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HRM in IPOs

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Want to Make Money on the New Initial Public Offerings?

Learn about their Human Resource Management Strategies

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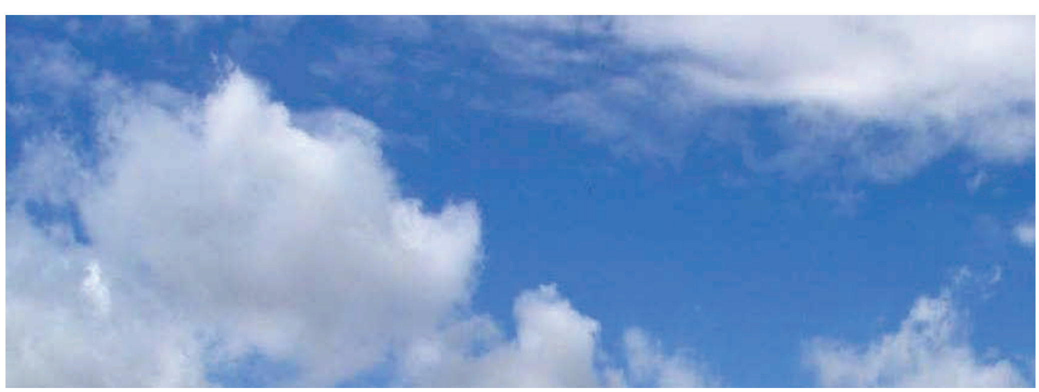


HRM in IPOs

ABSTRACT

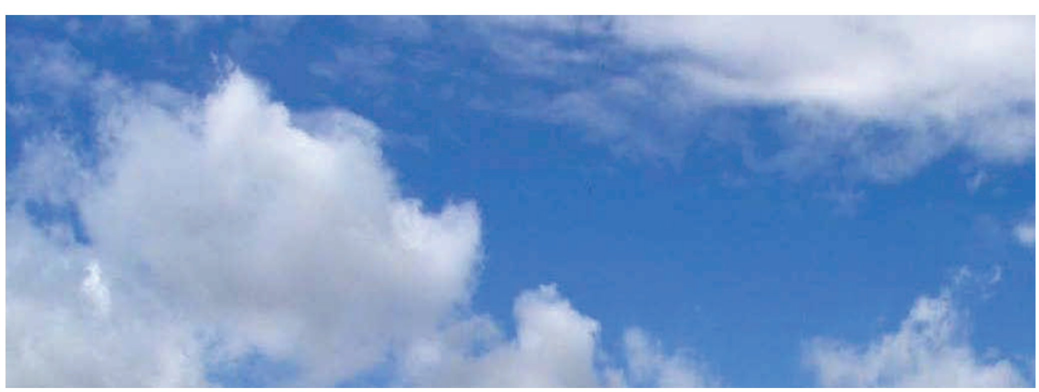
This article reports critical information for firms planning to go public and those going through high rates of change. Based on several empirical studies and case study work done over the last 20 years, the research finds that the key to survival, stock price growth and earnings growth is structural cohesion, which is an employee-generated synergy that propels a company forward in the direction needed to respond to change. When structural cohesion is high, firms can withstand change and thrive; when low, they go out of business.

Initial Public Offerings ("IPOs") are in the news again. Recently, the headlines were overflowing with articles about the General Motors IPO. And GM's not the only one; in June another auto company created a lot of "buzz" on Wall Street when Tesla Motors went public. About 80 firms have gone public so far in 2010, and this number is up quite a bit from last year. On June 18th, 2010, The Street[1] reported that IPOs in 2010 were up 533% from the same time period a year ago. The types of firms doing an IPO range from the large, post bankruptcy firms like GM to other organizations like:

> GenMark Diagnostics that reports "knowing the secrets of DNA" (63 employees, $1 million in sales at year end 2009)
>
> China New Borum, which *"keeps the baiju flowing"* and operates out of China and the Cayman Islands (862 employees, $155.2 million at year end 2009)
>
> Primerica, Inc., based in Duluth, Georgia, in the financial services industry (2,532 employees, $2,200.4 million in sales end of year 2009)

The 2010 IPOs are a diverse group of companies including firms that are small, large, old, young, in the United States and non-USA firms. These companies are set to grow and are seeking funding from investors to spur their development, create jobs and execute on new innovative business models. Forbes, in a 2009 article on the "IPO class of 2010," pointed to optimism in what could be a good year for IPOs, stating that "technology companies are going to lead the recovery[2]."

