

1-800-CONTACTS

In December, 1995, Jonathan Coon left the BYU MBA program just a few credits short of graduation to devote himself to his mail order contact lens business, 1-800-LENSNOW. The business was growing rapidly, and Coon, along with his partner John Nichols, saw potential for even greater growth. To realize this potential, they needed to raise significant capital. They had used several funding sources in the past and wondered if an initial public offering (IPO) would be the best alternative to meet their present needs.

The prospect of a public stock offering raised some issues that concerned Coon, now the CEO of his newly named company, 1-800-CONTACTS. He wondered if the company was ready for all of the hassles that come with being a public company. He wondered if the benefits were worth having to divulge some strategies and secrets. And he wondered if the market really understood their business and would give them a fair valuation. Coon knew the IPO market had been quite volatile in recent months, and if the issue weren't timed right, the pricing would suffer, and they might have to delay the offering for as long as a year. He knew they couldn't wait that long to grow. As 1997 began, Coon needed to make some important decisions: Should they go public? Who should help them with the offering? and, When should they do it?

The Contact Lens Industry

In 1978 a federal law passed that required doctors to release prescriptions for eyeglasses to every patient. Prior to this requirement, patients were forced to obtain eyeglasses and contact lenses at the doctor's office. This legislation opened up a whole new vision-correction market that fueled the growth of companies like America's Best, Lenscrafters, and Pearle Vision. These companies gained market share by offering more selection, faster service and lower prices. The entire United States contact lens market grew to \$2.7 billion in 1997.

The United States, with 29 million contact lens wearers, accounted for roughly half of the world's contact lens market. One in five vision-corrected Americans wore contact lenses, but the ratio was much less in other areas of the world (one in eight in Japan, one in fifteen in Europe and less than one in a hundred in most developing countries). Over the past several years, major U.S.-based manufacturers expanded into Japan, as well as other Asian and emerging markets where growth was in the early stages. Meanwhile, the U. S. contact lens market added 1.5 million wearers in 1997. Analysts estimated 5-10% annual growth in the U.S. through the year 2000. Mail order/direct marketing accounted for only 5% of the contact lens market in 1996. But mail order sales were expected to be over 15% of the market by the year 2000. If the trend toward internet retailing caught on for contacts, that figure could be significantly higher.

The contact lens market had several attractive features. First, the ongoing shift from conventional to disposable and planned replacement lenses drove strong industry growth. Disposable wearers spent three times more on lenses than conventional wearers. Disposable and planned replacement new fits/refits were up 12% in 1996 and 15% for the first half of 1997. Disposable wearers have become about 55% of the U.S. contact lens base, and this mix shift will likely continue in coming years.

Second, contact lens manufactures benefited from lower per unit fixed costs achieved with higher volumes. Third, a consumer shift from commodity lenses to specialty lenses produced higher revenue per patient, as new fits and refits in this category grew by 10% last year. In addition, about 30% of U.S. cosmetic lenses are worn by people who do not require vision correction. Fourth, favorable demographics continued to encourage the industry: 60% of new fits last year were for consumers under the age of 25. Over the next 10 years, this segment of the population should grow 1.4% annually, vs. 0.8% for the rest of the population.

The Competition

Principle competitors are primarily ophthalmologists and optometrists in private practice, who accounted for 70% of contact lens sales in 1996, but this group is experiencing flat to negative growth. National optical chains such as Cole National and Lenscrafters, as well as mass merchandisers such as Wal-Mart and Costco, accounted for 25% of sales.

An estimated 15 mail-order companies dispense contact lenses. All, except Lens Express Inc., founded in 1987, had annual revenues under \$10 million. Lens Express was the largest player in the mail-order contact lens industry, with annual sales estimated to be \$50 million. They were purchased by Summit Technology in 1995. Sales at Lens Express were down slightly for the first nine months of 1997. A membership club, Lens Express charged a \$25 user fee for three years (\$40 for five years). In addition to contact lenses, Lens Express sold eye care solutions, lens cases and sunglasses. Lens Express employed an estimated 300 people at year-end, with an estimated \$167,000 revenue per employee.

Company Origin

As an undergraduate student, Coon wore contact lenses. He thought he could save money on his own lenses if he could get them in bulk quantities. He began to look for sources of inexpensive bulk contact lenses and purchased excess inventory from wholesalers, reselling what he couldn't use personally. He started a business in 1992 called "Eye Supply," selling contacts out of his Wymount apartment at BYU. His initial advertising consisted of putting up flyers wherever he could around campus. A communications and advertising major, Coon graduated from BYU in 1994 and entered the MBA program there in the fall. He spent much of his first semester writing a business plan for a new company, 1-800-LENSNOW.

An ad in the back of Popular Mechanics magazine led him to John Nichols, a registered optician with two years' experience at Bausch and Lomb, who ran a business in California called "Discount Lens Club." Coon had been looking for alternative lens sources, and he began to buy surplus from Nichols. They soon regularly bought and sold inventory from each other and eventually decided to go into business together.

Initial Financing

Initial financing came from credit cards and some of the proceeds from Coon's student loans. They soon obtained an SBA loan for \$36,000. The Commission for Economic Development provided another \$40,000 loan, and a private investor put in \$25,000. These funds were used for inventory expansion and new marketing programs.

To qualify for the loans, Coon used the business plan he'd written during fall semester. He entered the plan in a contest sponsored by the Center for Entrepreneurship at the Marriott School at BYU. His plan won first place and a cash award. "Winning the award was nice," he said, "I really needed the \$1000 since we were still in the earliest stages of the business. It was also helpful to get the feedback from a group of entrepreneurs on our plan."

