Stephen Wood, Eiger Capital

Stephen Wood is a principal and co-founder of Eiger Capital, and Senior Portfolio Manager for the Eiger Australian Small Companies Fund. Prior to establishing Eiger Capital, he was the lead portfolio manager of the UBS Australian Small Companies Fund, which he ran since 2006. Prior to joining UBS, Stephen worked in investment banking where he was an equity research analyst covering a variety of sectors. He studied Commerce with Honours from the University of Victoria, New Zealand.

PROFITING FROM IPOs

Do IPOs in Australia provide a good return for investors?

Stephen Wood

An IPO [initial public offering] typically presents a snapshot of a business as it prepares to list. There is usually a 'proforma' profit and loss and balance sheet, which means that the accounts are not what actually existed just prior to IPO.

Post IPO the 'proforma' business, as it was presented, no longer has the ability to choose how and what to include in its accounts. Investors will own a share of a business that will progressively reveal how well it can deliver on its IPO investment outlook and how well its management, products and structure can cope with positive and negative surprises.

This paper examines a database of almost 1,900 IPOs that have taken place since the year 2000. We attempt to answer the question as to whether there is a degree of financial alchemy in the IPO process that causes underperformance as a business reveals its level of profitability and sustainable return on capital.

"In the end, alchemy, whether it is metallurgical or financial, fails. A base business cannot be transformed into a golden business by tricks of accounting or capital structure." Warren Buffett, *1989 Annual Report* Berkshire Hathaway

These issues have been around forever

In 1720, while discussing the significant volatility surrounding South Sea shares, Sir Isaac Newton, who at the time was Master of the Mint, remarked that, "I can calculate the motions of the heavenly bodies but not the madness of people."

For this reason, it is necessary to examine the performance of IPOs over a reasonable period of time to remove the impact of positive and negative short-term speculation and trading noise. We are interested in examining returns over a sufficient period for the business to report multiple interim and final results and to hold multiple annual general meetings. That way investors will be able to access value not just based on the snapshot presented at IPO but on multiple sets of accounts and presentations.

During the era of Sir Isaac Newton's tenure as Master of the Mint there were all sorts of interesting capital raisings including those to create a wheel of perpetual motion and many to profit from trading with the newly discovered Terra Australis. What could possibly go wrong?

The sage of Omaha

Before examining the IPO data, we can't resist one more classic Buffett quote. This one specifically on IPOs:

"It is almost a mathematical impossibility to imagine that, out of the thousands of things for sale on a given day, the most attractively priced is the one being sold by a knowledgeable seller (company insiders) to a less-knowledgeable buyer (investors)." Warren Buffett

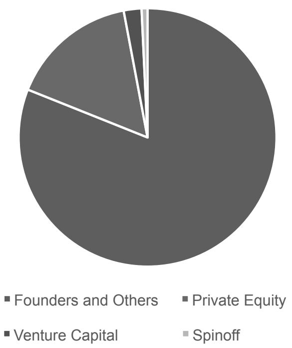
The Australian IPO market

We have used Factset to create a database of all the IPOs that have occurred in Australia between 1 January 2000 to 30 June 2019. Our database identified 1,899 IPOs since that time.

We have focused our attention on the 269 IPOs that raised over $50 million. In 2014, for example, there were 39 IPOs greater than $50 million; the most in any one year. The overwhelming number of IPOs are either Private Equity or Founder originated.

- 1,899 IPOs since 2000; $125 billion raised
- There were only 269 significant raisings (defined as >$50 million).

Figure 1. Australian IPOs since 2000



Source: Factset January 2000 – June 2019.

Table 1. Velocity of significant raisings

2014	39
2015	32
2005/2013	21
2016	19
2004	18
2017	16
2019 (YTD)	6

Source: Factset January 2000 – June 2019.

Some more statistics

We have split the significant (>$50 million) IPOs into two groups: those that raised >$1,500 million and those that raised between $50 million and $1500 million. We have classified the larger group ‘midcap IPOs’ and the small group ‘small cap IPOs’. The larger group typically enter the ASX 100 almost immediately. This was the case with Medibank, Healthscope and QR National, which are in this category. While this group individually raised the largest amount, they are by far in the minority. 95% of the IPOs >$50 million are the small cap variety and raise between $50 million and $1,500 million and transition to the small cap index.

On average, these small cap raisings were for $235 million each.

- 95% of significant raisings were small caps
- only Medibank, QR National and Healthscope were not small cap IPOs this decade
- average raising of IPO below $50 million is $20 million
- average significant small cap IPO raised $235 million.

Performance of significant IPOs

Largest IPOs on average appear to perform better

How have these IPOs performed? Including the larger (>$1,500 million) IPOs reveals that the average, median and weighted average IPO performed roughly in line with the small cap (XSO) index for 6 months. However once we season to 12 months, the median IPO has fallen to -4% relative underperformance.

The median IPO underperforms by just over 10% over two years. The rate of underperformance steadies between two and three years, but does not improve. The weighted average raising outperforms over one, two and three years, indicating that the largest raisings perform significantly better than the smaller ones.