With all the news about IPOs, there's a secret about their success that has not been shared widely. This piece of knowledge is all about the effect of human resource management on firm performance at the time of the IPO and after the IPO.



HRM in IPOs

HRM factors predict survival, stock performance and growth in earnings

In a series of studies conducted with large cohorts of IPOs (all the firms that go public in a given year) and within individual firms (case studies), our IPO research team found that investing in employees at the time of the IPO has two separate effects on the firm:

Short term performance signal: People are a drain on the company

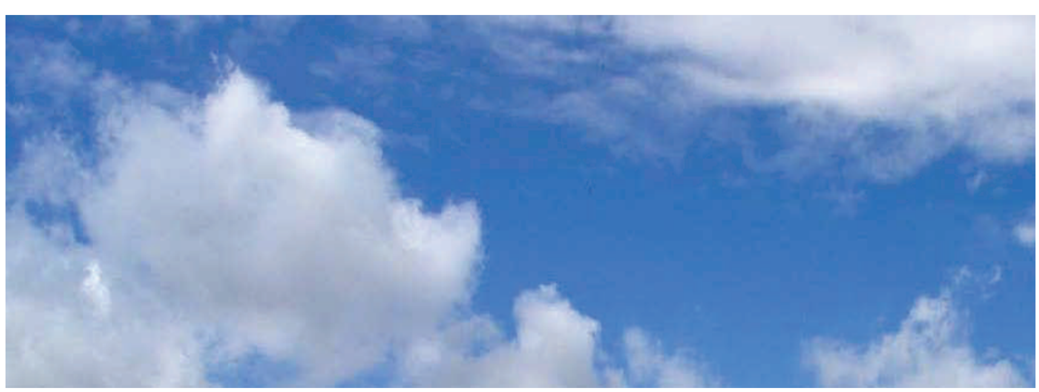
In the short run, investments in employees and signaling that people are valuable to the strategy of the firm have a negative effect on the initial IPO "going out" stock price.

In our research, we examined perceived market potential by assessing the effect of these HR-related variables on the percent price premium and Tobin's Q (initial stock price over book value)[3].

The people who are most knowledgeable about the firm, who are involved in the initial pricing, and who invest in IPOs downgrade the initial value of the IPO if the firm invests in employees. This may not be intentional, but this effect is borne out by the data[4]. In supplemental studies, where our team used survey data sent to the top executives at the firms going public, we found the same result. When caught up in the excitement of the IPO, investments in people not only do not matter; they are seen as a negative to the firm. HRM is thought to distract the company and perhaps is only viewed as a cost.

Real performance post IPO: HRM factors are the most important and <u>positive</u> predictors of 90 day, 1 year, 3 year, and 5 year stock price and earnings growth in addition to firm survival five years after the IPO

Firm survival[5], only five years later, is predicted most strongly and positively by these same HR factors that the financial communities thought were negative for the firm. In fact, survival is dramatically impacted by HR investments. Firms with high scores on the HR factors we studied had a .92 chance of survival five years post IPO, and those low on these factors had only a .34 survival probability. We studied survival because it's often difficult for the financial community to agree on what the "correct" firm performance metric is, and we thought survival (alive or dead) would be less disputed. We also studied longer-term stock price growth and earnings growth (90 days, 1, 3 and 5 years post IPO), and we found the same pattern of results. The HR factors made a significant and, in most cases, the strongest positive impact on performance.