In February 1995 Coon and Nichols wrote a buy/sell agreement and a shareholder agreement. They incorporated the company as 1-800-LENSNOW. Stephen Gibson of the Center for Entrepreneurship provided advice and some of the initial capital. Said Coon, "When we went about raising initial capital we didn't want to get money from just anybody. We wanted someone with experience, someone who had 'been there, done that.' Getting the money isn't hard. There's a lot of money out there." Gibson put in \$25,000 for 10% of the business, and then another \$27,000 for 10% more. He would meet with Coon and Nichols every week to go over the company's plans and operations. "He'd run a recruiting operation before, so he was very helpful when it came time for us to hire people, how to interview, what to look for."

Marketing

Coon and Nichols focused primarily on print advertising: newspapers, particularly Sunday papers; coupons; and glossy inserts. “We didn’t push much because we didn’t have a call center yet to handle a large volume of orders,” said Coon. “We leased a new home in Orem as the business location. John moved to Utah in December, 1994, lived in the house and took the calls. He’s a pretty early riser. If the phone rang at 4 am he would answer it. We didn’t have the 1-800-CONTACTS number yet. My company was 1-800-LENSNOW, and his was the Discount Lens Club, so we used a couple of different numbers for ordering and information.”

The company did print testing with the flyers and inserts to determine costs per order. They tested different demographics, different areas of the country, and different income levels. The company also arranged packages with a leading contact lens solution supplier to provide small inserts to be placed inside storage and cleaning solution packages.

The company acquired the 1-800-CONTACTS telephone number in July and changed their name. Recounted Coon: “We had to track down the guy who had the number, which was difficult because he never answered it. After we found him, we learned he hadn’t ever used the number in the five years he had it, but he knew what it spelled and what it was worth. We agreed to pay him \$163,500 for the number, which was a lot, but we knew it would separate us from everyone else in the industry and give us a significant advantage with every advertising dollar we spent. People never forget the phone number.”

Building on the new brand, the company shifted advertising efforts toward direct mailing and cooperative mailing (such as Val-Pak coupon mailers), while continuing to use glossy inserts (**Exhibit 1**). TV, radio and magazines were being considered for the future.

Results of Operations

Indeed, acquiring the new number proved to be a huge benefit. Sales that month increased from \$35,000 to \$78,000. The reorder rate improved by 25%, and “advertising effectiveness” (revenue increase during a specific period after an ad campaign) improved by 20%. January 1996 saw \$97,000 in sales with \$20,000 profit. “We could have been satisfied with a small profitable business, where we both would have made \$150,000-\$200,000 annually, but we wanted to grow the business to its full potential,” explained Coon. The company had a 37% gross operating margin, with about 12% SG&A without advertising. They spent 40% of sales on advertising. “We knew we’d eventually get into a regular pattern. As an S-corp. we didn’t want to take a lot of profits to avoid the tax hit. We wanted to focus first on growing the top line.”

The firm bought out Gibson’s 20% of the company for \$250,000 in March, 1996. They were approached by Don and Steve Yackman in April, who put in \$300,000 for that same 20%, plus a \$250,000 line of credit, which was later increased to \$500,000. “Having the connection with the Yackmans was quite helpful when it came time to prepare for the IPO,” explained Coon. “They’ve been on the other side of the table enough times to know what people are looking for.”

Strong sales growth for the young company continued. 1-800-CONTACTS had revenues of \$146,000 in April, \$165,000 in May, \$220,000 in June, \$280,000 in July, \$360,000 in August, \$450,000 in September and \$620,000 in October. Coon talked about the company’s financing strategy: “We avoided debt because we didn’t like it, but the Yacktmans wanted us to turn on the gas and crank up the marketing program. We started to think outside the box and realize the potential of the business. Once you do that, you don’t think in terms anymore of what you want your income to be. You stop comparing yourself to small local businesses and you start thinking on a new level. You realize you’re a tiny company when you see all the big companies there are, but still we knew we could be much bigger than we were now. We thought we could become a \$100 million business.” Coon knew that kind of growth would soon require a huge infusion of capital.

Operations and Technology

The 1-800-CONTACTS call center processed orders by phone, mail, fax and email from 6 a.m. to 8 p.m. (MST) Monday through Friday, and from 8:00 a.m. to 3:30 p.m. on Saturday. Agents were trained extensively, including a period with an experienced mentor, and were evaluated regularly. Agents were provided with a sales script, and were taught to provide energetic and understanding customer service, to provide information about promotional items, and to resolve any complaint, return or refund issues. The call center could handle 19,000 calls per day. 90% of calls were answered within 10 seconds.

The company developed a proprietary management information system that integrated the Company's order entry and order fulfillment operations. This integrated system tracked each order, monitored inventory levels, and processed credit card orders. The company believed this allowed them to provide unmatched customer service and superior efficiency.

The system provided the company's telephone agents with real-time product availability information via a point-to-point satellite connection with the Company's shipping facility. Agents could check to make sure the shipment contents matched the order, and they could provide an estimated delivery date. The system later notified the agent of delays, so the agent could notify the customer with an explanation. Agents had immediate access to all customer profiles and order information.

The input order was sent via the satellite link to the shipping facility where an invoice and shipping label with bar-code was printed. The bar-code contained all order information and was scanned for accuracy after the order was pulled from inventory. After the order was automatically boxed and sealed, the bar-code was scanned again to determine the shipping method and automatically direct the package to the appropriate bin. The company contracted with several independent couriers for shipment. The automated packaging system could process, fold, seal, scan, move and ship over 10,000 orders in a twelve hour shift. 80% of orders were shipped within 24 hours.

