Investors Mutual Market Musings

August 2014: Surfing the Current IPO Wave

Investment bankers must be a jovial lot these days. Global corporate activity is rising to levels not enjoyed since the boom preceding the GFC, with one market commentator describing it as a "veritable explosion"[1].

Never one to miss out on a good thing, Australia too is joining the party, in particular through a very hot IPO market that is set for its best year in a decade[2]. The issue considered in this *Market Musings* is whether it is a good time for investors to join in. The answer often lies in looking at the motivations of whoever is throwing the party.

Historical context of IPOs: whatever floats your boat

Given rich valuations and a receptive crowd, it is little wonder that vendors are choosing now to publicly list their businesses.

Prevalent among those taking advantage are the private equity firms, or PE firms, who in the first half of 2014 accounted for just over two-thirds of the total value of all Australian IPOs[3]. PE firms are motivated purely towards financial outcomes. Their mandate is to buy low and then sell for the best possible price. This means considering all options, including a trade sale in which the value to a buyer may be augmented by available synergies. If after exhausting these options and deciding the IPO route still offers the best price, their mandate does not allow them the generosity to leave much on the table for new investors. Given this, PE-backed IPOs, like all IPOs, should come with a very strong wealth warning: caveat emptor!

One of the major problems is that vendors in an IPO have typically been intimately involved with their business for some time before the float. This involvement ensures they typically know significantly more about the business than would-be investors, who are therefore placed at a considerable disadvantage.

With their friendly investment banks by their side, most vendors in an IPO present an appealing story to these would-be investors. Almost certainly, the marketing of an IPO will include a growth story of some sort and this may sometimes require a large dose of optimism in portraying the company's prospects.

Myer's IPO in 2009 is a case in point. Myer operates the 100-year old chain of department stores, which at the time of the IPO had experienced broadly flat sales since 1990. No worries, Myer's IPO still came with a growth story, supported in part by a short term hit to retail sales off the back of the stimulus from Kevin Rudd's $42 billion cash give-away.

The growth story was predicated in part on sales growth comprising:

(i) a store rollout strategy – with a target of increasing store numbers from 65 at the time of the IPO to 80 over the subsequent five years (with the stated long term potential being over 100 stores); and

(ii) growing same-store sales.

How this played out is best seen in the numbers. Myer's sales were $3.1 billion in the last reported financial result. This was down from $3.3 billion in the year of the IPO and actually flat on what was achieved all the way back in 1990! In contrast to the growth story laid out in the prospectus, just two new stores have actually been added in the five years since the IPO, and same store sales have in fact declined.

The consortium of mostly private equity firms bought Myer in 2006 with $400 million of their own equity. They were able to take a $525 million dividend in the first year of ownership after selling key properties and running an inventory clearance sale. And then in 2009, they reaped another $2 billion plus by selling out of the company through its IPO. This was clearly a great result for private equity's investors. Investors in the IPO on the other hand have not fared as well, with Myer shares having almost halved.

The growth story in most IPOs is invariably supported by a glossy prospectus that usually presents equally glossy financial forecasts. It is important for investors to assess the sustainability of these forecasts; often they can only be achieved by pursuing short term strategies that may come at a cost to the company in the longer term. IML previously highlighted this issue in a 2004 edition of *IML Fundamentals*. Our discussion then looked closely at the much hyped up PE-backed IPO of Pacific Brands, the owner of brands including Berlei bras and Bonds underwear that was bought three years prior out of the once market-darling conglomerate Pacific Dunlop.

The Pacific Brands IPO was supported by a rash of publicity and a racy prospectus featuring Sarah Murdoch who, thanks to the company's products, also seems from the photos to be well supported!

---

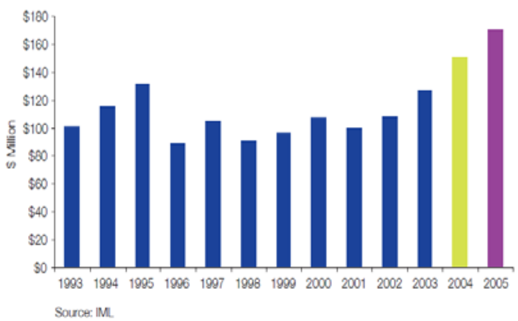
[1] GMO's Jeremy Grantham on page 6 of GMO Quarterly Letter 2Q14

[2] EY Global IPO Trends 2014 Q2, page 6

[3] EY Global IPO Trends 2014 Q2, page 6

The prospectus also included some pretty racy forecasts. The graph below, extracted from our 2004 article, shows the earnings growth implied in the prospectus against what was a period of relatively flat earnings in the prior decade.

