

Why Small Business Owners Should Not Worry about “Money Left on the Table” in IPOs!

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Abstract

Purpose – this study aims to investigate how those directors of listed companies to make profits when their firms were listed to public.

Design/methodology/approach –This is an empirical study; we adopted the formula from Ritter (2001) for this research.

Findings -this study finds that directors of issuing companies usually get benefits from the money left on the table due to two factors. First, they usually retain larger percentage of shares before or after the companies going public; second, the first-day closing market price is normally higher than the initial file price ranges (defined as the expected price per share by issuing companies just before the firms go public). **Originality/value** - the findings may be used for future academic research literatures which focus on IPO or primary market. This research would help individual investors better understanding primary market especially IPO market.

Key words: IPO, Listed companies, Directors, Money on the table, Shareholders

JEF Classification: F300. G100. G150

1. Introduction

Ritter (2000) finds that during 1990-1998, companies going public in the United States left more than \$27 billion on the table. During 1999-2000, the amount of money left on the table jumps to \$51 billion, where the money left on the table is defined as the first-day price gain multiplied by the number of shares sold (see Table One).

A portion of the money left on the table comes at the expense of preissue shareholders. Most companies going public are relatively young firms with large blocks of equity owned by the small business owners as the firm's board of directors. Thus throughout most of the article, we will use the terms “preissue shareholders” or “directors” interchangeably with the notion of the small business owners who are taking their firm public, so as to continue growing the firm.

Although preissue shareholders leave a large amount of money on the table, we find that the owners commonly gain more than they lose during the IPO process. The purpose of this paper is to provide empirical evidence that whether issuing directors get benefits from money left on the table depends on two factors. One of the factors is that these

owners usually control large percentage of shares before or after their firms going public. The second one is the first-day closing market prices usually are higher than the initial file price ranges, where the initial file price range is defined as the expected value per share by preissue shareholders just a few days before the IPO initially announced.

The remainder of the paper is organized as follows, section 2 is literature reviews. Section 3 is data section and methodology, section 4 is the samples and empirical analysis, and conclusion is in section 5.

2. Literature review

The money was left on the table which is associated with the high initial return (the price change measured from the offering price to the market price on the first trading day) in IPOs of common stock. The existence of the high initial return phenomenon in IPOs is well known by the economic literature, and seems to be a common characteristic of most international markets, as highlighted by Loughran et al. (1994).

Most of theoretical models explaining IPO important initial share three features: imperfect information and agency costs among firms, intermediates, and investors; choice and institutional setting of introduction procedure and; investors over-optimism in hot issue markets.

Rock (1986) categorizes investors into two types: informed and uninformed. He gives the winner's curse hypothesis to explain the IPO underpricing. Benveniste and Spindt(1989) state that the underpricing is a means to induce informed investors to reveal private information about the demand for shares in the pre-selling phase, thus allowing the intermediates to better evaluate the offering. Ritter (1998) names Benveniste and Spinet's (1989) hypothesis as the market feedback hypothesis.

Grinblatt and Hwang (1989), Allen and Faulhaber (1989) , Welch (1989) and Chemmanur (1993) instead identify the firm's managers as the informed party , and interpret the underpricing as a " signal" of a firm's quality and as a meant of counter balance the costs borne by the investors in collecting information.

Ritter (1998) states that, in order to generate excess demand and be able to have a large number of small shareholders, issuing firms intentionally underprice their shares. The disperse ownership will both increase the liquidity of the market for the stock it more difficult for outsiders to challenge management.

There also are several financial economists explain the relationship between directors' benefits and the money left on the table.

Loughran and Ritter (2000) state entrepreneurs do not get upset about money left on the table. Trueman(2000) finds that gross profits are positively and significantly associated with stock price. Moreover, he also finds that the bottom-line net income positively associates with stock price for preissuers. Arosio, Giudici and Paleari (2000) point out those issuing directors rely on private information signalled by the revision of the final offer price, compared to the initial file range. The more optimistic the price revisions in prospectus range after book-building activity, the higher the initial return since issuing directors are provided with good news.

Arosio et al. (2000) state the controlling shareholders after the IPOs discover they are wealthier, and this is good news for them. Miche and Ljungqvist (2000) argue that the owners can minimize their wealth loss during the IPO process by retaining a large number of shares. Miche (2000) points out that an issuer selling more shares clearly stands to lose more than an issuer selling fewer shares for a given level of underpricing.

