Don't go overboard

Company floats should be carefully assessed, advises Roger Montgomery

MANY INVESTORS WILL HAVE noticed that, after a number of dry years, the market is suddenly awash with initial public offerings (IPOs). Given the flood of potential opportunities, what are some of the things investors should bear in mind in considering whether to participate?

First, it's good to be clear on the motives of the key players. When a business owner "floats" a business they are effectively selling it and naturally they want to get the best possible price. The main tool available to achieve this is timing: floating when similar businesses are fetching good multiples. History shows that float activity does correlate with market peaks.

On the other hand, the broker managing the float wants the price to reflect good value. The broker needs to sell the issue to its clients and it wants to keep them happy too. The broker has a particular incentive to achieve good value where they are underwriting the issue and may be left holding the bag if investors shun the offer.

The result of these dynamics tends to be IPO pricing that reflects reasonably good value compared with similar listed companies, but at a time when those similar companies are trading at elevated prices. Of course there are exceptions but, as a general observation, participating in IPOs probably makes more sense for investors with a shorter investment time frame.

Another danger for long-term investors is the possibility that reported earnings have been "managed" in preparation for the IPO. For example, in the short term a business vendor may be able to improve reported earnings by cutting back on expenses or capital investments. If the cuts compromise service, quality or brand, there may be negative consequences some way down the track.

Naturally they want the best possible price

Potential IPO investors also need to bear in mind their financial relationship with the broker. If you want to increase your chances of receiving allocations to the best floats, it is essential that you actively and frequently employ deeply networked, full-service brokers.

So, what do we make of the current deluge of IPOs hitting our desks?

One cannot form a full view on some floats – for example, the investment merits of Nine – until the final price is known and a comparison with its estimated intrinsic, or true, value can be made.

Pact Group is another likely "blockbuster" float this year. Media reports suggest the packaging company could be "valued" at up to $2.1 billion on listing. Pact may be an attractive business, depending on the final price, but keep in mind that packaging companies can be highly cyclical.

Other confirmed or speculated floats include Dick Smith, education group Vocation, Redcape Hotel Group, McAleese Transport, credit-reporting company Veda, Industria REIT, PM Capital Global Opportunities, LifeHealthcare, GDI Property Group, Real Energy Corp and Bis Industries.

A potential blockbuster privatisation of Medibank Private and possibly an IPO for EnergyAustralia in the next few years, could further boost the market. A $5 billion-plus offer of Queensland Motorways, should it choose to float, could also set the IPO market alight.

A reasonable interpretation of all this activity is that owners are rushing to market because they feel valuations are attractive. The rush is also a function of the fact the IPO window was closed for a long time and vendors such as private equity who need to keep turning over their portfolios have probably built up something of a backlog. This situation can actually work in favour of investors.

Also, as with all equity investments, we need to be wary of making broad generalisations and it's likely that we will find both some gems and some dross among the various offerings. For investors willing to put in some legwork and properly analyse the businesses coming to market – using the techniques we have advocated here and which we use at Montgomery, as well as the circumstances of each offer and its particular risks – IPOs can be an opportunity to acquire high-quality businesses before others have fully appreciated their virtues.

At Montgomery, we have been studying with interest the different opportunities and, while we are wary about current valuations generally, we also think there are a few long-term gems waiting to list.

Roger Montgomery is a portfolio manager at Montgomery Investment Management. For his book, Value.Able, *see www.rogermontgomery.com.*

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