved in the deal had been told of the plan because Goldman was also one of the early investors selling more shares.

On May 16, two days before the IPO, Facebook disclosed it was increasing the number of shares by nearly 84 million, or 25%, for an offering of more than 421 million shares. The increase would allow early Facebook investors to sell more of their shares.

It was a gutsy move. Just 3.4% of all U.S.-listed IPO deals since 1995 have increased both the number of shares and the price range of their IPOs before pricing, according to Dealogic.

Tim Ghriskey, a hedge-fund manager with Solaris Group in New York, says the news spooked him. The prior week, when his head trader ordered 10,000 Facebook shares from underwriter Wells Fargo & Co., a sales official there told him he would need to order more to get a significant allocation.

"You're not going to get anything" on this deal, the sales official said, according to Mr. Ghriskey. A spokeswoman for Wells declined to comment.

Mr. Ghriskey says he was concerned about the company's valuation so he didn't increase his order. When the IPO's size increased, he says, he pulled out entirely, deciding to wait and see how Facebook traded once it went public.

Fidelity and Los Angeles asset-management firm Capital Research expressed concerns to Morgan Stanley, according to people briefed on the conversations. A Fidelity representative declined to comment.

The night before trading began, a manager at Capital Research told a Morgan Stanley official that the deal's pricing was "ridiculous," according to one person familiar with the discussion. The firm slashed the number of IPO shares it planned to order, that person says, and some of its fund managers decided not to buy any. They included Gordon Crawford, a well-known portfolio manager, says a bank official.

With the deal size expanded and some institutional investors scaling back orders, demand dropped to about 4.5 times the available shares, says one person familiar with the book.

Morgan Stanley, led by its chairman of global capital markets Daniel Simkowitz, said demand remained strong, according to people involved in the deal. Morgan Stanley told Facebook that the number of shares ordered by institutional investors had increased that week.

Individual investors often are shut out of hot IPOs because the shares usually are coveted by big, fee-generating clients of investment banks. But individual investors weren't excluded from Facebook.

On May 15, three days before the IPO, Knox Massey, a 49-year-old Atlanta investor, was in his office when he got an email from Bert Madden, his Morgan Stanley Smith Barney broker, asking if he wanted any Facebook shares.

Mr. Massey, who manages the Keith-Massey Family Investments for his family, says he hadn't requested any Facebook shares. He says he called Mr. Madden and told him he was surprised at the last-minute offer but was interested in buying. His broker, Mr. Massey says, told him he thought he could get 500 shares or more. "See what you can do," Mr. Massey recalls telling his broker.

The final offering price was set on May 17, the day before the IPO. Messrs. Grimes and Ebersman provisionally agreed on a price of $38 a share, bankers said. When Mr. Ebersman conferred with Goldman investment bankers later that morning, they agreed $38 was the right price but also told him that given the size and range increase, there was a risk the stock wouldn't trade well, according to people with knowledge of the conversation. One person close to Facebook, however, says that Goldman's final pricing input helped convince the company that $38 was the correct level.

That afternoon, a final pricing call was held among the three lead underwriters and Facebook. It lasted barely 10 minutes. Mr. Ebersman said he intended to go with $38. At that point, say people familiar with the call, nobody raised objections.

That evening, brokers at Morgan Stanley Smith Barney, a part of the firm that deals with individual investors, were told that their allocations of Facebook shares had been raised to a maximum of 5,000 per account, from roughly 500 shares.

That same night, Mr. Massey says, Mr. Madden informed him that 800 shares would be placed in his account. Mr. Madden declined to comment.

The next morning, a Friday, just hours before trading was set to begin, brokers at local Morgan Stanley Smith Barney offices around the nation, including in Buffalo, N.Y., and Pittsburgh, still were trying to allocate shares to clients, according to people involved in those efforts. A Morgan Stanley spokesman says such last-minute efforts are common for large deals.

Facebook shares opened late, amid technical glitches at the Nasdaq, at around $42 a share. As the stock sank back toward $38, Morgan Stanley stepped in to buy shares the underwriters previously had sold from what is called a "green shoe"—extra shares that can be removed from the market to help prop the price of a faltering IPO. Shares ended the day 23 cents higher.

The following Monday, the stock quickly slipped below its offer price, where it has remained ever since. It closed Friday at $30.01.