Lahnerman and Tvershy (1979)) argue that issuers care about the change in their wealth rather than the level of wealth. Michel and Ljungqvist (2000) argue that owners care about underpricing to the extent that they stand to lose from it, and that any such losses are proportional to the number of primary (new) and secondary (old) shares being sold.

Lioughran and Ritter (2002) stated that pre-issue shareholders sum the wealth loss from leaving money on the table with the wealth gain on the retained shares from a price jump, producing a net income in wealth for preissue shareholders. Ritter (2000) also argues that to avoid losing more money on the direct fee of underwriters, issuers like leaving money on the table.

Ritter (2001) points out, in general, the wealth gain for preissue shareholder from the revaluation is greater than his or her share of the money left on the table. He also gives a formula for explaining the condition. The formula will be shown in the methodology section later.

3. Data selection and methodology

The main data in this research is collected from internet web site www.edgar-online.com. In this web site, we can access both the US and other international IPO markets. Because this study aims to investigate how those directors of listed companies to make profits when their leave money on the table, we believe which would be a market

scenario rather than a special period phenomena; therefore, we just culled available market data for this study between 1990 and 2002. In the US IPO market, we only can find 62 listed companies provided how many or percentages of IPOs owned by director or executive shareholders before or after public listing between 1990 and May 2002 (see Table Two). In other international IPO markets, there were 655 IPO details available in 61 countries up to June 2002 (see Table Three); however, only 94 provided such details to public (see Table Four) in the same period.

The methodology used in this research is basing on Ritter (2002) formula; following Ritter(2000) data selection criteria: the IPO should issue ordinary common shares and should not be a unit offering, closed-end fund, real estate investment trust (REIT) or an American Depository Receipt (ADR); the IPO should have an offer price of at least \$8.

Ritter (2001) points out, in general, the wealth gain for preissue shareholder (i) from the revaluation is greater than his or her share of the money left on the table, when the following condition is met:

$$\{ \text{Shares retained (i)} + \text{secondary shares sold (i)} \} * (\text{OP} - \text{midpoint}) + \text{shares retained (i)} * \{ \text{P} - \text{OP} \}$$

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$$\{ \text{P} - \text{OP} \} \{ \text{Secondary shares sold (i)} + \text{primary shares sold} * (\text{shares retained (i)} / \text{shares retained}) \}$$

where P is the market price, OP is the offer price, primary shares sold are being sold by the firm, secondary shares sold(i) are existing shares being sold by shareholders(i), and the shares retained without a subscript are for all shareholders combined (see Barry (1989) for related work). For issuers with an upward revision of the offer price (upward revision means the offer price is above the initial file price range; midpoint is the middle of the initial file price ranges), this condition will be met unless shareholder (i) is selling a large number of shares in the offering or the offering is huge relative to the preissue number of shares. In practice, young companies going public rarely have any secondary shares in the IPO.

It is clear that Ritter's model is based on the situation that offer prices are higher than initial file price range (upward revision). Ritter (2002) agrees that among the IPOs which left money on the table in the whole world market, there are only about 24.3% of IPOs that have higher offer prices than original file price ranges. Considering this situation, we change Ritter's formula as below:

$$\{ \text{Shares retained (i)} * [\text{P} - \text{midpoint}] + \text{secondary shares sold (i)} * [\text{OP} - \text{midpoint}] \}$$

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$$[\text{P} - \text{OP}] * [\text{secondary shares sold (i)} + \text{primary shares sold} * (\text{shares retained (i)} / \text{shares retained})]$$

Actually, this new formula is same as Ritter's. But in this study, we do not pay attention to the relationship between the offer price and initial file price range; we focus on the relationship between the first-day market closing price and the initial file price range. P, OP and i have the same meaning as Ritter's.

Due to the formula, the condition only can happen if (i) the market price (the first day closing price) is below the midpoint and ;(ii) shareholder only retains a little number of shares before or after IPO process. Because young companies going public rarely have any secondary of shares in IPOs [Ritter (2002)], so the most important factors in the formula are shares retained and [P- midpoint]. Issuing directors only can get benefits from money left on the table when **they hold large number of shares** and P-midpoint is positive.

