



IPO pricing: recent experience

by Dr Steven Bishop and Justin O'Brien

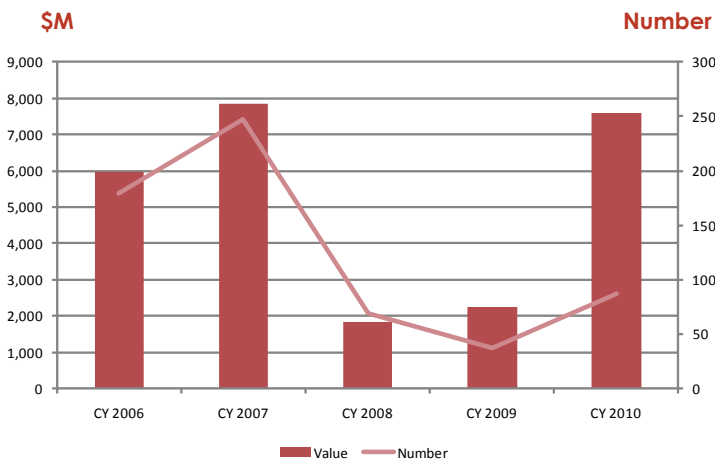
Global Initial Public Offering ("IPO") activity for the year to date 2011 (as at 25 February 2011) was the highest on record with firms raising a total of US\$24 billion, a 20% increase on the same period in 2010¹.

This follows record IPO activity in Q4 2010 when US\$122.2 billion was raised globally, a significant increase over 2009 when US\$105.8 billion was raised in the whole year. One explanation for this substantial growth in IPO fund raising could be that there has been a 'catchup' of funding needs that was slowed by the global financial crisis.

IPOs in Australia over the last 5 years

While both the number and value of issues also slowed significantly in Australia during 2008 and 2009, there was a recovery in 2010 to pre-GFC levels (by value), even though the number of IPO issues were less than half pre-GFC levels. The 2010 figures by value were helped significantly by the QR National IPO of circa \$4 billion.

IPO Activity in Australia



Across the five years starting 1 January 2006 to 31 December 2010 in Australia:

- 619 IPOs were affected (with issue price data on Bloomberg);
- \$25.5 billion in capital was raised.

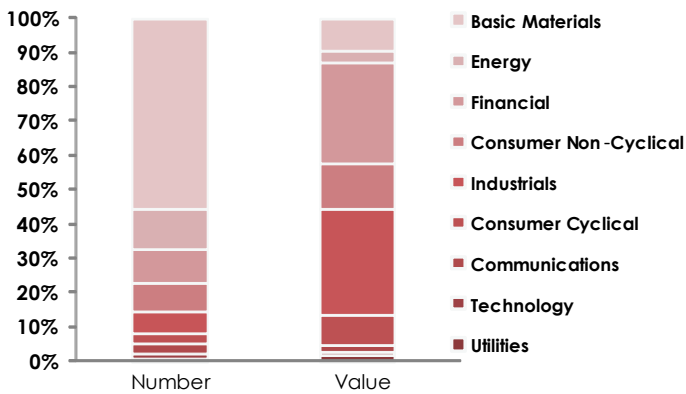


The average size was \$41 million and the median was \$4.6 million consequently there were some large raisings which affected the average.

It is interesting to examine IPOs by sector. The basic material sector dominated the volume but not the value statistics. Some observations of a sector view are:

- More than half the number of raisings were in the basic materials sector and nearly 70% were in the materials and energy sector over the past 5 years;
- The vast majority of these basic materials and energy issues were small in size representing just 13% of the total value of issues;
- The two largest sectors by value were the Industrial and Financial sectors;
- The significant IPOs by value in the Industrial sector over the past five years include QR National (\$4.0B), Boart Longyear (\$1.9B), BrisConnections (\$1.1B), and Dyno Nobel (\$0.8B), while the large IPOs in the Financial sector include Westfield Retail Trust (2.0B), Platinum Asset Management (\$0.3B), and Challengers REIT (\$0.2B).

Australian IPO activity 1 January 2006 to 31 December 2010 (% of total)



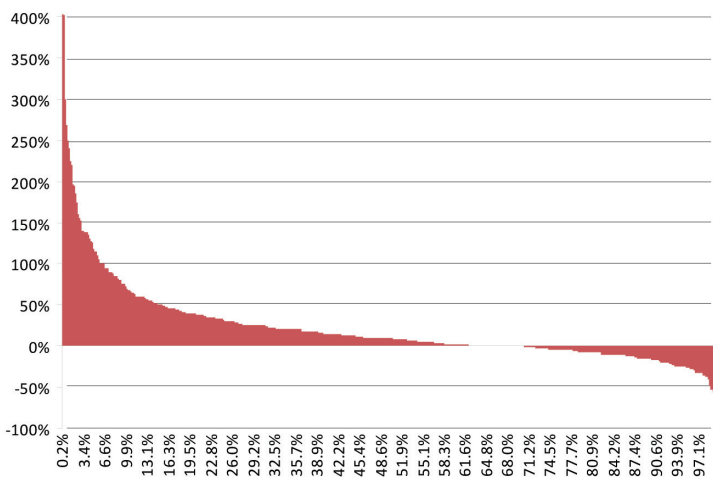
IPO Pricing in Australia

A common finding in markets globally is that the average IPOs listing price on the days immediately following the issue is above the issue price. This was certainly the case for the majority of Australian IPOs over the last 5 years.