A battery powered back-up system supported the entire call center, servers, and phone switch. A generator capable of operating the company for five days supported the back-up system. All critical data was written to back-up drives throughout the day, and all company data was transmitted at the end of each day by satellite to an offsite location.

Company Competitive Advantages and Growth Strategy

1-800 CONTACTS attributed its success in the direct marketing segment of the contact lens industry, and its significant opportunities for growth, to several competitive strengths, including the 1-800 CONTACTS telephone number, the proprietary management information system, outstanding customer service, extensive inventory, convenient and rapid delivery, and competitive pricing. The company's growth strategy was to expand sales and marketing activities, continue to deliver high levels of customer service, leverage their existing infrastructure, and capitalize on favorable industry trends.

The company had a track record of outstanding performance, and future prospects looked good, particularly when compared to industry averages. A comparison to Land's End, a traditional mail-order retailer, showed the strong position of 1-800-CONTACTS (results reflect operations from the year ending December 31, 1996):

	1-800-CONTACTS	Land's End
Sales per Employee	\$840,000	\$327,000
Gross Margin	37%	43%
Operating Margin	15%	8%

Inventory Turnover	20	5
Catalog Expense (% of sales)	0%	15%
Advertising Expense (% of sales)	25%	8%
Expected Annual Revenue Growth (next two years)	140%	12%

The company sold an attractive product in an expanding industry. Contact lenses had a high bulk to value ratio, sales were not subject to seasonality, reorder rates were very high, inventory mix was predictable (customers usually reordered the exact same type and amount), and return rates were very low. See **Appendix A** for a more detailed description of company strengths.

Company Risks

Any and every risk facing the company must be spelled out in exquisite detail in the prospectus.¹ Explained Coon, “By the time you finish reading a prospectus, you think to yourself, ‘why would I ever want to invest in that company?’ The explanation of the risks must satisfy the SEC and protect the company against liability if the offering goes bad.” The company faced many substantial risks. The most serious of them was that they regularly broke the law--they did not comply with regulations in several states.

The laws and regulations for dispensing contact lenses varied from state to state, from requiring a valid prescription, requiring the dispensers to be licensed in the state as an eye-care professional, requiring the lenses be sold only in face to face transactions, to laws placing little or no restriction on the sale of contact lenses. While the company’s practice was to attempt to obtain a valid prescription from each of its customers or its doctors, the company estimated that only approximately one third of its sales were made in compliance with applicable state laws and regulations.

Other risks included tenuous supply arrangements, their ability to manage rapid growth, their inexperience resulting from a limited operating history, increased competition from discounters, alternative technologies such as surgical procedures or laser therapies, dependence on telephone and management information systems, dependence on Coon and Nichols as key executives, the concentration of ownership (existing shareholders would control 64% of shares after the offering), their ability to adapt to on-line shopping, their ability to retain the 1-800-CONTACTS telephone number, shipping cost volatility, shipping strikes, potential state sales tax collection, and product liability exposure. See **Appendix A** for a more detailed description of company risks.

IPO Considerations

Management wanted growth and knew how to achieve it--they just needed to arrange the financing. The company needed money primarily to increase marketing programs. Coon explained, “This is a business where as soon as you spend money on marketing, you see an immediate impact on sales.” For example the company recorded about \$600,000 in sales in both November and December 1996, but after a new marketing promotion was introduced, sales jumped by 50% in January 1997. Proceeds from an offering would also be used to purchase additional inventory and pay down debt.

¹ The prospectus, also known as the “red herring” is the document filed with the SEC and made available to investors that contains background information, financial data, risk factors and other key information about the company going public.

Why didn't the company consider bank loans or a debt issue? Said Coon, "I'm not a big fan of debt. Banks won't lend much to a business our size anyway. Banks want a long history of profitability. They want collateral. Prior to the IPO we did have a credit line of \$500,000 [from Yacktman Asset Management] that we barely even used."

An IPO had many advantages. Private transactions almost always included restrictive covenants involving the company's operations. Equity financing decreased leverage and financial risk in the capital structure, and equity could be raised at a lower cost through an IPO than by alternative methods. If the stock performed well, subsequent offerings could raise additional capital with less time and expense. Furthermore, a public company benefited from the increased attention of the investment community. The associated publicity could spill over to product marketing, adding credibility with customers as well as suppliers. Publicly traded stock could be used to establish stock option plans, stock purchase plans and ESOPs, increasing the issuer's ability to attract and compensate key employees.

Said Coon, "In order to capture the potential of this business, we knew we needed to raise a lot more capital than we could raise from private investors or the bank. The public markets are the least expensive source of [equity] capital because you get the highest valuations. And you give up the least amount of ownership and control of the company."

An IPO provided liquidity for shareholders. Often it was the vehicle through which early stage investors, such as venture capitalists, harvested their investment. Because harvesting implied closure, Coon believed the IPO had a different fundamental purpose. "Doing an IPO is not about hitting the jackpot. It's giving up part of the company in exchange for capital to grow the business. It's not cashing out. An IPO is for a growth business."

Existing shareholders' shares were split to get an appropriate number of shares for the offering. For the 1-800-CONTACTS offering the split was 410 to 1. The valuation of the shares was higher than if valued as a private company, because public market offered more liquidity. Occasionally, existing shareholders would sell some of their shares as part of the offering.

