Back down to earth

A float's rosy predictions can often be a trap, warns Roger Montgomery

THE REPORTING SEASON FOR THE 2015 financial year is now behind us and some of Montgomery Investment Management's attention – as at many leading brokers – has returned to the pipeline of initial public offerings (IPOs) slated for marketing over the coming months.

While MIM has participated in a number of IPO gems, this reporting period was marked by disappointing results from companies that have recently become public entities and it serves as a warning for greater caution when assessing investments for your portfolio.

Dick Smith (ASX: DSH) is one such company that underwhelmed this reporting season after floating in December 2013. Although it listed for $2.20 a share and provided an attractive return for its vendors, its new shareholders are deeply in the red with the share price at around $1.40.

Clearly, there is a distinct difference between the float price and the subsequent market prices. So before investors are swept up by another round of public candidates, we thought it was timely to reiterate how this divergence can occur.

Perhaps the best place to start when analysing any float is to understand why the company is moving from private to public hands. When you receive a prospectus, turn to the section that details the use of funds. Does the company require capital for expansion, or are the sellers hoping to realise an investment?

Dick Smith was primarily floated as an exit strategy, though the former private equity owners retained 20% of the outstanding shares as a sign of faith in the business. Yet despite assuring the market at the 2014 financial results announcement that it had no intention of selling the shares at the prevailing market price, it exited the position in the following month.

Now, floating a company to realise a return is not an issue if the company is priced accordingly. Unfortunately, the prospects for a new float tend to be viewed through rose-coloured glasses.

Private businesses are typically marketed for an IPO with only a few years of financial statements and one year of forecast earnings. The statements are a mere snapshot of the business's fundamentals, and it is in the best interests of management and the sellers to set achievable targets.

Dick Smith is a relatively mature retailer and so its prospects are more dependent on same-store sales growth, rather than growth of the store network. Yet a main part of Dick Smith's growth strategy at the float was store openings.

When Dick Smith came to market in October 2013, it had 359 stores in its network. This included 298 branded stores in Australia, compared with 164 JB Hi-Fi stores and 206 Harvey Norman outlets.

At the 2014 full-year result, management planned to have 400 stores within the following 12 months but finished the year with 393 stores due to store closings. Management has also reduced the 2017 network target from 450 to 420-430 stores.

You might see similarities with another mature retailer. When Myer floated in 2009 it planned to expand its network from 65 to 80 stores over five years, with a longer-term target of 100 stores. It ended the 2015 financial year with 66 stores and has flagged more closures.

Both companies have also been challenged by soft retail conditions. Myer's weakening competitive position has been well documented, as it attempts to compete against large international players while also coping with a structural shift away from department stores. Dick Smith, however, disappointed the market by reporting weak same-store sales growth at the start of 2015-16.

High fixed costs make retail earnings very sensitive to top-line growth. Dick Smith extensively documented these risks in its prospectus but management commentary at the time was notably optimistic, expecting retail conditions to improve and a stable pricing environment among competitors. Fast-forward two years and the macro-economic outlook is decidedly more cautious.

As is painfully obvious in both instances, the short-term expectations for the business were too rosy. Investors must not extrapolate from a small window of historical statements or rely on management expectations when valuing a company. This is especially true for cyclical mature businesses such as retailers, as they are likely to be marketed during an upturn in their performances. This allows one party to exit at a favourable price while others are left with a position that was based on a bullish valuation.

There are certainly opportunities in IPO participation, particularly with non-cyclical businesses that have excellent prospects of sustainable growth. But MIM is deeply critical of some research analyst and management assumptions. Sure, MIM may miss out on short-term price appreciation associated with this optimism, but it will also limit the risk of capital loss over the longer term.

Roger Montgomery is the founder and CIO at The Montgomery Fund. For his book Value.Able*, see rogermontgomery.com.*