

thebigpicture

guideposts for the private investor

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IPO'S: TRACK RECORDS COUNT MOST

IPO's may be an overrated investment opportunity. Changing pricing arrangements are making them less attractive. Now, research from the USA shows up a need for investors to be very choosy: a company's history says a lot about its post-IPO risk of failure.

A history of strong short-term price gains for new listings has caused them to be sought after by investors. Over the 20 years to 2000, the average difference between the offer price and the closing price after the first day of trading for some 9,000 US IPO's, for example, was 18.8%¹.

However, longer-term performance is less attractive. Over three years, the average US IPO underperformed the market by 23.4 percent and underperformed seasoned companies with the same market capitalization and book-to-market ratio by 5.1 percent. Not a good prospect for a genuine investor.

In Australia, even the shorter-term gains are becoming a remnant of history. More offerings are being priced through book building processes reducing greatly the chance of a large first day price gain.

Where vendors used to set a selling price, they risked being too conservative either because they were unsure of market conditions or the appetite among larger investors for the shares being offered was uncertain. Conspicuous examples of this occurred in some of the government asset privatisations. Prices were set at levels where demand for stock greatly exceeded the supply and the price subsequently rose by a multiple of the issue price.

Nowadays, brokers are increasingly using a book-build which allows the price to be set by larger participating investors. Institutions are invited to bid for stock at a range of prices. With this information, vendors can easily calculate a market-clearing price at which the offer can be completed and which maximises their returns. By definition, the short-term returns of the buyer are minimised.

Since all investors of size have generally been given the chance to bid prior to the opening of the market, the chance of a mispricing on the opening is virtually eliminated.

Opportunities for gains are not lost permanently. They are more likely to occur over a lengthy time period and be based on fundamental improvements in the underlying business rather than misjudgements by vendors about what the market will bear.

This system also risks lengthy periods of underperformance as stock is sold by people who are disappointed by the lack of short-term appreciation. One example of this recently in the Australian market was the IPO of the Foster's subsidiary, Australian Leisure and Hospitality (ALH).

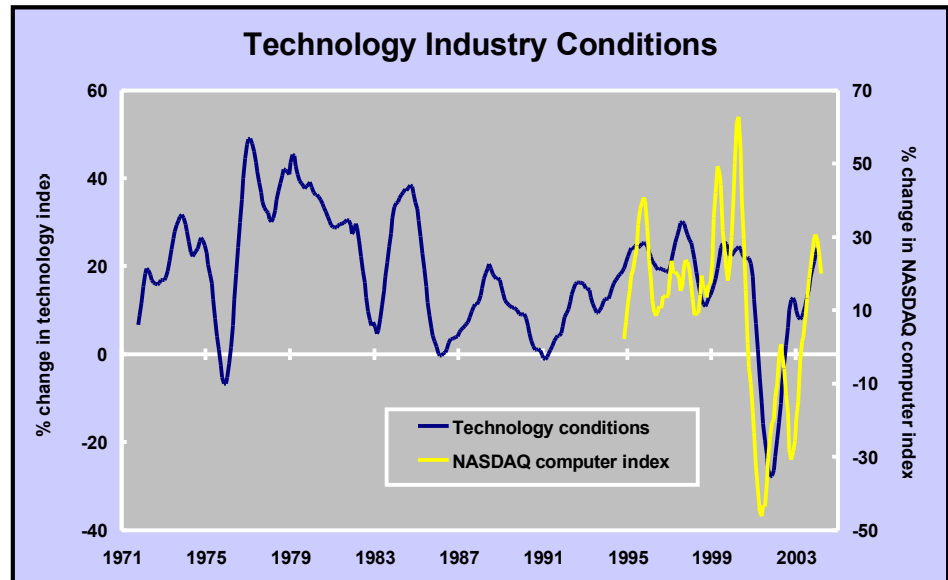
The initial performance of ALH was also undermined by a substantial quantity of stock being offered to larger institutions at a discount to create initial interest. While disclosed, there seems to be some argument that many smaller investors were not conscious of this three-tiered pricing structure (book build + discount for large institutions + retail price) when taking the decision to purchase stock.

"The ALH offer is a clear example of why it is necessary to be wary about how an issue is being priced when deciding whether or not to participate in an IPO."

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THE WEEKLY CHART SPOT

The indicator of technology sector conditions in the USA prepared by the New York Federal Reserve (the blue line) was up 24% over the 12 months to January although the forward momentum had begun to ease by the middle of 2003. The NASDAQ computer sector (the yellow line) has recovered similarly. It is now 20% higher than a year ago. However, its gains have also tapered off in the past two months. This market segment is now 15% below its most recent peak value in mid-January.



Source:

IPO'S: TRACK RECORDS COUNT MOST CONT'D

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The ALH offer is a clear example of why it is necessary to be wary about how an issue is being priced when deciding whether or not to participate in an IPO.