Concerns About Going Public

An IPO had disadvantages as well. Present shareholders would incur an immediate dilution of their holdings. Management faced the risk of loss of control. The fees associated with the offering made the transaction fairly expensive when compared with debt financing. Investment banks typically charged 7% of the proceeds for an IPO, but just a small fraction of that for a debt offering (for the fee schedule of the 1-800-CONTACTS offering, see **Exhibit 2**). Furthermore, compliance with SEC requirements increased administrative costs, and management must spend time and resources meeting with analysts, investment bankers and shareholders.

In this particular case the company would also have to deal the regulatory issues, particularly disclosure, because as Coon put it, "There are laws in states like Georgia and New Mexico that we knew we couldn't comply with." Despite the significant threat of litigation, they would continue to ignore the laws in these areas after the offering, because they believed the laws were anti-competitive and would not hold up if the company were brought into court.²

² The company believed its ability to comply with regulations requiring a valid prescription is hampered because customers are often unable to get a copy of their prescription. Traditional contact lens prescribers have refused to release copies of the prescription to patients or to mail order companies. Laws in 22 states do require that contact lens prescriptions be released to patients. Federal law already required that eyeglass prescriptions be released, and a law requiring the release of contact lens prescriptions has been debated, with strong opposition from optometrists and ophthalmologists in private practice.

Mostly there were competitive concerns about losing the anonymity and secrecy that they'd previously enjoyed in the industry. "Nobody knew how big we were, nobody knew our size," said Coon. "We were kind of hiding out and not giving our competitors any cause for concern. We were concerned about coming out and telling everyone what we were doing." The initial prospectus and subsequent SEC filings would reveal a significant amount of information about the company that would not otherwise be available. Competitors would have full access to this information. All significant corporate actions would be subject to scrutiny by competitors, shareholders, the SEC, the press and the investment community.

Going forward the company would have to publicly report every quarter. With industry analysts' conference calls the company would get lots of detailed questions about marketing strategies. How could the company explain things to investors in a way that they could understand without disclosing strategies to competitors? Said Coon, "Investors ask questions like, 'How much are you going to spend on advertising next quarter?' You'd rather not talk about it, but they need to know."

Analysts' reports that commented on strategies were publicly available. Anyone could call an analyst to get an opinion and discuss the company. Conference calls were open to anyone who wanted to call in and listen. The roadshow was open to anyone who found out about the presentations and wanted to attend. Tapes were made of the conference calls and circulated after earnings were released. "I get tapes of other people's calls. Any of our suppliers and competitors can get a copy of our tapes," said Coon.

Going public exposed the company to potential shareholder litigation if the stock price performed poorly at any time after the offering. This was sometimes referred to as "getting Lerached," in reference to California lawyer William Lerach, who attempted to buy shares of every publicly traded company. When the share price of any of his holdings would tank, he would scour all of that company's recent communications to find evidence that shareholders were not warned properly about negative events.³

Taking a company public could also result in an invasion of personal privacy. "People can look up what your net worth and annual income are," since employees making over \$100,000, as well as principles' ownership shares of the company were public information. Coon continued, "People you know sometimes don't see the difference between stock and cash when they look at your net worth. It affects their expectations when gifts are given, etc. [And] public shareholders watch what we do and ask lifestyle questions about what we're doing with our money, like if we're buying new cars and houses, and how many hours we're working and what our personal plans are. We don't have to answer these questions, but we usually do."

The Process

The company further believed that laws requiring the dispenser of contact lenses to be registered in the state or to be in personal attendance at the place of sale were written before mail order or other interstate distributors began selling contact lenses. The company also believed these laws did not apply to replacement lenses.

In June 1997, the company received notice from the Georgia Board of Optometry that the Company's sales in Georgia violated Georgia law, which required face-to-face delivery. The Board did not recommend action be taken at that time, but reserved the right to pursue future violations. In November 1997, the company received notice from the New Mexico board that the company's sales violated New Mexico law, and the company was ordered to cease and desist selling contact lenses in New Mexico. The company still had never been subject to actual legal proceedings, and the company believed any such proceeding would fail because the laws resulted from the strong lobbying of non-competitive private eye practitioners.

³ See "William Lerach: Silicon Valley's Worst Nightmare" *USA TODAY*, January 7, 1999.

When a company decides to do an IPO, they must choose an underwriter. Usually the company would try to find an investment bank with experience doing offerings of similar size in their industry, with a strong research team and with a solid retail distribution network that will promote the stock. The bank must show enthusiasm for the company, thoroughly understand its business, and commit to making a market in the stock. The company might also call around to businesses in the area that have gone public or to members of the investment community to get references. The company would then mail out a request for quotation (RFQ) to a variety of banks in order to gauge interest, gather information about the potential underwriters, and see what kind of valuation the company would get.

It helped if the company had an established track record of financial results. "What the public market likes better than anything is for you to predict your performance and then go out and do it," said Coon, "And that's what we did." The company contacted investment banks they thought they might want to work with, introduced themselves, and struck up a relationship. "We told them what we were going to do, then we provided them with our results. Without already being a public company we were able to establish a history of predicting and executing."

In January, 1997, 1-800-CONTACTS sent RFQ letters to five different regional investment banks (with phone inquiries to several others) that had experience doing \$20-50 million offerings in the direct marketing industry. "If they're interested they'll call," related Coon. "Sometimes they'll send a rejection letter, but if they're not interested they usually don't want to waste any time."

