eToys-Goldman Sachs, lack of models or conflict of interests?
Joan Fontrodona, IESE professor

eToys lawsuit against the investment bank Goldman Sachs claiming the banking giant intentionally undervalued the e-tailer's 1999 initial public offering has reopened a discussion about the origin of dotcom mishandling during the IPO. Was it a result of ignorance or was it a product of the underwriter's mala fide? In May 1999, eToys debuted in Nasdaq at $20 a share. The shares closed the session at $76.56. At that time, everybody looked happy. eToys raised $166 million, its brand appeared in the glamorous ranking of IPO's that multiplied their initial price by 100, and Goldman Sachs scored a new success in this kind of operations. Two years later, the share price was worth just 9 cents and the company filed for bankruptcy.

And now everybody complains, of course. Analysts, accused of having undervalued the share, may argue that in the short run it was situated below the price they had set. eToys moans that if the starting price had been higher, they would have raised more money and, therefore, would have had more cash to consolidate the business. Others wonder if $166 million wasn't more than enough to prove whether the company was viable. And so on... In the meantime, some made their money. The lawsuit now under way considers that, with the low valuation of eToys, Goldman Sachs wanted to reward some of its clients offering them the chance to buy cheap in order to sell later at a price substantially higher, and even perceiving some kind of commission for this "good service".

Historically-long before the Internet revolutionized the stock market--, analysts have received pressures to issue buy or sell recommendations of a company's shares or to set an IPO price in accordance with the interests of some of their clients. There are several reasons for this. On the one hand, strong competition forces investment banks to maintain excellent relationships with both current and prospect clients. On the other, walls between research and commercial departments are not clear in the internal organization of banks. Moreover, sometimes the analysts' compensation system is tightly bound to the volume of contracts they generate. Thus ethical codes, internal and government regulations and the enormous sums of money that firms spend to build ethical cultures of investment are practically useless against the prospects of operations that may become direct commissions for the analysts or for some of their clients.

Apart from how right each of the parties involved may be, in this case they seem to be two of a kind. On one side, the irrational euphoria-something we can only say now-of the late nineties joined together with the potential conflicts of interests in which financial analysts develop their activity and the immaturity of the market. This drove them to seek new formulas to value rapid growth companies but without any profit, such as dotcoms, to the detriment of the traditional financial instruments for company valuation.
While suits from affected investors abound, up to now there is no precedent of a dotcom company complaining about its initial valuation (and less, once bankrupt). Lack of models and the crisis of trust that the investment-banking sector is going through make it difficult to determine how the case will turn out or if some others will follow. On the horizon of eToys-Goldman Sachs conflict plenty of financial and even ethical questions arise. There are also issues about the model of analysis of an industry that is still under construction.