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Google should beware the 'Winner's Curse'

It's official: Google will run its eagerly-anticipated initial public offering by auction, abandoning the traditional process. The timing of the announcement last Thursday was impeccable, coinciding with Frank Quattrone's testimony about dotcom-era IPO misdeeds when he was flying high at CSFB.

Auctions could transform the troubled IPO market. They are more transparent and fairer to investors, while raising more money for the issuer. In the dotcom era, getting shares depended less on your valuation of the company than on being a "Friend of Frank", and the issuing companies left $70bn "on the table" in 1997-2000.

But auction design is not one-size-fits-all, and Google is a very special case. The danger of its "Dutch" auction design can be illustrated with a simple classroom game. The professor puts a large jar of pennies in front of the class and asks students to write down: How many pennies are in this jar? What is your bid for it?

Most students fall prey to what auction theorists call the "Winner's Curse". Say you guessed 1,000 pennies, and bid slightly less to try to make a profit. You might be spot on; you might have underestimated (it's really 1,500), or overestimated (really 500). While the *average* of people's guesses is often fairly accurate, the curse is that the winning bidder is usually whoever has the *highest* guess. Somebody else probably bid more if the real answer is 1,500, but if the real answer is 500, you're a likely winner – and likely to regret your bid. So you should bid cautiously.

Google is a lot like a very large jar of pennies. If over-optimistic bidders buy all the shares at auction and do not account for the Winner's Curse, they will lose money.

A less idealistic company might welcome the inflated bids: auctioning jars of pennies to naive students has long been a good way for impecunious economics professors to supplement their incomes. But if Sergey Brin and Larry Page, Google's founders, are sincere when they write in the prospectus that they want a broad, fairly priced placement of shares, they need to be careful with their auction.

First, the auction price should primarily be determined by institutional investors, whose full-time job is to size up penny jars. The Winner's Curse poses no problem for experts, who know to base their bids not on their initial estimate, but on a lower view which allows for the fact that winning estimates are often too high. An auction could be held for institutions, and small investors given the option of small allocations at the same price. Or an ascending auction format, similar to one at Sotheby's or on eBay, could allow individuals to observe and mimic more sophisticated bidders.

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Because all bidders pay a uniform price in Google's auction, overpricing arises only if over-optimistic bidders win all the shares. But since Google is so well known, and its auction may therefore attract a lot of unsophisticated bidders, this is possible. So the company needs to specify just how it plans to counteract this risk. It may be able to use its flexibility to repeatedly adjust the offer range to signal information. It also says it may lower the final auction price based on its own views and information, by selling additional shares or simply rationing bidders. But a small fix may not be enough, and the possibility of it could even encourage more aggressive bidding and exacerbate the problem.

Second, non-experts – many of whom form Google's current user base and future business – need proper warnings about the risks of bidding. Requiring all bidders to open an account with, and be vetted by, the investment bankers will weed out complete naifs, but others need more than the legalistic hints of risks in the 768-page prospectus. Google should, for example, create a practice auction on its website: most investors will never have bid in a Dutch auction before.

Finally, better information helps fight the curse – imagine bidding for the jar of pennies after the person who filled it has given you his own estimate. Transaction prices for mergers and acquisitions are analysed in exquisite detail in banks' fairness opinions, and banks are legally liable for faulty analysis. IPO pricing should be just as transparent. Current practice is merely to offer indicative price ranges which have neither legal standing, nor any clear analytical support.

If anything Google seems to be offering even less financial disclosure than the traditional process. Rather than abandon the traditional 'roadshow' meetings to inform investors, as Google apparently might, Mr Brin and Mr Page should conduct webcasts explaining the business to smaller bidders. Providing better information is Google's basic competence. It should "Googlify" its own auction.

Google the website is the world's most powerful information tool, but Google the stock is just a jar of pennies: investors cannot 'google' Google's real financial value. Google is right to use an auction for its IPO, and this will also set a valuable precedent. But it should take steps to protect its user base against the risk of the Winner's Curse.

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