Among these they contacted Jeffrey Stein of McDonald and Co. in Cleveland, the recognized "ax" of the optical industry (an "ax" is the top expert analyst in an industry, to whom investors look for leading opinions). McDonald had done the last two big optical IPOs, including one for Cole National, a \$1 billion owner of optical retail chains such as Pearle Vision, TSO, Montgomery, and Sears. The company provided Stein with a detailed business plan that outlined their competitive strengths, including monthly sales projections and ad expenditures for 1997 and yearly projections for 1998-2000. They followed up each month.

The company had revenues of \$1.1 million in March, \$1.4 million in April and hit \$2 million in August. Said Coon: "We had shown them doubled sales in six months. We were nailing every month's forecast, either right on, or a little over, though a year, maybe six months at least, would be required before they would be willing to do an offering. But they decided to get things going even sooner. We talked in March, but our first real meeting when they came out and visited us was in April."

The company started meeting with accountants in April to prepare for an audit. How did they choose a firm? "I don't feel that you can really pick an accounting firm on price--any big firm is going to be expensive," explained Coon. "We chose Arthur Anderson because of their reputation and because we felt we could get along with them."

The audit process was very laborious and time consuming. Coon described the experience: "There's a ton of work that goes into this. We're a small business and we didn't do the best job of keeping track of our records. We had everything in Quickbooks, we knew what our results and balances were each month, but in terms of each PO and each invoice and check. We bought a lot of stuff on credit cards, and we had the credit card statements, but we didn't have something for each individual record. Arthur Anderson wanted to go back to the predecessor company, John's, and that was a shoebox audit. What records he had were mixed with a box of all kinds of junk." To further prepare the company, Coon needed to hire additional management. He had used Quickbooks to manage the company's finances himself and had done all the Accounts Payable and payroll (an outside bookkeeper helped with the deposits) until November 1997, when he hired a controller and CFO. For 1-800-CONTACTS financial statements, see **Exhibit 3**.

The company had revenues of \$21.1 million in 1997 (compared with \$3.6 million in 1996), 6% above their \$20 million forecast. They achieved their 1997 results spending only 3% more on advertising and 5% more on marketing than planned. Said Coon, "McDonald was very comforted by the fact that we were able to predict our performance like that, which is unusual for a small growing business. Comfort is the big word

in the offering process. If we had missed our targets at any point along the process it would have been over. The bankers would have lost comfort. They say things like, “I need comfort from the accountants on this issue.’ There’s a lot of comforting going on.”

The investment bank engaged in a “feeling-out process” with the company, involving as many people as they could in the process. Recalled Coon, “They invited me to [a Cleveland] Indians game. But the purpose of it was to get me in front of people, to have them hear my story and then later tell my bankers what they thought. I’d be watching the game and they’d say, ‘Go up to the luxury box. There’s a guy we want you to meet.’ Then later it would be, “Go down to the seats by the dugout and talk with [whomever].” This informal process gave the bankers more “comfort.”

One of the biggest issues with an IPO was timing: how was the market for IPOs? What were the amount and sizes of deals? Which industries did the market currently favor? Getting the timing right was one of the most crucial tasks of the investment bank. “[It] takes several months in advance planning to start to identify the appropriate underwriter, put together a registration statement for filing . . . you have to do that on a speculative basis before you know whether the market will be there,” said Kenneth Hoffmann of the investment firm Greenberg Traurig. Said Coon, “[The investment bankers] look at the market and decide when you want to be out on the road. December [for example] is usually not a good time, the exception being if you’re an internet company, because IPO activity really slows down at this time.” World economic conditions, activity in the equity market, and the amount and type of recent and pending IPOs all influenced this decision.

Syndicate/Co-manager

A “syndicate,” or group of investment banks, would jointly organize the IPO in a way that leveraged the strengths of the various participating underwriting organizations. *The Syndicate*, an internet publication, explained this concept: “Because most new issues are too large for one underwriter to effectively manage, the investment banker, also known as the underwriting manager, invites other investment bankers to participate in a joint distribution of the offering by forming a syndicate. Members of the syndicate usually made a firm commitment to distribute a certain percentage of the entire offering and are held financially responsible for any unsold portions.”

Three banks, McDonald, Dain Bosworth, William Blair, had responded to the RFQs. To pick the lead manager for the offering, the company had each bank present the 1-800-CONTACTS strategy and concept back to them. They chose McDonald. “Though we’d given each of them all our information, McDonald did a better job than the others presenting us,” said Coon. “Even if it wasn’t much more than repeating back what we’d told them, they were the only ones that seemed to get it.”

A company looked for an underwriter who could provide adequate marketing and distribution for the offering. Typically an offering sought a placement mix of retail and institutional investors to provide a stable price after the offering. Retail investors were typically individuals. Institutions were large organizations such as mutual funds, insurance companies or pension funds that bought large blocks of shares. Said the CFO of another firm who recently did an IPO, “As much as possible, you want to control who owns your stock. If it all goes into institutional hands, your price is based on their whims and desires and can fluctuate significantly. If it all goes into retail hands, you don’t get any significant institutional following or any sustaining power behind your stock.” Very small deals, less than \$5 million, were usually handled by a single underwriter who focused on either the retail or the institutional market.

The underwriter should also provide research coverage for the stock once it begins trading. Investors needed the assurance that they would have timely information about the company in the future. Since McDonald had the premier optical industry analyst, they were an attractive choice for 1-800-CONTACTS.

At McDonald’s recommendation 1-800-CONTACTS selected Morgan-Keegan as co-manager. They had previously done deals together, and the geographic coverage of their respective distribution systems

complimented each other well. As lead underwriter, McDonald was responsible for producing all of the documents and coordinating all of the tasks and events (**Exhibits 4, 5 and 6**) associated with the offering.