Pacific Brands EBITA



Pacific Brands actually achieved its short-term prospectus forecasts and appeared to many investors – not IML it must be said - to have a great long term future. Unfortunately as it transpired, the company had stretched itself in the process, and this ultimately came at the cost of the company's longer term health. The result is best demonstrated in the decline in the company's pre-amortisation EPS, from 20cps in its first full financial year in 2005, to an expected 5cps for the current 2015 financial year[4]. While the shares debuted at a healthy premium to the IPO price, the shares are now down approximately 75% from their IPO price.

The current wave of IPOs: Déjà vu all over again?

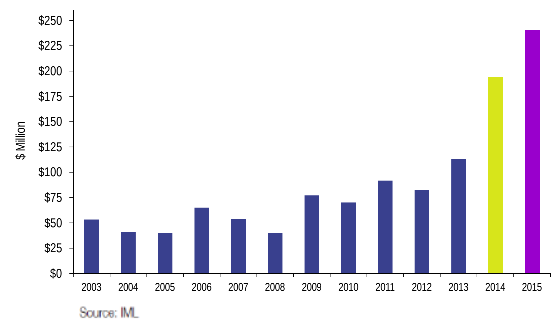
So are we seeing a repeat in the current wave of PE-sponsored IPOs?

Time will tell of course but examples like Pacific Brands and Myer should encourage investors to understand a company's longer term earnings power and to be cautious in extrapolating prospectus numbers too far.

It is interesting to look at this year's float of Spotless as a more recent case study. Spotless is a long established company that operates a cleaning and outsourced facilities management business. It was listed on the ASX for decades before PE firm PEP took the company over in August 2012 for $723 million, after many years of lacklustre earnings. This year, PEP sold down its ownership in Spotless through an IPO that valued the company at $1.9 billion, generating a wonderful profit for its investors over the two year holding period.

The graph below sets out Spotless' earnings for the last decade together with the forecast earnings set out in the prospectus for the next two years (both exclude earnings from the Braiform business, which was divested pre-IPO).

Spotless EBITA



As seen from this graph, the prospectus presents a tripling of earnings between 2012 and 2015. While owned by private equity, the company took dramatic action to reduce many costs, including in the "non core" functions of business development and compliance.

Whether these actions are sustainable in the long term remains to be seen but clearly history suggests some caution is warranted. In the context of the IPOs of Pacific Brands and Myer, private equity's claim to be able to turn around a business and within a few short years put it onto a new growth path must be considered questionable. Spotless is fundamentally a slow-growth business. Its sluggish historical financial performance, as shown in the graph above, may give a better indication of its longer term prospects.

All of this may suggest that one should avoid all IPOs, particularly PE-backed IPOs. After all, of the more than 2000 stocks for sale on the market on any given day, what is the chance that the best idea will be one presented for sale by someone knowing much more than the buyer and who has the luxury of selecting the sale's timing?

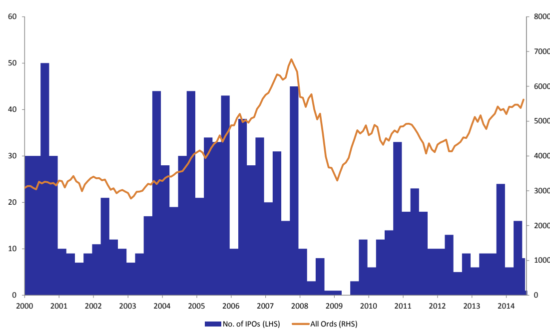
It must however be acknowledged that there have in fact been a few PE-backed floats of reasonable quality that have done fairly well. Examples include JB Hi-Fi, Invocare and more recently Veda. Long term successes have however tended to be the exception rather than the rule.

[4] Per current Bloomberg consensus estimates

More fertile fields for IPO success

As is often the case, this IPO wave is following the bull market in the broader market.

Number of IPOs Vs Market Levels:



Each IPO wave has its own unique focus, whether it be to fund the chase for eyeballs during the tech bubble in the late 1990s, or to fund exploration and mine development activities in the mid 2000s. This one currently seems mainly focused on vendors opportunistically and unapologetically taking advantage of the heady valuations and cashing out.

Our advice is that investors are more likely to find attractive IPO candidates in circumstances where maximising the exit price is not the sole motivating factor.

One simple example is the IPO that is motivated by regulatory, prudential or other similar reasons. In these instances, there is less concern for the IPO price as there is for successfully getting the IPO away. An example is the IPO in 2003 of Promina, which was the Australian general insurance business of the UK-based Royal & Sun Alliance Insurance Group. At the time, Royal & Sun was hit with large flood-related claims and investment losses, and as a result it was forced to undertake a radical restructuring that required it to raise cash to shore up its prudential position. The sale of Promina through an IPO provided investors with an attractive IPO opportunity. Promina floated at a price of $1.80 per share. Three years later it was bought out by Suncorp through a takeover that valued the company at $7.65 per share.

There are also a number of broad categories of floats that give rise to attractive IPO candidates.

