AURORA
FUNDS MANAGEMENT

THE ALTERNATIVE VIEW

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Inside a Hot IPO

Two weeks ago the initial public offer (IPO) of ***Viva Energy*** (a portfolio of 425 Shell service stations) listed on the ASX. This was a very successful IPO, well managed by its investment bankers who structured the deal astutely to create demand from institutional investors and the stock gained +16% on its first day of trading. Indeed the success of this IPO has prompted ***Woolworths*** to look at spinning out their portfolio of service stations into a property trust with an expected valuation between $1.3 and $1.5 billion.

We are always very sceptical about new IPOs, however occasionally a great IPO comes along, either for a long term investment or one with a high probability of making a short term gain on its opening day. In this week's piece we are going to look at the machinations of institutional investors during the roadshow and listing of a hot IPO and the game of *Liar's Poker* that goes on between fund managers and the investment banks running the IPO process.

List of 2016 Initial Public Offerings

Ticker	Company Name	Listing date	Listing Price	Current Price	Performance Since Listing	IPO Size	BANK
TFC	TFS Corp	8-Apr-16	$ 1.55	$ 1.70	10%	$60m	Canaccord & Moelis
WTC	Wisetech Global Ltd	11-Apr-16	$ 3.35	$ 4.94	47%	$167m	CS & MS
RWC	Reliance Worldwide Corporation	29-Apr-16	$ 2.50	$ 3.33	33%	$919m	JP Morgan
MTO	Motorcycle Holdings Ltd	29-Apr-16	$ 2.00	$ 3.85	93%	$46m	Morgans
RBL	Redbubble Ltd	16-May-16	$ 1.33	$ 1.13	-15%	$40m	Canaccord & Morgans
GTN	GTN Ltd	1-Jun-16	$ 1.90	$ 2.50	32%	$188m	Macquarie
SSG	Shaver Shop	1-Jul-16	$ 1.05	$ 1.20	14%	$98m	Ords, Shaw
KGN	Kogan.com Ltd	7-Jul-16	$ 1.80	$ 1.60	-11%	$50m	Fosters, Canaccord
SCO	Scottish Pacific	13-Jul-16	$ 3.20	$ 3.46	8%	$293m	Citi, GS
RAN	Range International Ltd	22-Jul-16	$ 1.00	$ 1.49	49%	$50m	Morgans
VVR	Viva Energy REIT	3-Aug-16	$ 2.20	$ 2.57	17%	$911m	DB, ML
PLG	Propertylink Group	5-Aug-16	$ 0.89	$ 0.78	-13%	$503m	CS, GS, JPM

Source: IRESS

Ignore, a Quick Trade or a Core Position?

On initial receipt of a soon to be listed company's prospectus and the detailed research reports from the sponsoring investment banks, the investor has to determine whether the IPO could become a) a core part of their portfolio, b) is not investment grade at the offered price or c) could be a profitable short term trade. As discussed in the piece Beware of Bankers bearing Gifts, most IPOs fall into the second category, as IPO vendors know the business far better than investors and are choosing the most favourable time possible to maximise the price when they list the business on the stock exchange. The final category of profitable short term trades occur where the float is in a sector currently in favour with investors (Lithium or Fintech), is similar to other recently listed companies that have performed well or the IPO is being priced relatively cheaply compared with other listed comparable companies.

Liar's Poker

This term refers to the dance that goes on between institutional investors and the investment banks prior to an IPO, especially one where the pricing is yet to be determined. The investment banks listing the company are incentivised to both exaggerate demand and the superior investment merits of the company; whereas institutional investors will downplay their interest and are attempting to develop a picture of what is the real underlying demand. This process will involve numerous conversations with the sponsoring investment banks and discussions with other large institutional fund managers to gauge their interest.

The Liar’s Poker dance is of the greatest importance in a hot IPO, where the fund manager is looking to sell their allocation on the day it is listed for a profit.

Getting Noticed

For the Perpetuals and Colonials of the funds management world, getting noticed by the company is not an issue, but for bulk of fund managers getting noticed and showing interest is part of the process in helping secure an allocation in a potentially hot IPO. This involves attending management briefings, asking intelligent questions and writing nice letters to management thanking them for their time, whilst emphasising your fund’s long term interest in their company. The thought process behind this dance is the hope that when the allocations are done in some dark smoke filled back-room, your fund may get a better allocation than another fund manager who did not show any interest.

Allocations in the smoke-filled Backrooms?

One of the reasons why investment banks are keen to run an IPO process or a capital raising (other than the fat fees) is that in the allocation of holdings they can reward their good clients and use it as a lever to attract new clients. From my observations large allocations tend to go to the funds that generate the largest brokerage commission, which are often high turnover hedge funds rather than long term owners of the company.

Indeed in 2009 ***Bendigo Bank*** conducted a deeply discounted capital raising, which had a high probability of delivering capital gains to participants (BEN traded up +30% when it resumed trading post listing). At the time I was helping to manage an Australian equity fund on behalf of Bendigo Bank and I was extremely surprised to find out that the investment banks gave the bank’s own fund a very small allocation to their own raising. This was ultimately changed after some muscular discussions with the bank’s management and the investment banks involved. Occasionally the company runs the allocation process, as ***Amcor*** did in their 2009 $1.6 billion capital raising conducted at $4.30 per share which mainly went to loyal long-term shareholders.

Underwriting and Sub-Underwriting

In many IPOs and also large capital raisings, a key reason why a particular bank is awarded the mandate by the company (and the associated fees) is where the bank is able to underwrite the deal. This removes the risk for the company or the IPO vendor that they are unable to raise the expected amount. Underwriting is where the bank effectively uses their balance sheet to guarantee that the company will receive a fixed amount for the shares being sold.

Post the GFC, few banks want to take the risk that a global catastrophe could occur that could cause investors to walk away from an otherwise desirable float, potentially leaving the bank’s shareholders with several hundred million dollars’ worth of equities that are worth less than the underwritten price. To mitigate this risk, investment banks will call some of their better clients and offer them the opportunity to sub-underwrite the issue. Here unitholders will generally receiving 0.5% of the amount sub-underwritten, for “loaning out” their fund’s balance sheet to the investment bank. In a desirable issue this can be a great way to augment portfolio returns, as there is little chance that you will actually have to take a large amount of unwanted stock.

Bidding

When I started in the industry the thought process for a hot IPO was to work out what you really want and then bid for five to ten times that amount. Then when your fund is then allocated a fraction of the original bid amount, the fund manager can either stoically accept the allocation or engage in high Shakespearian drama shrieking at the bank running the IPO of how their unitholders have been slighted, whilst secretly being satisfied. The investment bank running the IPO process is happy to indulge in this charade, as they can point out to the company that the issue was say five times oversubscribed, implicitly highlighting the bank’s superior relationships with the capital markets. The current thought process is to give a more realistic bid of twice what you actually want, and highlight to the investment bank running the IPO that this is the “*real number*’’.

In any IPO or deeply discounted capital raising it is an extremely poor outcome to actually get the allocation asked for, as this is an indication **not** that company is very keen to have your fund as a shareholder, but rather that the fund manager has misread the actual demand for the IPO and that the bank is struggled to fill demand. In this situation the IPO inevitably performs poorly on listing, as shareholders dump their excess allocations.

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Disclaimer: The author of this piece was unhappy with the minute size of his fund's allocation to the Viva Energy IPO.

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