The Prospectus (“red herring”)

Prior to the organization of the prospectus, the underwriting firm will have completed its own due diligence work on the company. The due diligence process involved a careful examination of the company’s financial records, management, operations, suppliers, customers, markets, industry and competitive position. This included many “Q&A” sessions with management and discussions with auditors and legal counsel (**Exhibit 7**).

Once completed, the due diligence provided information for the creation of the S-1 statement (SEC registration) and a preliminary prospectus (the “red herring”), both of which were required by law before a company may execute an IPO. Known as the Securities Act of 1933, Full Disclosure Act, the Truth in Securities Act, and the Prospectus Act, the law “attempts to protect investors by requiring full disclosure of all material information in connection with the offering of new securities.”

Writing the prospectus was an extremely long and tedious process. Typically the attorney, accountant, investment banker and the CEO of the company would spend 12 hours a day for several months locked in a conference room tediously crafting every word and sentence in the document. Since so many people with different perspectives were working on the same document, contention would arise as differences of opinion slowed down the process. The company doesn’t want to say too much about its operations, strategy and competitive position, but they must disclose enough to avoid liability.

It could take up to several weeks for the SEC to review the company’s filing. Said Coon, “We filed the initial registration statement (S-1) with the SEC just before Thanksgiving, then waited for comments. Sometimes over 100 are submitted. We had very few. The SEC’s job isn’t to make sure that it’s a viable business, or a good idea, or something people should invest in, their job is to make sure all risks are fully disclosed.”

The Roadshow

The roadshow was the process by which company management and their investment bankers traveled the country for two or three weeks pitching the offering to potential investors. Large offerings required hotel ballrooms for their roadshows where hundreds of investors might attend. Midsize offerings would meet in conference rooms with 5-10 investors per meeting. Small offerings met investors in even smaller groups, in breakfast or lunch meetings, or one-on-one in investors’ offices. In these meetings the investment bankers talked about the financial structure of the offering, its attractiveness to investors, the strength and composition of the syndicate, and the analysts who would provide future research coverage. An officer of the company, usually the CEO or CFO, talked about the company’s strategy and strengths. Then the investment bankers explained the logic behind the offering’s pricing and began to build a book of orders from impressed investors.

Coon described his roadshow experience (**Exhibit 8**): “One guy from the bank is the manager. There can be up to ten meetings in a day, especially in large cities. You ride around between the meetings in a big limo, not for luxury or prestige, but out of necessity. It’s like a mobile office. After a meeting you jump in the limo and five people at once start talking on cell phones, “How was it? What was the reaction? Did they place an order? Did they make a commitment? You often eat your breakfast and lunch in the car, because you don’t have time to eat at breakfast or lunch meetings. And you have no time in between because you’re going from meeting to meeting all day long. You wolf down something where you can. We had breakfast meetings as early as 6:45 am, which meant getting up at 5 am to prepare. We carried a slide projector and copies of the slides in three different carousels. For smaller meetings with just a few people we’d use a flipbook. We always carry our stuff on person. You learn to never check anything.”

“This is what it all usually comes down to: you sitting down with a portfolio manager and doing little presentations with your flipbook. You have 20-25 minutes for the presentation and 5-10 minutes for questions. Sometimes they’ll say they don’t want to hear the presentation and just want to ask a few questions. One of the running gags in New York is for them to keep you as long as they possibly can so you are late for your next meeting. The roadshow was my favorite part of the offering. It’s fun to talk about the business.”

The Offering

After the roadshow underwriters had a better understanding of demand for the offering. If necessary, underwriters would use other brokerage firms to assist in selling additional shares. As *The Syndicate* explained, “Selling groups of chosen brokerages are often formed to help syndicate members to meet their obligations to distribute the new securities. Members of the selling group usually act on a ‘best efforts’ basis and are not financially responsible for any unsold portions. Under the most common type of underwriting firm commitment, the managing underwriter makes a commitment to the issuing corporation to purchase all shares being offered. If part of the new issue goes unsold, any losses are distributed among members of the syndicate.”

Another critical challenge faced by the underwriter was accurately pricing the issue. Correctly pricing an initial offering was very difficult, and Michael Brush of *Money Daily* explained why: “The job is risky. When pricing the stock, the bank has to hit the nail on the head. If the market price of the stock goes too far above what the investment banks predicted, then the company going public will be unhappy. It will think it could have gotten more money for the shares if the bankers had done a better job of valuing its stock. The bank is left with an unsatisfied customer, which often leads to lost business in the future. On the other hand, if the market pays less than expected, or doesn’t buy up all the shares, the investment bank has to eat the difference. To be sure, plenty of sleepless nights are spent worrying about what price to set for shares when a company is take public.”

Several approaches could be used to effectively price the stock. The underwriter would initially look to “comparables”, or companies of the same industry and size, if available, in order to find a range for pricing the stock (**Exhibit 9**). All company financial information would be carefully analyzed. The underwriter might also choose to do a discounted cash flow analysis, or use some other commonly used benchmark, such as a revenue multiple. McDonald’s bankers projected earnings-per-share for 1-800-CONTACTS of \$0.50 in 1998 and \$0.70 in 1999.

Using comparable PE’s, earnings, and earnings growth, the underwriters would determine an appropriate price range (“filing range”) for the offering. The underwriters would continue to build their book of orders throughout the roadshow, carefully monitoring investor interest. This allowed them to adjust the price until the final price is set the day before the shares begin. Typically the offering would be priced at a discount to comparable stocks in the sector, to insure that the offering would perform well in the first week (particularly the first day) of trading. There were three reasons for this: 1) the company wanted positive publicity from price appreciation, 2) the underwriters’ wanted their reputation strengthened to attract future deals, and 3) the investors wanted to know they’d gotten a good deal. If the stock fell, the underwriters would have trouble selling their next offering.

