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Private Asset Management Ltd

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FOOD BAG DISASTER – AN INQUEST – Part 2

Two weeks ago we looked at the dire performance of My Food Bag (MFB) since it listed on the NZX and discussed a research paper by Michael Mauboussin and Dan Callahan of Morgan Stanley's research department. The authors demonstrated that the valuation of a company was particularly sensitive to assumptions as regards forecasts of growth in profits and cost of capital. Today we will, based on that research, try to understand why the MFB share price has fallen so much. For the record we have no exposure to MFB but I imagine that investors who bought at the new issue price of $1.85 will be struggling to understand why the shares have been recently trading at around 23 cents.

But before we do that let's provide some perspective as regards the performance of new companies when they list on the stock market and their typical impact of portfolio risk. New listings are known as IPO's (Initial Public Offerings) and investors need to be aware that IPO's, both locally and overseas, tend to dramatically underperform the broad market, with the occasional exception. Back in 2021 I compared the performance of all the new companies that listed on the NZX between January 2013 and September 2021. Over that time the average IPO returned -3.5% pa whereas the broad NZ market returned 13% pa. The poor performance of IPOs was despite the stellar returns of the three SOE floats - Meridian, Mercury and Genesis.

That's the return dimension of iPOs covered, now lets consider risk. In respect of portfolio risk IPOs are also generally bad news. Because IPO companies are often small the addition of an IPO stock to a portfolio can introduce higher risk and high tracking error into that portfolio. Most institutional investors manage risk by having regard to the relative size of a stock. Because most stocks being IPO'd are small they don't constitute a big part of a stock market index. Investment theory and best practice says that the least risky portfolio is the portfolio that approximates the weightings of the index. This is how fund managers manage risk but often anything goes as far as retail portfolios are concerned. The fund manager strategy is acknowledged as best practice globally and is the rationale behind index funds which we know outperform most active fund managers. At its peak MFB was capitalised at about $448.5m so, with the NZX then valued at $189bn, a market weight in MFB would be just 0.3% of NZ shares portfolios, ie virtually zero.

I was an expert witness in a legal action against a stockbroking firm about 10 years ago. The broker concerned managed the portfolio on a discretionary basis where he made the decisions for the client …. not always a great move. Recall Woody Allen's comment that "a stockbroker is someone who invests your money until it is all gone". That is almost what happened here. The reality of "discretionary" in this case was that whenever the firm underwrote an IPO which was unpopular the discretionary client ended up taking lots of the surplus stock.

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This brings us to the question of access to IPOs. The truth of the IPO market is that the more wealthy and valuable the client is to the institution in charge of allocating the shares the more chance they have of getting shares in the IPO. In a recent paper from The Journal of Portfolio Management: "Hedge Funds and their Prime Brokers, Favourable IPO allocations" the authors concluded that investment banks tend to allocate larger amounts of cheap IPOs to their best clients. This is exactly what happened with the SOE floats - the richer you were the more stock you got.

So if you combine the fact that IPO's are generally small stocks which make portfolios risky, that unless you are on the rich list you often only get access to the unattractive IPO's, and that on average they underperform the broad market after listing it is not difficult to conclude that they aren't the "free lunch" the finance industry likes us to believe they are. Yes every now and then an IPO is sold cheaply but most aren't. To paraphrase a sarcastic comment in the Financial Times a few years ago about access to hedge funds: "I wouldn't buy any shares in an IPO I was able to get shares in".

Let's get back to MFB. At the $1.85 issue price it was floated at a relatively high PE ratio of 28.7x forecast 2021 profits and the financial information contained in the PDS showed that profits had been steadily increasing from $5m in 2018 to a forecast of $20.1m in 2022. That's an impressive growth rate, hence the high PE multiple. At the time of the float brokers were also forecasting that the good times would continue with profits in 2023 forecast to rise by 10% to $22m.

Mauboussin and Callahan to illustrate how small changes in the growth assumption have a large impact on the valuation of a company and thus it's PE multiple. In one scenario they reduced the assumed growth in profits from 10% pa to 7% pa and wrote "the change in growth reduces next years earnings by only 2.7% but the PE multiple drops a more precipitous 22.9%. Investors often calculate the PE multiple using the current price and next years earnings. As a result they sometimes believe that the market over reacts to what appears to be modest changes in the near – term earnings. But if expectations for the trajectory of growth really do shift down, the large apparent drop in the PE multiple is completely justified".

I wrote a simple DCF model replicating reasonably closely the Mauboussin and Callahan results then used it with brokers forecasts for MFB at the time of the float to get a DCF value per share of $1.85. The authors cite profit growth and interest rates as being two of the largest factors determining a company's price earnings multiple. Of those two variables it looks like worries about growth is the biggest factor in the decline of MFB but the market also appears to have underestimated the volatility of MFB earnings and thus its risk. The latter variable is reflected in a higher discount rate thereby further impacting the net present value of the shares. Compounding MFB's problems the company appears to have high operating leverage. When demand for its products is high it makes lots of money but, as with the airline industry, when sales are low costs don't fall proportionately, and profits take a big hit.

The cash flow forecast in the model were then reduced to reflect the trading update announced in February 2023 whereby forecast cash flows for 2023 are now likely to be half of the levels forecast by brokers around the time of the float and the discount rate was increased to reflect higher interest rates and the higher risk of MFB shares. These changes reduced the theoretical price of MFB to just 38 cents. So the combined impact of the 50% decrease in profits and higher discount rate has reduced the theoretical value of MFB by 80%. Bottom line is MFB shares look to have been fundamentally overpriced at the time of its floatation.

Disclosure: No holding in MFB

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

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