Privatisations: buy what the Queen is selling

It is often typical of a privatisation arising through an IPO that the vendor, being the Government, will intentionally seek to leave something on the table for investors. The Government commonly seeks to distribute shares broadly among the public – it is their asset to begin with after all – and to give incoming investors, who are also voters, a profitable experience. As a result, the Government will very often price an IPO at an attractive price.

Understanding this generosity has allowed many investors over the years to profit from IPOs including Commonwealth Bank, CSL and more recently Aurizon. In addition, it is common in privatisations that the company can be run far more efficiently in private hands than when owned by the Government, and the benefit of these efficiency gains will fall to the new investors. It is true that some privatisations have disappointed – Qantas floated at an IPO price of $2.10 in 1995 and trades closer to $1 today – but the general experience has been a positive one.

Hence Peter's Principle: "Whatever the Queen is selling, buy it"[5]. Incidentally, the privatisation of Royal Mail late last year gave the UK public the opportunity to buy the Queen herself, or at least stamps of Her Majesty. Investors enjoyed a near 40% stag on the first day of trading, prompting a political controversy and a summons for the Business Secretary and Lazard, the advising bank, to a select committee to justify the IPO's pricing.

Demergers: adopt an orphan

Demergers involve the distribution of shares of a subsidiary company to the shareholders of the parent company. Similar in a sense to privatisations, shareholders come to own what they already owned, except that they now have two pieces of paper to show for it. In recent examples which are typical of most demergers – Recall's demerger from Brambles and Orora out of Amcor – the companies were floated without any proceeds raised.

[5] Peter Lynch in *Beating the Street*

There may be a number of reasons to pursue a demerger but the essence is to separate out a business that is considered non-core. The hope is that the combined value of the two separate companies trading independently will (ultimately) exceed the value of the former combination. The reality is less clear, with historical precedents mixed in their outcomes. To take some examples: Origin demerged from Boral in early 2000 and has risen seven-fold since and Dulux has doubled since its demerger from Orica in mid-2010. On the other hand, the demerger of Paperlinx from Amcor, and of both OneSteel and BlueScope from BHP Billiton, have not fared as well. What is clear however, and as backed up by empirical research[6], is that investing into the early days of the freshly floated orphan company can make for a profitable investment.

There are a number of reasons for this. Except in those few instances which also involve a capital raising – a recent example is Woolworths's demerger of Shopping Centres Australasia which also involved a placement to outside shareholders of $472 million - there is no incentive to talk up the prospects of the float. Indeed, management of a newly demerged company are often incentivised against doing so. To take just one example, Recall's new CEO received $6 million in share rights as part of the demerger, and other key managers also received rights in the newly floated company. In each case, and consistent with the incentive structure used in respect of many other similar demergers, the number of shares to which these rights converted was determined based off Recall's average share price in the first five days of trading. As it turns out, the first few months of trading in Recall's shares were subdued. Meanwhile, with management's shares now vested, they are fully aligned with all other shareholders and they now have the independence and freedom to chart the company's own profitable course.

Adding to the opportunity around a demerger is that many shareholders in the newly demerged company will choose to offload their new shares soon after the demerger. This may be for the same reasons that the parent divested the subsidiary in the first place, or because the new company is too small or falls outside a fund manager's mandate, or perhaps because it is easier to sell than to learn about the new company. Whatever the reasons, the effect is that the new shares often trade at depressed prices in the early stages of their listed life and may offer a good opportunity for the astute investor.

Mutualisations: mutual benefit

Demutualisations can likewise be a boon for those members who are gifted shares, as well as for those investors alive to the potential for the initial mispricing of the shares in the early days of their listed life. While the big wave of demutualisations in Australia swept through in the 1990s, it is wise to be alert to their existence. The latest demutualisation, of private health insurer NIB, has been a near 5-bagger since its float in late 2007.

An interesting aspect of the three broad opportunities above – privatisations, demergers and demutualisations - is that their timing does not beat to the drum of any particular economic or other cycle. Privatisations arise when Governments wish to pay down debt or deregulate industries; demergers arise when management decide a division is non-core or feel the division is undervalued by the market; and demutualisations arise sporadically, with for example a build up of funds and ongoing board conflicts the main reasons behind NRMA's demutualisation.

The unpredictable timing of these opportunities compares to many other floats in the IPO cycle, which as now, tend to occur because of elevated values in the stock market.

Conclusion

The current buoyant market conditions should give investors cause for caution. Such advice applies with greater force when assessing the current wave of IPOs. This is not to say that investors should automatically knock back the invite to join the IPO party; it is just that prudence based on a sober analysis of the particular opportunity is in order.

At IML, this means focussing on IPOs of quality businesses at reasonable prices. It also means understanding the vendors' motivations. Beware of IPOs in which the vendor is likely motivated purely to maximise their exit price. Profits are more likely to be made where other factors are at play, with prime candidates being recent and future privatisations and demergers.

IML Investment Analyst
August 2014

---

6 See for example UBS' note titled *Demerger Analysis: Maybe we should break up ..., 21 October 2013*