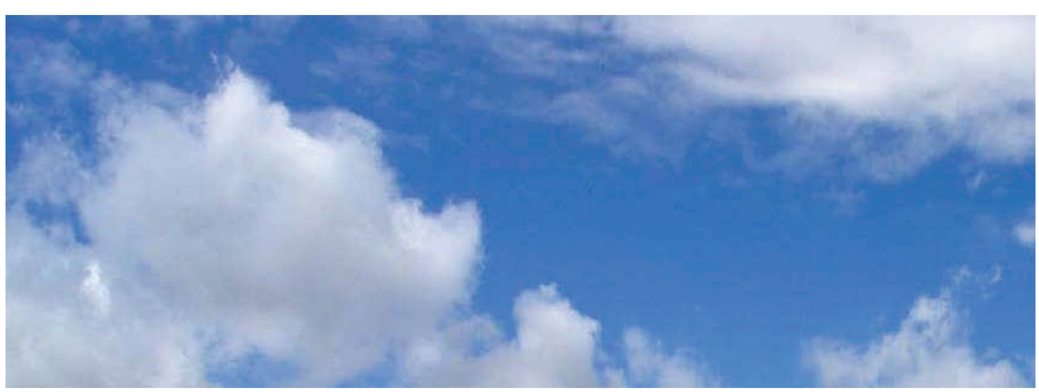
Structural Cohesion is Key to Success Post IPO

The HR factors we studied fall in two buckets. The first was something labeled HR value. We searched the prospectus for indicators that the firm valued its employees. We coded numerous variables including the risk factors associated with employees, strategy statements to see if employees were mentioned vis-à-vis other assets, the level and existence of an HR officer in the firm, and more. We also coded several compensation variables to determine if rewards were limited to the top team or shared with all employees (e.g. profits, stock options). Lastly, we did significant survey work and collected data from multiple members of the top team in these firms. The years studied spanned from 1988 to 1993, 1996 (the biggest IPO year ever), 1998 and the years going forward. We also selected cross samples of firms, including all software firms from 1993 to 1996 and all non-USA based firms in that same multiple year timeframe. The research discovered that the reason the HR factors we studied made a positive difference in the long run was due to their effects on structural cohesion. In our work we define structural cohesion as "an employee generated synergy that propels the company forward." Going forward instead of standing still is key to success. Also the direction in which a firm is going forward is critical for strong financial performance. Motion, energy, momentum and sense of urgency are all factors studied in this research. Employees going forward in the same direction and on a path that fits strategic goals drives positive financial performance and long-term survival.

Impact of Rate of Change on Structural Cohesion

As the research developed, we learned that rate of change was a key variable in the performance equation. Basically, the higher the rate of change, the more important the HR factors. By important we do not mean that as rate of change goes up, more HR is needed. In fact, in some ways, as rate of change goes up, we found that less HR, or perhaps "lighter and faster" HRM was the key to making a positive or negative impact in the firm.

When it comes to specific HR practices, our research began to find that putting in heavy HR systems can backfire and have negative effects on structural cohesion and the firm's ability to move forward[6]. What the research shows (both the larger empirical work and case studies) is that as rate of change increases, the impact of HR investments is more significant on the firm's performance. The higher the rate of change, the more important it is to invest in the right type of HR processes in the firm[7].



IPOs in Recession Years and Post Bankruptcy

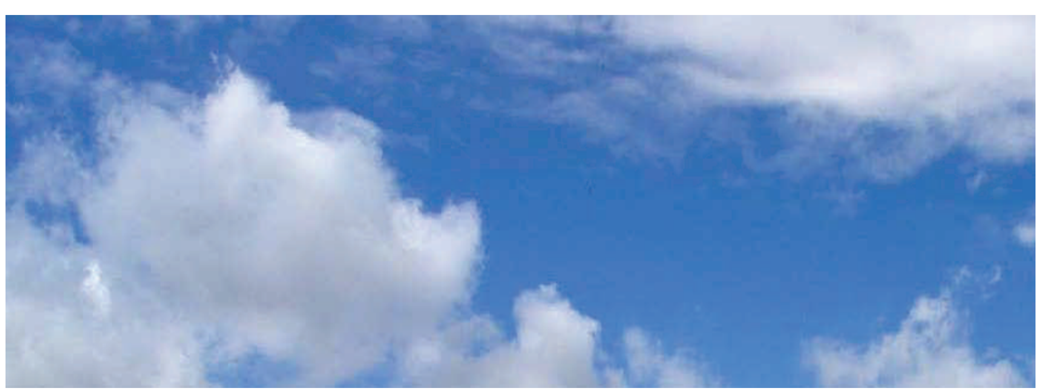
I am excited about the recent increase in new IPOs; I've been waiting for them to come back. The IPO presents a way to create new jobs, help companies grow, and they drive innovation. I'm sure we are all ready for the recession to end and growth to start again. At the same time I'm concerned about the probability of success of these IPOs. The recession has escalated the rate of change in most firms, and this particular type of change has been fairly negative in terms of its effect on employees and structural cohesion.