Total proceeds from the offering were split among the contracted parties. The largest block of funds, naturally, went to the issuing company, while the “spread” or fee was divided among the underwriters and brokerage firms. *The Syndicate* explained the fee structure, “Whenever new shares are issued, there is a spread between what the underwriters buy the stock from the issuing corporation for and the price at which the shares are offered to the public. The price paid to the issuer is known as the underwriting proceeds [fees].”

Market Conditions

The IPO market struggled in 1997, getting off to a very slow start at the beginning of the year (**Exhibit 10**). The market recovered July, but in September and October, as 1-800-CONTACTS contemplated their offering, a financial crisis in Asia and U.S. stock market jitters shook investor confidence. Goldman, Sachs & Co. remained the Street's leading underwriter of IPOs in 1997, placing 39 new offerings for \$6.78 billion. Technology was by far the leading IPO category, followed by industrial, health care, and financial services (**Exhibit 11**).

The aftermarket performance of IPOs improved in the later half of 1997 after a year of weakness (**Exhibit 12**). The S&P New Issues Index rose 5.3%, compared with 1.0% for the S&P 500, the only small capitalization index that beat the S&P 500. Small caps had performed well in May, giving 1-800-CONTACTS hope that this market would finally turn around in time for their offering later in the summer, but the "asian contagion" ruined the turnaround.

Buoyed by eager, cash-rich investors, low inflation and interest rates, many deals eventually cleared the market toward the end of the year as it was assumed the worst of the Asian crisis had passed. November, in fact, became the biggest month ever for IPOs with more than \$8 billion raised. But December saw the market dry up again and the drought continued into January 1998. A revival in the tech sector encouraged the markets and contributed to better small cap performance in the first ten days of February, but would that be enough for the IPO market to stage a comeback? Most experts weren't sure.

Historically, new issue volume tended to pick up in February, but 1998 was not looking good. "We expect both the number and dollar volume IPOs to slightly trail 1997 levels," said Dick Smith, managing director at Nationsbank Montgomery Securities. "The equity markets will not be as robust next year as we have enjoyed over the past year," predicted Robert Natale, Director of Equity Research at Standard & Poor's, noting a general fourth quarter 1997 flight to quality. "Some larger-cap stocks should continue strong into the new year, but potential earnings disappointments could increase market volatility."

That the market for new equity issues would be slow in the opening weeks of 1998 was no surprise--only six had rolled out by the same time in 1997--but market observers said that continued hesitation caused by stock market instability and the asian financial troubles could prove damaging in the long run to the IPO market. "People have a short memory [with regard to equity cycles]. They don't realize we go through this cycle during the first four to six weeks every year," said David Menlow, president of IPO Financial Network Corp. "However, what is new is the addition of the 'Asian equation' [that is] exacerbating the level of volatility, which is generally a difficult pill for the new issue market to swallow." Menlow added that very few players were willing to commit support to a deal in the aftermarket "if they feel there could be a downdraft caused by extraneous factors, most notably with Asia." Others agreed. "Indirectly, Asia is causing this," said Stephen Blum, a partner in corporate finance at KPMG Peat Marwick. "Any time a company and its underwriters don't know where the stock market is going next, there is a question as to value, and people tend to hold up."

Others viewed the market phenomenon as a function of seasonality. Barbara Bradley, a managing director with Laidlaw Equities Inc., said that the market simply needed a jump start. "The [IPO] market is just like a big machine," she said. "It all comes to a halt by the third week in December when all the deals are cranked out. Then you've just got to crank the thing up again." Still others viewed the market downturn as the result of an institutional investor preference for fixed income securities in a hot bond market.

Regardless of the reason, there was concern that the IPO market had topped. That perception led to a repricing of deals to more accurately reflect conditions. "The fundamentals haven't changed, but in the short run people are not sure what the right multiple is," Blum said. Menlow added that the valuations of IPOs already in the system could drop as much as 25% to 30%. "Deals prior to the end of the year were being priced at the low end of the range," Menlow said. "That evaporates confidence in the market's ability to take on the size and quantity of deals that remain in the pipeline."

Most believed that the basic principles that had driven the IPO books--the use of high stock market values to determine the value of new issues, the recycling of huge amounts of capital, and the belief that equities return more than debt in the long term--still applied. "Companies will still be banging at the door to go out," Blum said. "That door will only lock if the stock market ceases to be a sideways market and goes down another 10% or so." For further market information, see **Exhibits 13-16**.

Going Forward

1-800-CONTACTS originally wanted to do their offering in July or August, 1997, perhaps October at the absolute latest. The market was hot and the timing seemed perfect. But they couldn't get things moving fast enough, so the offering was eventually rescheduled for the end of October. Furthermore, McDonald's bankers insisted the company change its business model and start complying with state regulations. They worried about potential litigation from optometrists in those states. Though they had been threatened, 1-800-CONTACTS had yet to see a lawsuit filed against them. Coon reemphasized his view that those regulations were anti-competitive, and complying with them would destroy their business in those states. Yet the bankers insisted that the company change their operations. Said Coon, "We kept telling them it was impossible, and eventually we just told them we would continue to finance ourselves."