- The listing price at the end of day 2 was higher than the issue price for 69% of companies and lower for 31% of companies;
- On average, the listing price was 22% above the issue price;
- The median, however, was 10% and the weighted average was 3.8%.

The lower median indicates that there was skewness in the data, i.e. that there were a small number of very large gains that pushed the average up. The lower weighted average indicated that the gains were also concentrated in lower value issues. This phenomenon is apparent in the following chart.

End of day price (day 2) as % increase on issue price (%)



While prevalent, this apparent 'under-pricing' appears to change over time. In the US, for example, Loughran and Ritter² have observed that the degree of under-pricing has changed significantly. During the 1980s the average underpricing was 7%, during 1990-1998 this increased to 15% and then reached 65% during the internet bubble of 1999 and 2000, reverting to 12% during 2001-2003.

We also examined the performance of the IPOs after a 3 month period post listing to shed light on whether it is a short term phenomena.

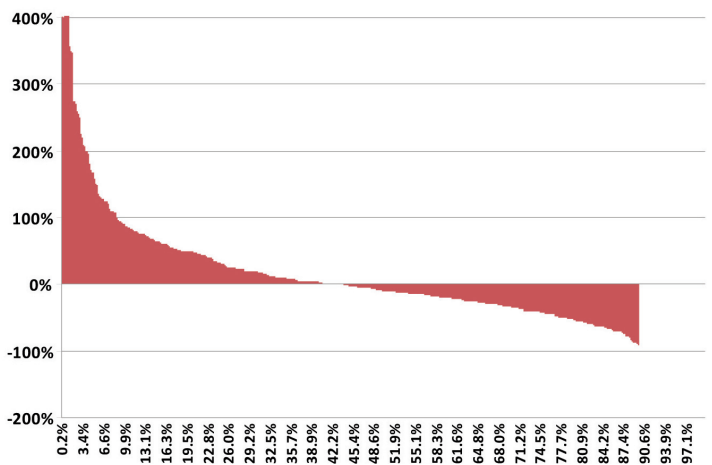
Of the 619 companies that had issue price data, only 555 had price data three months later (some of 619 companies had an IPO date that was less than 3 months from the date that we undertook the analysis).

- The listing price at the end of 3 months was higher than the issue price for 48% of companies and lower for 52% of companies;
- On average, the listing price was 19% above the issue price;
- The median, however, was -2.5% and the weighted average was -2.7%.

Performance three months after the issue date was in most cases similar or slightly worse than the listing price, implying all of the gains were made at listing, with the medians and weighted average implying the larger and less profitable listings went backwards post listing.

After the 3 month period, of those still trading, 48% were at or above issue price, while 52% of companies were below.

End of day price 3 months after listing as % increase on issue price (%)



Is it 'under-pricing?'

A number of explanations have been offered in the finance literature for what appears to be consistent under-pricing of IPOs.

One is a reward for risk borne by the underwriter. If an offering is not attractively priced to investors it faces the risk of being undersubscribed, potentially leading to lower underwriting fees and greater risk of financial loss to the underwriter left carrying excess stock. Additionally there is often a significant time delay between setting the price and the issue occurring exposing the underwriter to adverse market or sector price movements and consequent under-subscription.

Further, underwriters often have competing objectives. On the one hand they are seeking to raise capital for their corporate clients. On the other hand, they need to ensure the interests of institutional and other clients are served i.e. they also rely on these investors for other equity raisings as well as secondary market trading activity and the associated fees. Consequently they may do better by making the raisings successful over time and attracting investors even if it means some element of under-pricing of the corporate issue.

However, the current most widely accepted explanation for the apparent under-pricing phenomena lies ultimately with the asymmetric information risk that investors bear and must therefore relate to a compensation for a risk borne by the investor,³ i.e., a premium is required to induce investors to participate in an IPO issue.

The information asymmetry relates to the value of the firm prior to listing. The underwriter and issuing firm management will know more about the value of the firm than investors. This is due to limited disclosure of information prior and through the IPO process⁴. Clients of the underwriter will be perceived as being 'in the know' and will invest when the offer is 'under-priced' but not when it is 'over-priced'. Thus, investors not 'in the know' will be allocated most shares in the latter case and relatively few in the former case – a form of winner's curse.

Consequently, it is argued, average investors require 'compensation' for this risk of being allocated most of the over-priced issues.

An additional view by Certo, Daily, and Dalton⁵ (2001) is that IPO under-pricing is correlated to the issuing firm's governance structures, specifically the perceived independence of the Directors. This is because Independent Directors help to provide credence to the quality of the information put forward by the company through the IPO process and therefore investors can have greater confidence in fair pricing of the offer.

There are a number of explanations for apparent IPO under-pricing and it appears to vary with the general state of equity markets. Offering a 'premium' to investors appears to be a necessary part of providing unlisted firm's with access to capital markets. In this sense the term 'under-pricing' may be a misnomer.

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1 MacLellen, K & Jessop, S 'Global IPOs have best start to year on record' Reuters, 25 February 2011

2 Loughran, T, and Ritter, J, 'Why has underpricing changed over time?' Journal of Financial Management, Autumn 2004

3 Hughes, P 'Signaling by Direct Disclosure under Asymmetric Information, Journal of Accounting and Economics, 1986

4 Beatty, R. and Ritter, J. 'Investment Banking, Reputation, and the Underpricing of Initial Public Offerings' Journal of Financial Economics, 1986

5 Certo, Trevis S., Catherine M. Daily, and Dan R. Dalton 'Signaling firm value through board structure: an investigation of initial public offerings' Entrepreneurship: Theory and Practice 26 (2) (Winter): 33-50, 2001