Our research demonstrates that a primary reason so many IPOs fail[8] is that the human factor is purposefully ignored, put on hold or forgotten in the rush to do the IPO. Remember, the going out price is positively affected by low value in HRM. This means the spoken (or maybe unspoken) word "on the street" is that investments in employees are bad. That also suggests that the senior management team's advisors are not encouraging investments in people, time with employees, or anything related to HRM. This lack of adequate attention to employees prior to the IPO is most likely even more exaggerated in firms that are emerging from bankruptcy or that have suffered more significantly during the recession because their rate of change has been very high up to the IPO.

Bankruptcy to IPO: The Special Case of Two Employee Clusters

In the post bankruptcy firms we are seeing a "tale of two clusters" of employees. One group is made up of employees who plowed through their company's bankruptcy. Employees in these companies had their salaries cut, benefits taken away or reduced, lost friends, and were suffering from stress so much that many were in hospitals and physically sick from the experience. What do these people expect from the IPO? Will they get what they deserve for all the pain and suffering? Will they personally benefit from the IPO?

And what about the "shiny new people" who make up the second cluster? These are the newly hired and hopeful. They negotiated new contracts and were hired to be part of the new company. They don't share the pain and suffering of the survivors of bankruptcy. The people in this group most likely know what to expect from the IPO because that was the focus of their hiring discussions. Even though these two clusters of employees are not standing on two different sides of a line in their companies, the new people feel different from the survivors.

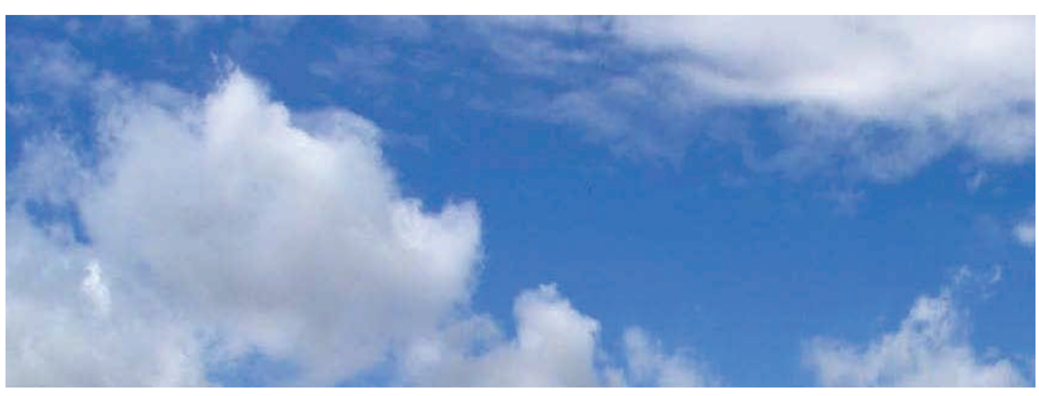


This two cluster phenomenon lowers structural cohesion, and lower levels of structural cohesion bode poorly for the odds of success post IPO. The two clusters create a divide that pulls employees apart instead of bringing them together to move forward. Without proactively dealing with this situation and making people a key asset in the new company, our research would suggest that these bankruptcy to IPO firms will have significantly lower chances of success.

An IPO makes the structural cohesion problem even worse because senior management is focused on the outside before, during and after the IPO. Management teams are worried about investors, the stock price, the IPO process, quarterly results and all the short-term issues that will take over their lives in the time before the IPO and at least the first year post IPO. Overall, leaders are externally focused and distracted the closer they are to the IPO date.

