# WEEKLY REPORT SEPTEMBER 2021

## Private Asset Management Ltd

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## IPO'S: MORE FLOP THAN POP

With the relatively poor performance of My Food Bag subsequent to its IPO in March of this year, at $1.85, I thought NBR readers might appreciate a deep dive into the nuances of the IPO markets, both locally and overseas. Investopedia defines an Initial Public Offering (IPO) as "the first sale of stock by a private company to the public. IPOs are often issued by smaller, younger companies seeking the capital to expand, but can also be done by large privately owned companies looking to become publicly traded. In an IPO, the issuer obtains the assistance of an underwriting firm which helps it determine the best offering price and the time to bring it to market".

That's great but what Investopedia doesn't say is that the investment bankers' marketing IPO's purport to offer investors the proverbial "free lunch": IPO's are typically promoted on the basis that the shares afford exposure to a new growth industry and/or are under-priced. Additionally, and possibly of more importance, IPO sales teams cultivate the idea that only important people are getting access to the issue by virtue of their relationship with the bank/broker. This massages the egos of the buyers, but as we saw with Feltex and My Food Bag it's definitely a higher risk marketing strategy.

So when a new company is looking for capital should the average retail investor buy shares? Will they be a bargain? Are there shares available? Academic research about IPO's and their subsequent performance says no to questions one and two and portfolio management (risk) considerations invariably flag an emphatic no to the first question as well, for all but the largest of investors. The reality of the murky IPO market is that the answer to the last question is that the availability of IPO stocks to Joe Public is usually inversely proportional to their attractiveness. In the next couple of stories this column will examine each of these issues in turn.

The underlying selling proposition with IPO's, admittedly ridiculous but successful nonetheless, is that the share or bond which is the subject of the IPO is being sold below the price at which it will trade when it lists on the secondary market. Whilst this does happen every now and then, especially when the Government sells assets, in aggregate the proposition is silly for these reasons:

- Firstly the broker, via its investment banking division, acts for the seller and its retail advisory division acts for the buyer. But the finance sector is usually far more engaged with the seller as the seller has more money and the chief executive of your average broking firm usually has an investment banking background rather than retail. Thus the broking firm is more likely to put the sellers' interests in front of those of the buyer. This is a universally accepted truth in the investment world making the FMA's assertion that "clients interests must be put first" look, at best, embarrassing and naive.

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- Secondly the institution or individuals selling the business are far closer to the business than the buyers (think venture capitalist or management/owner liquidating their holding) thus have a better appreciation of the value of what they are selling.

- Thirdly while some IPO's "pop" on listing it is usually the seller that determines the timing of the sell-down so "pop" is frequently followed by "flop".

Warren Buffet, arguably the world's most successful investor, warned a few years back that we are unlikely to find too many bargains in the IPO markets : "In an IPO the sellers decide when to come to market so its way less likely that it's going to come at a time that suits you" he said. His partner, Charlie Munger was a bit more blunt "the average person buying IPO's is going to get creamed". Stockbrokers around the world love quoting Mr Buffet but for some reason his views on IPO's haven't got much publicity. That's because the new issue business is big business – higher than usual margins and fat profits. According to the London Financial Times the average cost to a company to do an IPO is around 6% - 7% of the market value of the stock. In contrast institutional broking rates are barely above zero these days. The Feltex IPO for example disclosed fees of $21.5 million which at $1.70 share and a company valuation of $250 million came in at around 8.5%. My Food Bag was floated at a value of $449 million and IPO costs were $14.1 million so fees as a percentage were 3.1%

So whilst IPO's are good for intermediaries the historical research on the subject suggests that investors would do better as Mr Buffet suggests by looking for bargains amongst those stocks already listed. One of the most exhaustive studies[1] of IPO performance was published in the Journal of Finance in 2002. The paper, A Review of IPO Activity, Pricing and Allocations, looked at US IPOs from 1980 to 2001 and found that over the five years subsequent to the IPO the average IPO underperformed the broad market by 23%. One of the authors, Professor Jay Ritter of the University of Florida, updates the data in this paper annually and in the period 1980 to 2019 he estimates the average IPO underperformed the broad market by a total of 15.8% in the first three years subsequent to its IPO.

Other research confirms this trend; writing in the Financial Times, Elroy Dimson and Paul Marsh at the London Business School found that, when looking at UK IPOs between 2000-2011 that returns over long periods were poor in both absolute and relative terms. After two years IPO shares had lost about a fifth of their value suggesting that IPO stocks tend to be overpriced at IPO.

So that is the return dimension of IPOs covered, answering the question: "Will they be a bargain?" In two weeks time we consider IPOs from the perspective of portfolio management and best practice, and then explore the murky world of IPO allocations.

Brent Sheather is a Financial Advice Provider. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.

[1] The New Issue Puzzle, Journal of Finance

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