4. The empirical analysis

Let's take the example of Netscape's IPO, where director Clark held 9.34 million shares. Based on the midpoint of the file price range of \$12-\$14, the expected value of his Netscape holdings was \$121 million at the time that the preliminary prospectus was filed. At the closing market price on the first day of trading, his shares were worth \$ 544 million, a 350% increase in his pre-tax wealth in the course of a few weeks. So at the same time that he discovered that he had been diluted more than necessary due to the large amount of money left on the table, he discovered that his wealth had increased by hundreds of millions of dollars. Since he owned 28.2% of the company before going public, \$43 million of the \$151 million wealth transfer from preissue shareholders to new investors come out of his pocket. Although he lost \$34 million, his gain is more than his loss. He got both news at the same time, bad news is that he lost some money on the table because of the underpriced IPO; good news is that he gained more money than he lost. This is shown as Panel A below:

Panel A

Clark's wealth gaining in IPOs

shares offered (million)	offer price \$	first-day price \$	money left \$million	initial file price \$	retained shares (million)	expected wealth \$million	actual wealth \$million	wealth gain \$million	net gain \$million
5	28	58.25	43	12--14	9.34	121	544	423	380

Source: www.edgar-online.com and

Ritter's (2000) web site <http://bear.cba.ufl.edu/ritter/SDCCOR.PDF>. Updated 25th May, 2000.

Table Five shows the relationship between offer price, the file price ranges and first day closing market price for IPOs. The data is got randomly from www.edgar.online.com, the fourth column, the first closing market price come from Ritter (2001). From the 24 random samples, except of CONE (its market price is lower than file price range), other 23 firms' first day closing market prices all are higher than midpoint, so we argue that in IPOs that left money on the table, the first closing market prices commonly are higher than file price ranges. It is clear that the first-day market closing price minus the midpoint (the middle of initial file price range) usually is positive, which means that **P- midpoint** is great than zero.

Although Arosio et al. (2000), Miche and Ljungqvist (2000) and Ritter (200) all believe that directors can get benefits from money left on the table in IPOs with shares controlling, none of them gives the evidence that the preissue shareholders retain a large number of shares before or after firms going public.

From Table Two, we can see that in the USA IPO market, the board of directors, on average, hold 62.25% of their equities prior to going public; after going public, the board of directors still control large percent of shares, average 40.71%. Table Four exhibits the percentage of shares that are held by the board of directors in international IPO market, among the 94 firms, before going public, the directors, on average, own 54.63% equities of the companies; after going public, these directors still own about 45.29 percent of shares.

From Tables Two and Four, it is clear that the preissue shareholders (issuing directors) always hold huge number or large percentage of shares either before or after their firms going public. So the second factor, issuing directors retain a large number of shares before or after firms going public, is absolutely prevailing in IPO markets around the world. Now, considering the formula, the directors always hold large number of shares before or after going public; the market price usually is higher than the file price range. Due to the both factors, the directors will get the high net benefit from the money left on the table. The greater the percentage of stock owned by top managers, the more likely they will make decision consistent with maximizing stockholders' wealth (Jensen and Meckling 1976), since that will ultimately maximize their own wealth.

We give another example, July 2000, Corvis company went to public, the offer price is \$36.00, the first day closing market price is \$84.72, the file price range is between \$13- \$15. The directors group own 148,549,248 shares, 49.4%, prior to going public. The total issue shares are 31,625,000. The price of IPO jumped \$48.72 per share. The expected values of their holding shares are \$2,079.69 million at the time the preliminary prospectus was filed (midpoint **price * number of shares they hold, \$14 *148.549 m= \$ 2,079.69m**). At the closing market price on the first day of trading, their shares' value increase to \$12,585 million (**\$84.72 *148.549 m**). This is \$10,505million increase in their pre-tax wealth in the course in a few weeks. Although the directors left large amount money on the table about \$716.14 million (**the total amount left on the table is \$1540.77 m= 31.625m *\$ [84.72-36.00], those directors own 49.4% of total shares, so they left 49.4% of \$1540.77m is \$716.14m**) in the IPO process, they gain more than they left the money on the table. We think they satisfied with the situation, because the **net gain for the directors is: wealth gain minus money left on the table=**

\$10,505million - \$761.14 million = \$9,744 million.

