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Bury FINANCIAL ADVISERS LTD

THE Adviser

What's an IPO?

The financial phrase of January has been IPO or Initial Private Offering. This carries on from last year when I was asked about Facebook and Twitter as well as the Royal Mail. One client even asked me last week whether his airline carrier would be able to fly him from Australia to New Zealand after a failed IPO launch. It famously also reared its head in the wonderful film "Wolf of Wall Street," which I watched on my birthday in an enormous cinema with a total audience of 4.

So what is an IPO?

It is the first sale of shares in a previously Private Company that is looking to list on a stock market (go public). Quite often they tend to be smaller and younger companies that are seeking capital to expand and develop. However, it is the larger Private companies that tend to attract the press and consequently the public attention.

Facebook launched in 2012 and raised $16bn on its first day. It instantly became the largest technology IPO ever and the third largest in US history. However, it was a technology malfunction on the Nasdaq stock exchange that became the focus of the headlines.

The largest IPO in history was The Agricultural Bank of China (or ABC) when it launched in 2010. The bank started out as a source of finance for rural farmers; by July 2010, it floated with a value of $128bn.

There are usually two groups of private owner that may wish to list a company, one is a family owner (or group of entrepreneurs) who, as I said earlier, are attempting to raise capital to invest in their business. Alternatively they may be wishing to sell on the company as they have taken it as far as they believe they can. The second group is Private Equity. These are professional investors who are looking for a return on their investment. They are floating the company because they have seen a return and wish to capitalise on it. Michael Douglas in the original film "Wall Street" was a very aggressive Private Equity investor. He often bought enough shares in a listed company so that he could own them outright (compulsory acquisition). He would then look to get rid of staff to make them more streamlined or break them up into smaller parts to offer back to the market at an inflated value.

Bury FINANCIAL ADVISERS LTD
18 Bolton Street, Bury, Lancs BL9 0LQ
Tel: 0161 764 7711 • E-mail: info@buryfinancialadviser.co.uk

What's an IPO?

What's an IPO? (continued)

Many clients asked whether Royal Mail was a good IPO to get involved in. Whilst this is always a difficult question to answer I produced my stock answer:
Most of my clients shouldn't hold individual equities, as their risk profiles do not lend themselves to investing in individual holdings. The risk is too high and all your money could be lost; this cannot happen with the funds that we hold. Secondly, the private investor is too small and insignificant in the stock market that is dominated by behemoth institutions like Hedge funds and Pension funds. It is this second point that became particularly pertinent in the Royal Mail IPO. As an individual investor you were allocated £750 worth of shares and if you asked for any more you got none. Factoring in the 48% share price rise on the first day of trading and of course the dealing costs of trading out and you may have been left with enough profit for a nice family meal out…..

Some people like IPOs as they are potentially the first chance to own a company that they have extensive knowledge of. They know the management, earnings history and forecasts etc. For them the only question is how much higher the share price can go.

The private companies often use Investment Banks to guide the public interest in a launch. This can give them a guide price for what to launch at, where demand will be satisfied and therefore provide the private owners with the most money. This was more than a little disastrous in the Royal Mail launch as the initial guide price was far from where investors demanded the shares, so the price rose very high, very quickly.

The other reason for using an Investment Bank is to underwrite the offering. The Investment Bank is left to purchase the shares which weren't demanded by investors. This makes pricing the IPO crucial as getting it wrong is costly both ways. The Investment Bank can also vet potential investors to make sure a fair allocation is made and not too many shares end up in the hands of an 'undesirable' owner.

We have highlighted a lot of 'upside' to IPO's here along with a few issues when they go wrong. At Bury Financial Advisers, however, we don't like our funds to engage in IPO's. It is a question I do ask of the fund manager when I meet them. I think that Private Equity listing IPO's can be a sign that the 'clever money' believes it is at the top of a market. And, like 'fattening for slaughter', I also think some of the company information can be manipulated to make an IPO look exceptionally attractive for a float only for it to fail when it is listed. This might be something like reducing capital expenditure in a run up to a float. This probably wouldn't have an effect on the earning of a company in the short term but probably would beyond this when you become the unfortunate owner.

This is not to say we ignore IPO's. On the contrary, they are a great talking point with clients as they do attract a lot of media attention. I also monitor the number of IPO's coming to the market, there are around 25 coming to the UK market in the first quarter. This is a comfortable number and shows all the productivity of an efficient and healthy stock market. When they start to come along more frequently than a Double Decker bus, then we should be concerned. Somebody somewhere is offloading their assets on to us as they fear for the future. You can rest assured, I will keep an eye on that!

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18 Bolton Street, Bury, Lancs BL9 0LQ
Tel: 0161 764 7711 • E-mail: info@buryfinancialadviser.co.uk