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Stock debuts alive and kicking but yet to roar

By Ralph Atkins in London – March 20, 2014

Amid the hype of the IPO rebound there are reasons for caution

Capitalism is back – alive and kicking. That, at least, is the impression created by the rush of companies debuting on the world's share markets.

Global "initial public offering" volumes have already exceeded $38bn in 2014, more than twice as high as in the same period last year. European IPOs have tripled, according to Thomson Reuters data.

Twitter debuted late last year; the IPO highlight of 2014 is likely to be the US listing of Alibaba, the Chinese ecommerce giant, which might be the biggest yet.

IPOs are the lifeblood of equity markets: they replenish share supplies and invigorate investors – as well as provide finance for companies to expand. So their revival is a sign of a return of Keynesian "animal spirits", or commercial risk-taking, and of financial markets functioning efficiently again after almost seven years of crises.

Or is it? Amid all the hype that makes IPOs so headline grabbing, there are reasons for caution. The animal spirits may be more those of bigger companies, bankers and financiers, rather than the smaller beasts in the jungle that will provide the economic growth of the future.

Paralysis postponed

A widespread fear not long ago was that IPO markets had fallen into paralysis with a dearth of activity, especially in Europe, that seemed to reflect long term structural changes.

Historically low interest rates and economic uncertainty were blamed for dulling pricing mechanisms. High-frequency traders, eking out profits from the smallest price movements, were accused of gaming the system; regulators of discouraging market making and risk taking; and bankers and advisers of failing to leave anything "on the table" for investors. The popularity of bonds encouraged talk of the "death of equities".

This year's IPO spurt suggests some, but perhaps not all, such worries were misplaced. With hindsight, a big reason there was so little IPO activity was simply that economies were so weak. Now prospects are picking up, the market has reopened. That is not the same as concluding the IPO market is back to rude health, however.

Obvious concerns are that the IPO surge is being driven by inflated expectations about the future earnings of digital-age companies – a repeat of the late 1990s dotcom mania – and by the global rally in equity prices powered by central bank quantitative easing.

That IPOs are focused in a particular sector is not unusual. Fads come and go. Currently, it is biotech and internet companies, including online retailers. A year ago, it was more property and healthcare groups.

But the surge in activity owes much to the strength of equity markets. As share prices soar, an IPO makes economic sense for more companies; private equity investors spot an opportunity to exit.

Buoyant equity markets have not just seen companies valued generously. They have meant some large post-launch "pops" – the surge in the share price in the days immediately afterwards. Twitter's shares jumped 70 per cent on their first day of trading in November, for example.

Pops and flops

Still, with others flopping, investors have yet to fall in love with IPOs. On average, share prices of IPO companies are 23 per cent higher after one year, calculates Mouhammed Choukeir, chief investment officer at Kleinwort Benson, which means that over the past 12 months they would only just have outpaced global equities.

"Not all IPOs have skyrocketed, some fell to the ground, which shows you that the market does not always buy the story," adds Malek Dahmani, who analyses small to medium sized European companies at Lombard Odier, the investment manager. Fuelling investors' suspicions are not just the large fees bankers earn from IPOs – Alibaba promises a feast – but disputes over how shares are allocated in IPOs. When AO World, the UK's online white-goods retailer, was listed last month, 85 per cent of the issue was awarded to just 15 investors, disappointing hundreds of institutions.

A broader economic worry is that the IPO market is still not serving the smallest companies. While volumes are near record highs, the number of IPOs is on a long term downward trend, which means the average size is rising. The first months of 2014 have seen about 200 IPOs globally. The same period in 1996 saw almost 700, although that was in the run up to the dotcom bust.

In the US, the Jobs Act, which was intended to help funding of smaller businesses, is encouraging companies to the market, although it is too early to quantify its impact. Otherwise, the impression remains that illiquid markets, new ways of trading equities and constraints faced by banks and brokers have scared entrepreneurial companies off IPOs. The market is not yet roaring.

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