Panel B

Corvis company's directors' wealth gain from money left on the table in IPO

shares offered (million)	offer price \$	first-day price \$	money left \$million	initial file price \$	retained shares (million)	expected wealth \$million	actual wealth \$million	wealth gain \$million	net gain \$million
31.625	36	84.72	761.14	13-15	148.549	2,079.69	12,585	10,505	9,744

Source: www.edgar-online.com/ipoexpress and <http://bear.cba.ufl.edu/ritter/SDCCOR.PDF>. Update: 30th May, 2002

From the above two examples, it is clear that when directors own large percent of shares prior or after going public; and the market price is higher than the midpoint (the middle price of the file price range), they will get the benefit from the money left on the table. The both factors are important for increasing their wealth in the IPO process.

5. Conclusion.

Ritter (2000) finds that there are huge amount of money was left on the table during the IPO process. He also finds that the preissue shareholders do not get upset about money left on the table and they can get benefit from the money left on the table.

From the formula that was established by Ritter (2002), we find that Ritter bases his theory on the upward revision (the offer price is higher than the initial file price range). Because there are not many IPOs' offer prices are higher than initial file price ranges (only about 24.3%) [Ritter (2002)], so we develop Ritter's formula.

In this new formula, we focus on the relationship between the first-day market closing price and the initial file price ranges rather than the relationship between offer price and the initial file price range. Depending on the new formula, we believe that the issuing directors get benefits from the money left on the table have to depend on two factors: they should hold a large number of shares before or after their firms going public; the first-day market closing prices must be higher than the initial file price ranges.

We analysis the data from the United States and international IPO markets and find the most of IPOs' first-day market closing prices are higher than the midpoint (the middle price of the initial file price ranges). And before or after firms going public, the issuing directors always hold large number of shares of their own firms.

So that, the pre-issue shareholders (issuing directors) usually do not worry about the money left on the table, they can get benefit from the money left on the table depend on the shares retaining and the higher first-day market prices. This research provides a clear picture to help investors better understand primary market particular IPO market. The findings of this research may be used for future academic research literatures which focus on IPO or primary market.

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Table 1. IPOs with a midpoint of the original file price range of at least \$8.00, excluding ADRs, unit offers, closed-end funds, REITs partnerships, and stocks not listed on CRSP (mainly foreign firms going public in the U.S. without ADRs).

Year	Number of IPOs	Average First-day Return	Aggregate Amount Left on the table \$billion
1990	89	9.46%	0.3
1991	250	11.37%	1.39
1992	338	9.87%	1.65
1993	437	11.64%	3.12
1994	319	8.56%	1.37
1995	366	20.38%	4.16
1996	572	15.99%	6.45
1997	391	13.80%	4.22
1998	267	21.76%	4.95
1999	446	70.89%	35.2
2000	333	57.29%	26.69

Source: Jay Ritter (U of Florida, 352.846.2837). Not: if smaller IPOs are included (those with a midpoint of the offer price range of less than \$8.00), the number of IPOs increases. If foreign IPOs are included, the amount of money on the table increases.

The amount of money left on the table is defined as the offer price to closing market price on the first-day of trading, multiplied by the number of shares offered (excluding overallotment options) on a global basis.

Table 2. The percentages and numbers of IPOs owned by directors and executives before or after companies listed (USA data up to May 2002)

Symbol	shares owned before offering to public		shares owned after offering to public	
	Number	Percentage of shares	Number	Percentage of shares
VRST	8501380	56.1	8501380	
ODSY	12284402	54.01		
SGEN	12598928	58.3		
GIVN	15748574	83.3	17248574	57.2
EXAS	3390387	53.5		
KCIN	2520298		2520298	
AFCE	30372748	70.3	30372748	
LGVN		43.2		
GLYN	5994830	57.5	5994830	36.8
REVU		59.19	11535524	43.33
SWSH		11		9.6
WMGI		85.31	18525875	54.35
CCRN		5.9		4.5
MOSY	14454182	58.5	1302500	48.7
MDTH	12073379	95.5		
ORH	48000000	100	48175000	73.9
MXRE	3139075	10.7		
NRGY	1583256	47.8	572542	40
SWRG	2599099	57.3		
HGOI	10884520	56.48	10854520	53.8
GME			14535775	21.8
INDI			10144100	95.7
GLAD			1293508	13.5
HPLA		87	17524328	57.1
APPX	35913113	99.18		
AMGP	15599254	52.7		
AHS	5473055	95.8		
RMK			152180405	90.5
BFUM		87.1	7740850	55.7
BRZZ		20.51		13.57
DJO	9958209	97.7	91804053	49.9

