The risks and rewards of investing in newly listed companies

By John Mulligan

A potentially lucrative sector

From time to time I review developments in the London new issues market in my monthly STAR Newsletter as, over the years, I have found that some of my most successful and profitable investments have been in companies that have listed their shares on the London Stock Exchange in the recent past. Although a large proportion of both larger and smaller initial public offers (IPOs) turn out to be poor investments, at least from the point of view of the wider public, occasionally there are a few really excellent growth businesses that prove to be exceptionally rewarding. In recent years I have done particularly well from relatively small stakes in Dechra Pharmaceutical and XP Power. Both of these have risen by more than ten times in value and have more than made up for the inevitable failures.

I started looking in depth at the new issues market back in the 1980s, when I contributed regularly to a publication on this sector distributed by leading national brokers Sharelink and subsequently for many years for the financial website Interactive Investor. When I undertook a detailed survey of all UK IPOs covering a ten-year period in the 1990s, I unearthed a few simple clues to help in the discovery of potentially profitable investments, which I summarise below.

While it seems at first sight logical that young, recently listed, companies are likely to produce above-average returns to investors, it is certainly not the case that all newly listed businesses will be good news for outside investors. This is because there are several reasons for companies deciding to list their shares on a public market and not all of these reasons will necessarily be in sync with the priorities of outside shareholders.

Questions investors should ask

From the perspective of the private investor it is vitally important to remember that the information provided in the listing prospectus is, in effect, a sales document. So, the first question to be asked by investors should be "Why are the current owners selling a stake in their business?" Essentially, is the listing intended to generate cash to help the business expand ("Good" as Trump might say) or is it primarily to provide an exit route for the existing owners or help pay off debt incurred, in some recent cases, by private equity owners (often a Trump "Bad").

In reality, of course, the motives for listing new shares are often more complex than this, but astute investors usually attempt an assessment of the basic reasons for the listing operation as their first priority. Generally, the most successful IPOs are profitable companies looking for additional cash to fund expansion.

As with other established investments, the key metrics for those seeking successful new issues include: a valid audited record of positive growth in sales and profits over at least the past three years, attractive rates of return on capital employed in the business, trading margins at least above the average for the sector, a niche market position that exhibits an element of pricing power and an ownership involvement by the directors and senior management that is sufficiently large to provide an incentive but not too large to confer complete control.

A couple of current examples

By way of illustration I have recently reviewed two large main market IPOs, TI Fluid Systems and Bakkavor, and assessed each according to the scores they achieve in relation to past sales and profits growth, business valuation at the current share price, expected future profits and earnings growth, management competence and incentives, strength of business model, extent of indebtedness and interest cover, dividend yield and other factors such as outlook for the relevant business sector.

In my monthly STAR newsletters I usually include one or two short analyses of companies that appear near the top of my share screening system and recently I have been looking at the two IPOs mentioned above. Ideally, I am looking for companies that achieve a STAR profile rating of 60 and above based on the above metrics. Unfortunately, neither Bakkavor nor TI Fluid Systems manages to achieve a rating of this order, with the former rating 55 and the latter coming in at 46.

TI Fluid Systems is an example of a well-established manufacturing group with global outreach that may well qualify as a "Bad" issue in that the previous owners, Bain Capital, were intending that the flotation would help reduce the large debt overhang. Not only does the debt pile remain high after the flotation but the total volume of the business could be under long-term threat as the motor industry goes electric.

The position vis-à-vis Bakkavor is better in terms of the overall growth potential for quality ready-made foods but less positive in that the founding directors remain firmly in control, with only 25% of the group shares available for the wider public and debt levels still remaining high even after receipt of some £80m following the recent public offer.

Sadly, I haven't caught sight of any Dechras and XP Powers among the recent flotations, but the search continues.

Editor's note: John would be happy to send copies of the STAR profiles on TI Fluid Systems and/or Bakkavor to anyone who is interested.

Carillion – A letter to the Financial Times

UKSA was a signatory to this letter, which was published in the Financial Times

Sir,

When it comes to apportioning blame for Carillion's dramatic demise, fingers are being pointed in all directions. But most are missing the real culprit: faulty accounts appear to have allowed Carillion to overstate profits and capital, thereby permitting them to load up on debt while paying out cash dividends and bonuses.

Prudent accounts are a fundamental pillar of the UK's capital maintenance regime: profits and capital may not be overstated. It is also illegal under Company Law to pay dividends out of capital. Anticipated revenues from long-term contracts cannot count as distributable capital, and foreseeable losses and liabilities need to be taken into account. All this is clear.

Carillion's accounts reported profit that was anticipated. They also seemingly failed to apply prudent judgment in determining impairments and liabilities. This is akin to an airline allowing a plane to fly with a fuel gauge that gives overstated readings, implicitly assuming that mid-flight refuelling (i.e. injections of fresh capital) would be available if needed. Given the dire consequences of running out of fuel, would we take this risk?

So yes, Carillion's directors need to be investigated for the company's collapse, but so too should the auditor, KPMG. If the auditor claims they were following the required standards (as they have in the past), then the problem is far deeper; and potentially endemic. Faulty standards would mean that accounts today cannot be relied on to protect capital, with devastating consequences for all stakeholders who depend on businesses remaining going concerns.

Carillion is yet another canary in the coal mine. How many more do we need for the Government to properly scrutinise our accounting rules?

Natasha Landell-Mills, Sarasin & Partners
Martin White, UK Shareholders' Association
Dr. Atul K. Shah ACA, University of Suffolk Business School
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