It is worth noting the significant outperformance over three years post-IPO of QR National (+120% ahead of the XSO benchmark), which was also the second largest IPO (>$4 billion raised) in our survey, as the overwhelming driver of weighted average outperformance

Performance of significant small cap IPOs

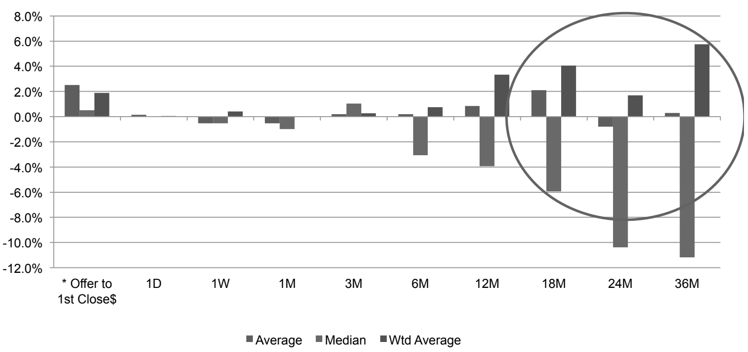
Twelve months post listing the rot sets in

Excluding the larger IPOs significantly alters the picture, if for no other reason than QR National is now excluded as it is a midcap IPO. The median small cap IPOs perform in line with the XSO index over three months (just) but then performance deteriorates. The worst period of

The quote

The largest raisings perform significantly better than the smaller ones.

Figure 2. Performance of significant IPOs



Source: Factset January 2000 – June 2019.
**Excludes IPOs with offer to 1st close absolute value >50%.*

The quote

Significant alpha is available by investing in IPOs.

underperformance is between six months and two years. Between two years and three years, underperformance vs the benchmark steadies but does not improve. Once again the weighted average underperformance is not as significant as the median, indicating that the larger raisings underperform less than the smaller raisings. However, excluding QR National, the weighted average is comfortably negative.

The key conclusion that we draw is that it is between six months and two years when a company reveals its true long-term intrinsic value and earnings capability. On average, the intrinsic value that is revealed is lower than what was described or expected at IPO.

Are small cap IPOs a poor investment?

They can be unless you are very selective. Is the obvious conclusion to ignore all IPOs (except perhaps the privatisations of government entities such as QR National) as, on average, they underperform? We believe the answer to this question is no. While the median and the weighted average returns vs benchmark are negative, the spread between the best and the worst is very large.

Table 2. Excess return one to three years post-IPO

Years post IPO[1]	1	2	3
Weighted Avg Excess Return (%)[2]	0.0	-4.4	-3.9
90th percentile	47.1	62.9	73.0
10th percentile	-39.6	-64.4	-67.4

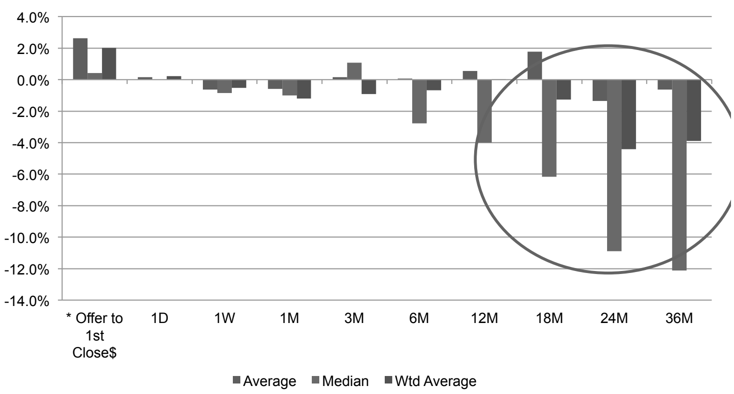
Source: Factset January 2000 – June 2019.

[1] Excess returns vs Small Ordinaries Index

[2] Weighted by amount raised at IPO

- median returns begin to decline around six months post IPO
- median returns remain negative out to three years
- weighted average returns are positive over one year, but then decline out to years two and three
- but the best 30% added alpha, while the best 20% added significant alpha.

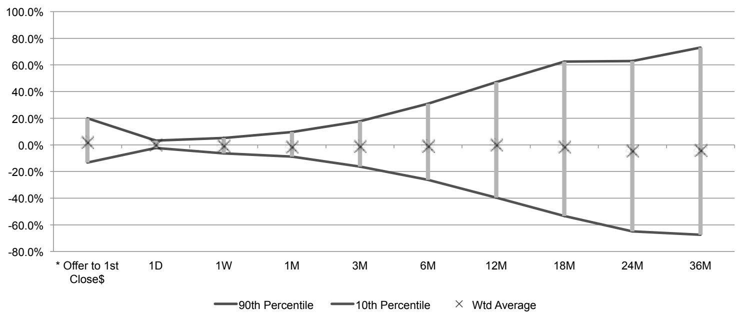
Figure 3. Performance of significant small cap IPOs



Source: Factset January 2000 – June 2019.

**Excludes IPOs with offer to 1st close absolute value >50%.*

Figure 4. Distribution of excess return

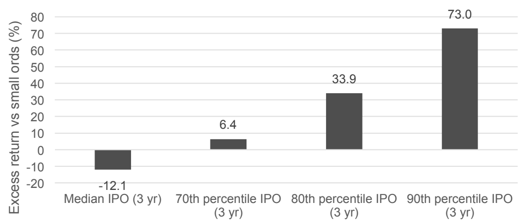


Source: Factset January 2000 – June 2019.

Key takeaways

IPOs require detailed analysis. The best 30% of significant IPOs outperformed the benchmark by 6.4% over three years. While this is only 2% p.a. the story gets better from here. The best 20% outperformed by 33.9% (10.2% p.a.), which is significant. The best 10% outperformed by significantly more again and delivered 73% or 20% p.a.

Figure 5: Excess returns vs small ords (p.a.)



Source: Factset January 2000 – June 2019.

We draw the following conclusions:

- Significant alpha is available by investing in IPOs.
- It is not always necessary to invest in the IPO as the outperformance of the best companies begins to really compound beyond the three to six-month period.
- Investors need to be very selective—the worst 70% will deliver an index return at best and will possibly significantly underperform.
- The best 30% will deliver alpha vs the benchmark; however it is only the best 20% that will really make a difference to investing in the XSO benchmark.
- Significant returns are available; however the 'Devil will take the hindmost'. **FS**