Facing up to Initial Public Offerings

Financial Spotlight

By David Just, Godfrey Pembroke Financial Advice Specialists

One of the most common questions asked of anyone involved in funds management would be "Should we invest in the IPO (Initial Public Offering) for XYZ Ltd?" Usually the person asking the question has already formed an opinion in the affirmative and is now merely looking for positive reinforcement.

For me, this question typically conjures up the same emotions as the old chestnut "Where do you think the Aussie dollar is headed?" In fact with the second question it is often easier to explain the logic behind the answer as most people accept that picking currency is 50% skill and 50% pure chance.

When it comes to IPO's we have a blanket rule in our office: not yet thanks. This is not to say that IPO's cannot be a success. Of course, at some point or other, all companies had an initial listing point. Any long term investor in an IPO that turns into a traded company which has been going for decades would undoubtedly have enjoyed the fruits of their investment.

By way of a local example is the much loved CSL which started life as the Commonwealth Serum Laboratories in 1916. In 1994 the business was floated to the public in an IPO, the company listed at $2.30 per share. In September 2007 CSL became the second Australian Company to reach a price of $100 per share. Then on 18/10/2007 the shares were split on a 3 to 1 basis and today trade at $38, or $114 if they had not been split. Even ignoring any dividends received this capital return alone is nothing short of spectacular. CSL had very little negative trading from the outset.

Sadly the above example is not the norm with IPO's however the expectation of most IPO subscribers is that their outlay will be in the black from day one and rise steadily from there. The reasons why the opposite is more often the case are not difficult to follow.

When a business wants to ask the public for money, or 'float' on the stock exchange, it must provide the potential investor with substantial information by way of a prospectus. This prospectus will include the company's reasons as to why they need the funds, what their plans for the capital will be, how the business intends to generate earnings growth and also the possible down side risk in providing it. The prospectus will naturally paint as positive a picture as possible as to why an investor should become an owner. After all, if you were listing your services to raise money would you search for reasons to give the public not to invest?

A widely held, though incorrect view, is that the financial regulator somehow closely vets the "up side" statements of the company prior to the date of issue. So long as wild speculation gives way to moderately reasonable forecasting and down side risks are set out then the prospectus will likely pass muster.

The brokers and bankers who are selling and underwriting the stock have a significant vested interest for one or more reasons that the "float" be a success. They will be receiving fees of various types for their efforts. And may have to take up any unsold stock themselves.

Additionally by the very nature of most of businesses that apply to use an IPO they have not been subject to close public scrutiny in the past. This is a point not to be underestimated. With the legal requirements for continuous disclosure for public companies comes an added pressure to ensure they know exactly what is happening at all moments on all levels of their operation. This fresh level scrutiny sometimes leads to poor judgement and decision making by those entrusted with the day to day running of the company.

The most difficult figure to gauge with a company that has never had the wide ownership brought about by shareholdings is exactly what is it worth? Where is the revenue coming from? How will expenses be contained or reduced in varying market conditions? How will profit drip through to the bottom line? Facebook anyone?

We have always been of the view that until a Company has a proven record meeting its continuous disclosure obligations, making profits and increasing earning per share over a number of years, we will not look at investing clients money in that business.

Please feel free to contact Godfrey Pembroke on 07 56891222 for a discussion on all your investment objectives.

This advice may not be suitable to you because it contains general advice that has not been tailored to your personal circumstances. Please seek personal financial, tax and/or legal advice prior to acting on this information.

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