Pricing arrangements aside, the diversity in business quality can pose a further risk for potential IPO investors. Despite having been subjected to numerous filters by the time it comes to market, one IPO is still not equivalent to another.

On one extreme, a company may contain a substantial operating business with a long performance history. On the other extreme, it may be at an early stage with promoters having run out of sufficient funds to meet the business objectives. Even companies with a long operating history may be falling short of an adequate return on assets as they come to the market for funds.

Problems with IPO quality characterised the late 1990s dot-com craze. However, a recent study² of US market data suggests that the quality of IPO's had been deteriorating well before the late 1990s. The quality deterioration was not limited to technology stocks.

The Peristiani and Hong (P&H) study covered over nine thousand privately held corporations which were brought to market in the USA between 1980 and 2002. The study used two indicators of financial soundness for issuing companies prior to

them being brought to market: return on assets and company net worth.

The two charts on page 3 taken from the study illustrate the essential conclusions:

- offering firms (solid line) displayed a marked deterioration in profitability in the 1990s while a control sample of non-issuing firms (dashed line), comparable in size and valuation to the issuing firms, exhibited a much more stable pattern of profitability; and,
- the financial net worth of issuing companies, measured as a ratio of equity to assets, declined dramatically, while the net worth of non-issuing firms maintained a steady level.

The effect of macroeconomic conditions, one potential source of IPO deterioration, is ruled out by the consistently positive performance of the "peer" firms.

While the unsound financial position of technology firms accounts for a considerable part of the decline in pre-issue performance among the IPO firms, P&H also find that the profitability and net worth of non-technology firms began to drop in the late 1980s, long before the onset of the swing to technology offerings.

Nor was the emergence of a choice in stock exchanges a defining difference. The NASDAQ exchange, with less stringent listing requirements, became more impor-

(Continued on page 3)

1. Ivo Welch and Jay Ritter, A Review of IPO Activity, Pricing and Allocations, Yale ICF Working Paper No. 02-01, February 8, 2002.

2. Stavros Peristiani and Gijoon Hong, Pre-IPO Financial Performance And Aftermarket Survival, Current Issues in Economics and Finance, Federal Reserve Bank of New York, Volume 10, Number 2, February 2004,

IPO'S: TRACK RECORDS COUNT MOST CONT'D

(Continued from page 2)

tant but firms listed on the NYSE also suffered a decline in earnings.

Another source of risk could have been a new breed of underwriters. However, the deterioration in quality was evident among firms whose securities were brought to market by large, or top-tier, underwriters as well as firms whose securities were brought to market by small underwriters.

There is ample evidence to suggest a decline in standards across the board. That might not have been so concerning if the listing of a company led to improved performance by giving it access to new forms and sources of capital, new management or improved governance standards.

The balance of evidence says that a sick patient is not helped by a public capital transfusion. Performance before the offering is indicative of what one can expect afterwards.

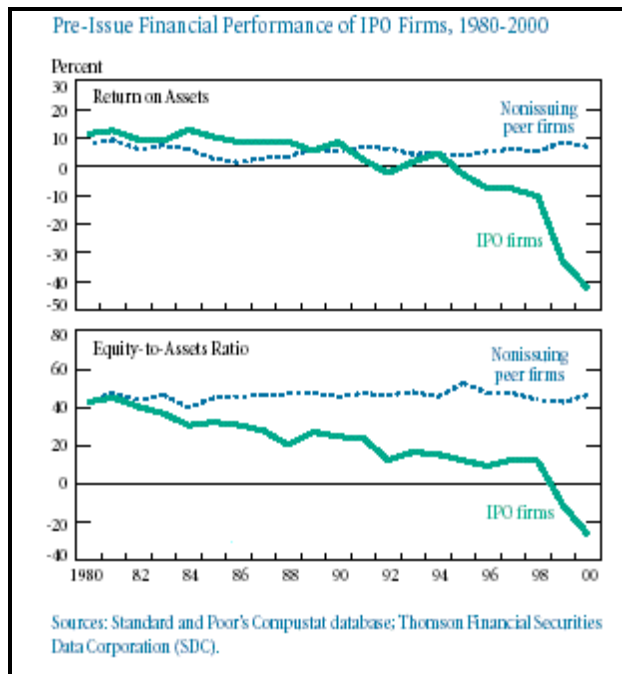
The P&H analysis reveals a strong and statistically significant negative relationship between the probability of subsequent delisting and a firm's pre-issue return on assets. They concluded that investors who risked funds on money-losing IPO firms faced a risk of delisting that was roughly three times greater than that faced by investors in profitable firms.