FPH				19.9
CHFN			278000	5.2
ALPE		89.89		88.85
DVS		99.3	3972000	79.3
LAVA		52.4		38.8
OMCL	213898	54.4	1056238	39.4
ABCO	4097172	25.4	4097172	32.3
PETC		15		11.3
WOOF		92.3	15815574	55.1
SCNO				11.4
TWLO			1550000	48.8
TASR		95.1		59.5
PULX		17.9		14.5
MDCV		45.8	3303912	37.9
ZGEN		100		
WTW	22299450	94.9		
MHLXU	878482	50.5	1535811	41.1
WLWD		85.58	3015001	58.53
WSTX	540179	28.5	540179	18.5
THER	13930555	44.73	754926	37.82
KMR			29230190	25.29
AIO		92.8	35987040	75.1
MLTC		33.35		47.9
TELM		30.2		27.7
OIS	25572535	75.5		
GMR		13.1		9.9
ICH		80.5		55.3
AQA		54		48.8
SLMC				96
GMXR		100		50
ATPG		100		
SUM		3175.03		1954.14
MEAN		62.25%		40.71%

Source:

The data is from the web site www.edgar-online.com , update 31st May 2002.

In each firm's report, only the shareholders who own more than 5 % of the total shares will be listed. All directors and executive officers are treated as a group.

Table 3. The numbers of IPOs listed in different countries up to 30th June 2002 (excl. USA)

country	sample number	country	sample number	country	sample number
Argentina	7	Germany	15	Puerto Rico	2
Australia	7	Greece	8	Russia	6
Austria	2	Hungary	2	Scotland	1
Bahamas	1	Iceland	1	Singapore	5
Belgium	3	India	6	Spain	3
Bermuda	26	Indonesia	1	Sweden	9
Brazil	9	Ireland	9	Switzerland	8
Jamaica	1	Israel	58	Taiwan	2
British Virgin		Italy	3	Nether land	24
Island	11	Japan	5	Turkey	1
British west		Jordan	1	U. K	46
Indies	4	Korea	3	US Virgin	
Canada	244	Luxembourg	4	Island	2
Channel		Malaysia	1	Venezuela	1
Island	1	Mexico	6	Thailand	2
Chile	6	Netherlands	1	West India	1
China	54	Antilles	1		
Colombia	1	New Zealand	3		
Costa Rica	2	Norway	5		
Denmark	1	Panama	1		
Dominican	1	Peru	2		
Ecuador	1	Philippines	1		
Finland	1	Portugal	2		
France	19	Prince Inward			
		Island	1		

Source: the data is from www.edgar-online.com/express-ipo, update is 30th June 2002

Table 4. The percentage of shares owned by directors and executives

COUNTRY	TICKER	BEFORE GO TO PUBLIC		AFTER GO TO PUBLIC	
		NUMBER	PERCENTAGE	NUMBER	PERCENTAGE
ARGENTIA	LCTO		87.5	26575384	68.9
	IMPT	42406315	56.9	42485394	46.4
AUSTRALIA	TBA			12491250	73.4
	ASIO	5559999	66.5		
	ITTE	16550000	93.43	15850000	74.24
AUSTRIA	TBA		95		58.46
BERMUDA	ESREF	2682129	100	3677820	69.9
	FTHL	107982096	100	102682096	79.54
	GBLX	172759314	88.99	170819314	80.9
	IWAV		75.8		61.7
	MRVL		70.5		
	WPL	5151983	10.8	4918987	10.39
BRAZIL	BRS		87.25		86.25
CANADA	TSIX	9840000	12	3325400	5
	TBA	2500000		2500000	71.42
	AML	5000000		5000000	71.43
	AAI		50.8		43.43
	AISI		100		54
	ATAG			2854900	38
	ATC		13.5		12.5
	MMC			2522000	71.43
	TBA			50000000	71.42
	BVI				49.5
	BPOU				58.4