Through the many case studies and empirical studies we have done on IPOs, along with the existing literature on IPOs in finance and accounting, we know that the risk of poor performance in the first year post IPO is great. Our research suggests the highest risks and the most unanticipated and least prepared for dilemmas will be focused on the HRM issues. When senior management is focused outward, employees become frustrated. When employees perceive unfairness because they think the IPO was supposed to do more than it did for them or that senior executives have “changed the culture” (e.g. employees will receive less communications; they will see less of their senior team), then real customer service and quality suffer. When customers are not happy, or when quality goes down, customers leave. When customers are not buying as much, real revenue decreases. When sales go down, financials decline, and the “street” notices. Then stock price tanks or does nothing because investors are not watching the stock any more. Finally, when investors and potential investors quit trading the stock, stock price continues to go down.

The bankruptcy to IPO firm is an extreme case; however, we see the same phenomenon in smaller doses in firms that lived through the recession and had to deal with layoffs, less investments for employees, and overall stressful and negative business situations. There is a lot of pain and suffering out there today, and the rush to IPO can hide what’s really going on inside the firm.



The People Factors Matter and Will be Rewarded

Ignore the human resource factor, and the IPO process can have a significant and negative effect on the firm. This is the central message of this article. It is a particularly important message for the special subset of bankruptcy to IPO firms because there is a 22% chance that a bankrupt firm will end up in bankruptcy again.

Based on our research, our advice is to invest in the IPOs with strong, innovative and fast HR teams. Invest in firms willing to take the first day "hit" on their stock price and buck the trend to invest in the long term (and by long term, remember the research shows gains starting from investments in HR 90 days post IPO).

Firms that value employees, which share the wealth, that are willing to take the risk and create an environment that strengthens structural cohesion will outperform their peers.

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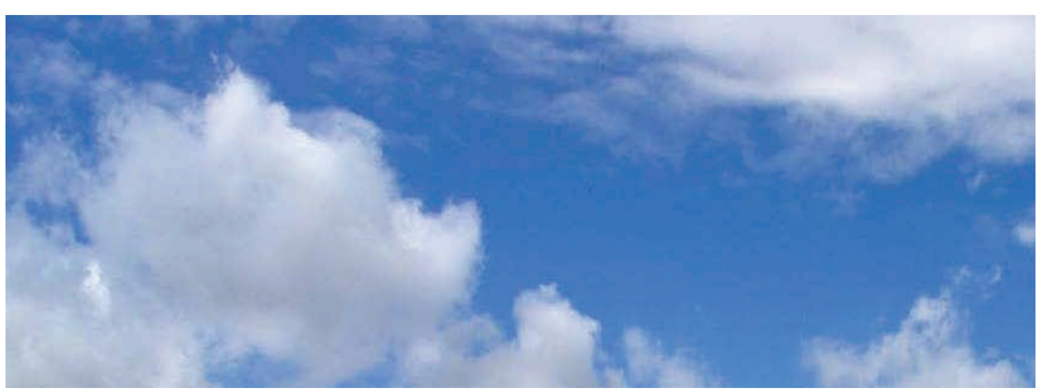

Endnotes

[1]Holmes, Robert (2010) The best IPOs of 2010. The Street (Market Features)

[2]Schaefer, Steve (2009) The IPO class of 2010. Forbes.com

[3]Welbourne, T.M. & Andrews, A.O. (1996) Predicting the performance of initial public offerings: Should HRM be in the equation? Academy of Management Journal, 39(4), 892-919

[4]All studies controlled for other factors that may be affecting stock price, and the research is longitudinal in nature with time 1 data predicting a time 2 outcome.

[5]Survival is coded by whether the firm, in its original form, is still in business. We coded survival different ways, always with the same results. For example, in some models, survival included mergers, with mergers coded as positive if stock price and other performance indicators were going up, and negative if those same numbers were significantly declining. In other models, we did the analysis without mergers. Always, the impact of HRM on performance was the same

[6]See Welbourne, T.M. & Cyr, L.A. (1999), The human resource executive effect in initial public offerings. Academy of Management Journal.

[7]For examples of the types of HR systems that help drive performance, contact the author. These specifics are the topics of other articles and research

[8]Five years after the IPO our research finds 60% are still "alive," and 10 years after about 40% of these firms remain in business