The deal was put on hold. McDonald later decided to go ahead with the offering as long as 1-800-CONTACTS publicly disclosed that they were not in compliance with those state regulations. "We had no problem with that," said Coon. In October, 1997, at a time when the IPO market had run dry again due to the effects of the Asian financial crisis, the decision was made to go ahead with the offering in February. The IPO market rebounded in November, but during the final preparations for the roadshow, and the roadshow itself, the IPO market dried up again. In this volatile environment Coon wondered what kind of price they would get and how receptive the market would be.

APPENDIX A

Company Competitive Advantages

1-800 CONTACTS attributed its success in the direct marketing segment of the contact lens industry, and its significant opportunities for growth, to several competitive strengths:

- *1-800 CONTACTS Telephone Number.* The company believed its easy to remember, toll-free telephone number could generate the greatest amount of customer awareness in the most cost effective manner.
- *Proprietary Management Information System.* The company believed that the operating efficiency resulting from its proprietary management information system was largely responsible for average sales per employee being approximately three to five times higher than its largest direct marketing competitor.
- *Customer Service.* Delivering high quality, consistent customer service had been a cornerstone of the Company's strategy since its inception, and the company believed that consistently providing every customer with prompt and courteous service throughout their relationship with the company increased the company's ability to attract and retain customers.
- *Extensive Inventory; Convenient, Rapid Delivery.* The company stocked a large inventory of contact lenses from which it could ship approximately 80% of its orders within 24 hours of receipt. They intended to use a portion of the net proceeds from the offering to invest in additional inventory.
- *Competitive Pricing.* The company believed that its prices were generally 25% lower than prices typically charged by eye care practitioners and comparable to those charged by large retail optical chains and mass merchandisers, who generally did not offer the convenience of telephone ordering and home delivery.

Growth Strategy

The company believed that it had significant opportunities to attract and retain new customers and increase overall sales through several strategic initiatives:

- *Expand Sales and Marketing Activities.* Following the offering, the company planned to significantly expand its sales and marketing activities to attract new customers and increase sales to existing customers. The company's experience had shown that increases in advertising expenditures had a direct and immediate impact on sales growth.
- *Continue to Deliver High Level of Customer Service.* Historically, each \$1.00 of sales to new customers has generated \$0.78 in reorder sales within 12 months. The company expected its sales to repeat customers to continue to grow as the contact lens market continued to shift toward disposable contact lenses, and consumers increased the frequency with which they replaced their contact lenses.
- *Leverage Existing Infrastructure.* To support anticipated growth, the company had expended considerable resources in establishing proprietary management information and telecommunication systems and operating and distribution facilities that had the capacity to handle the company's contemplated sales growth for the foreseeable future with minimal additional capital expenditures.
- *Capitalize on Favorable Industry Trends.* According to industry analysts, the number of soft contact lens wearers in the United States had risen from 19 million in 1990 to over 29 million in 1997 and was

projected to increase by approximately 5% annually through the year 2000 as soft contact lenses continued to gain popularity, and the number of 14-to-25 year olds (the prime age group for new lens wearers) increased.

Company Risks

Every risk facing the company must be spelled out in exquisite detail in the prospectus. The explanation of the risks must satisfy the SEC and protect the company against liability if the offering is unsuccessful or aftermarket performance is poor.

- *Lack of Compliance with Certain State Laws and Regulations.* Because there were no federal laws that regulate the distribution of contact lenses, the sale and delivery of contact lenses to the consumer was subject to state laws and regulations. The laws and regulations for dispensing contact lenses varied from state to state, from requiring a valid prescription, requiring the dispensers to be licensed in the state as an eye-care professional, requiring the lenses be sold only in face to face transactions, to laws placing little or no restriction on the sale of contact lenses. While the company's practice was to attempt to obtain a valid prescription from each of its customers or its doctors, the company estimated that only approximately one third of its sales were made in compliance with applicable state laws and regulations. While little effort had been made thus far (the Georgia Board of Dispensing Opticians and the New Mexico Board of Optical Examiners had both sent cease and desist letters including the threat of future legal action) to enforce these laws, efforts by professional groups to compel direct-mail retailers to comply with state laws could result in fines or lost sales.
- *Supply Arrangements.* A number of major contact lens manufacturers and suppliers have refused to sell products to direct marketers, which has forced the company to purchase from unauthorized distributors or large optical chains with excess inventory. The company was not an authorized dealer of many of the products it sold. This forced the company to pay higher prices than retailers, eye care practitioners and mass merchandisers, who could buy directly from the manufacturer, and to carry abnormally high inventories of certain products. The result was lower overall gross margins. The company currently purchased 60% of its inventory from just two distributors, neither of whom were authorized by manufacturers to distribute their products. Should either of these suppliers no longer be able to provide the company with inventory, there was no assurance that the company would be able to obtain sufficient quantities of contact lenses at competitive prices in the future to meet anticipated demand for its products.
- *Rapid Growth and Limited Operating History.* Additional experienced management, improved financial and management controls, better reporting systems, and well-trained employees must be added to meet the demands of expanded operations. There was no assurance that such management would be attracted and retained, or that the existing and new management would be able to timely and effectively implement such systems, or to manage future expansion successfully.
- *Other risks* included: increased competition from optical professionals in private practice, local and national retail chain stores, mass merchandisers such as Wal-Mart and Costco, alternative technologies such as surgical procedures or laser therapies, dependence on telephone and management information systems, dependence on Coon and Nichols as key executives, concentration of ownership (existing shareholders will control 64% of shares after the offering), ability to adapt to on-line shopping, ability to retain the 1-800-CONTACTS telephone number, shipping cost volatility, shipping strikes, potential state sales tax collection, and product liability exposure.