An investment portfolio should contain a range of company characteristics. Unfortunately, in the late 1990s, as the quality of IPO's deteriorated and a rising proportion of new offerings was unprofitable, portfolios became disproportionately weighted toward unprofitable companies as investors continued to support the IPO flow.

Investors were persuaded that internet stocks would transform how business was going to be done. The profitability of traditional companies was going to be transferred to a new generation so swiftly that there would be little time to react. The implied message was that waiting for the new companies to become profitable before investing would mean many lost opportunities.

The P&H analysis of a considerable volume of data suggests that in any environment they were going to have a much lower chance of success whether they were high-tech or old-fashioned widget makers.

Some lessons have been learned. Over the first three quarters of 2003, IPO firms achieved a positive 3.9 percent return on assets indicating a more prudent choice of firms by underwriters and investors.



There is a message in this research for followers of Australia's early-stage companies which so often lament how little interest is shown in them by Australian investors. They often contrast the investor attitude in Australia with the more favourable reaction likely to be shown by US investors toward early stage companies.

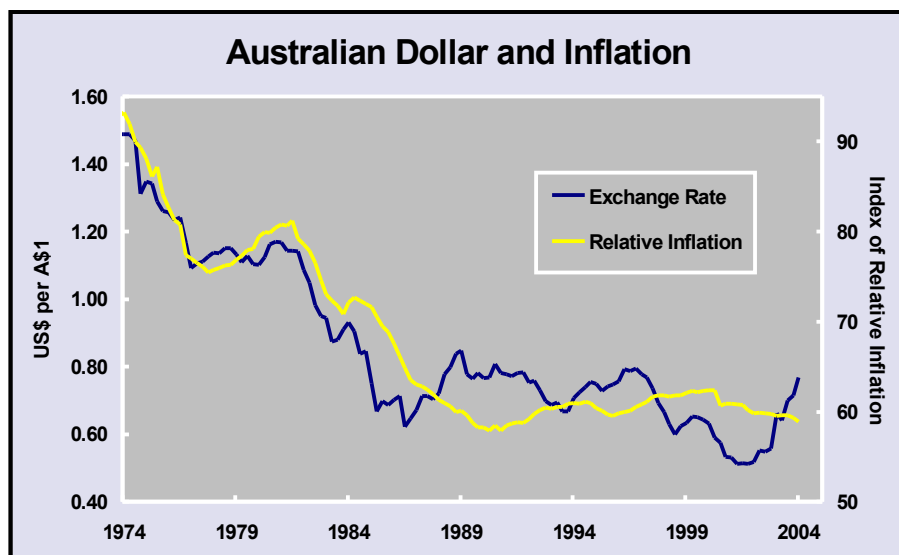
The evidence from the P&H study makes clear, however, that a willingness to take on a risky IPO is not the same as being more astute at recognising business quality. Indeed, the reverse might be true.

US investors have been prone to put their money into rubbish with the tendency getting progressively worse over more than 20 years.

This is the reality behind the apparently more robust overseas appetite for new offerings often cited by Australian companies seeking to bolster their local position by referring to their offshore listing intentions.

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EXCHANGE RATES: TRACKING INFLATION



Recent exchange rate movements are consistent with some stabilisation in longer-term currency value.

Barely a month ago, currency commentators were talking about the Australian dollar continuing to appreciate past 80 US cents. Now the headlines are about it falling. Have conditions changed so much?

Exchange rates are notoriously volatile and prone to overshooting what some might regard as their appropriate values. Huge speculative flows are attracted to these markets around the clock. The world's central banks are in the market following their own agendas. And, then, there is the impact of the world's trade and investment flows to take account of.

There is little value in trying to beat the professionals by distilling these influences in the short term. However, there is a longer-term perspective which is best illustrated by the chart and which might assist the individual with a longer investment horizon.

The blue line shows the average value of the Australian dollar in US dollar terms. A decline means the Australian dollar is losing value to the US dollar. The yellow line shows the relative inflation performance between Australia and the USA. A fall means that Australia's inflation rate is higher than the US inflation rate.

The most substantial depreciation of the Australian currency occurred in the decade after 1974 when Australia's relative inflation performance was worsening. This was an environment in which the Australian economy was relatively closed to outside competitive pressures and wage costs were less likely to be influenced by productivity outcomes.

The better inflation performance through most of the 1990s should have established a platform for a more stable longer term average exchange rate.

With other factors at play, this did not stop the currency being pushed to around 50 US cents in mid 2001. A sharp move toward 80 cents more recently might be an equally unsustainable (and inexplicable) reaction in the opposite direction.

The improved inflation performance suggests that these are swings around a higher central value rather than changes in trend.

For an investor trying to make longer-term judgements, the key guidepost comes from inflation. Put simply, if you expect future inflation rates to diverge significantly, then the exchange rate trend should change too.

thebigpicture view is that there are considerable pressures now in place preventing divergent inflation rates from occurring.

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