	TBA			150000	73.17
	BIVI			5550000	41.04
	BMI	304000	50.8	304000	43.43
	BCC		40		28.5
	BADC		12		9.1
	TBA			2500000	43.5
	XAIN			150000	73.17
	XMLG			6535000	23.9
	XUNA			4490000	89.8
	YACO			1725800	42.2
	TBA				71.43
CHANNEL ISLAND					
	AMDO			1725188824	87.2
CHINA	AONL	18578575	54.85		
	ASIA	10551535	70		
	ASTV			5351280	49
	CVMI	823084	22	823084	15.5
	IEIF		48.9		34.2
	HIOW		33.9		10
	ICAB			1500000000	81.5
	JADEF			3787200	59.5
	NEWC		43.2		3.52
	SOHU	4031257	38.9		
	TBA			33915555	24.42
COSTA RICA	CATB			6595970	55
	TBA			2083350	14.5
FRANCE	ACTI		13.5		12.1
	TBA		70		71.2
GERMANY	ISHP		27.5		25.5
	TRIN		52.5		44.2
HUNGARY	EEFT	4529458	40.5	4042295	27.99
INDIA	INDT		77.57		63.02
	INFY		31.7		20.8
	SIFY	370100	2.2	370100	1.7
ISREAL	ACCD		10.1		7.6
	BWEB		29.5		24.9
	CAMT	16284557	99.7	16284557	74.2
	CTVN		67.2		
	CKSW		53.3		50.1
	GIVN	16748674	83.3	17248674	67.2
	KERX		58.85		
	MNDO		53.8		45.8
	NURTF			4462954	38.45
	RVSN	9014764	65.4	7922932	43.6
	VRYA	7934168	41.9	7954168	33.9
JAPAN	IJI		15.31		15.15
LUXEMBOURG					
	CONE			31003890	92.8
	FMRK		100		
MALAYSIA	MYWB			2137750	19.8
NETHERLAND					
	STNN		71.63		25.88
POLAND	NTIA	143910	0.59	143910	0.54
SINGAPORE					
	STTS	13332500	1.7	13325000	1.4
	UTAC			244592312	43.1
SWEDEN	IMIC	12181058	98.2	10981058	70.4
THE NETHERLANDS					
	CBI			752953	5.1

	CRUZ		84		
	UPC		94.2		
UK	AREM	52312872	52.9	53123872	38.3
	TBA		58.21		58.21
	HGOI		55.48		53.8
	KNII		87.8		57.4
	LTGI		93.8		58.9
	TPC		95.83		57.24
	WSH		11		9.6
US VIRGINISLANDS					
	UTIW	1898314	9.5	1960814	7.9
TOTAL			3332.19		3497.97
AVERAGE			54.63%		45.29%

The data is from web site www.edgar-online.com, in the international IPO performance, there are 61 countries and areas are listed on the web site. Among the 655 IPOs, only 94 firms exhibit their conditions of shareholders, prior or after going public. The firms only list the shareholder who owns more than 5 percent of shares, the directors and executive officers are treated as one group.

Table 5. The offer and first day closing prices of IPOs

Ticker symbol	Offer price \$	File Range price \$	First Day Closing price \$
COPV	36	13-15	84.72
SCMP	38	18-20	184
AKAM	26	16-18	145.19
AWE	29.5	26-32	32.6
LNUX	30	11--13	239.25
FMKT	48	14-16	280
AVNX	36	13-15	172
CONE	17.48	65-75	34.5
WEBM	35	11--13	212.62
MCDT	28	19-21	85.56
FDRY	25	14-16	156.25
KCIN	18	6.75-8.75	23.48
ISIL	25	18-20	54
STOR	27	17-19	90.25
TRRA	13.41	13.41	38.25
FNSR	19	12--14	86.875
CHTR	19	17-19	22.75
GIGM	27	27	88
COBT	22	14-16	128.125
PCLN	16	7--9	69
CFLO	24	11--13	126.37
UTIS	18	12--14	57.25
ONIS	25	14-16	82.56
AVCI	31	18-20	96.75

Source: www.edgar-online.com, Update 11th, June, 2002.