Australia’s IPO market has weathered the current global volatility well. But buyers are being understandably selective in their choices.

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Craig Mennie, Head of Transaction Services
KPMG

While institutional investors are underweight given the lower volume of initial public offerings (IPOs) in the current environment compared to prior years, retail investors are desperate for yield in the face of low interest rates. That doesn’t mean they are happy to buy just any IPO though.

Uncertainty, driven by a number of key global events including the UK’s Brexit, the upcoming United States election and Australia’s own federal election, are contributing to continued market volatility. It is not surprising then that institutional investors in particular are limiting themselves to well-run companies with strong track records led by seasoned management teams and well-credentialed boards.

“What we’re talking about is relatively simple business models with good quality management,” says Mennie. “Businesses that are complicated and difficult to understand don’t have a real place in the IPO market in the near term.”

Investors are also keen to understand the competitive position of companies, says Alasdair Wight, Director, KPMG Makinson Cowell. “What’s more, they want to have a very clear understanding of companies’ capital allocation framework, whether that’s their dividend policy or their expectations around investment for growth going forward.”

A lesson learnt
It is a similar story with regards to private equity offerings. While underlying performance following the Spotless and Dick Smith floats caused some concern in 2015 and deterioration of shareholder value, they have not put off investors more generally.

“Investors will continue to look at floats on a case-by-case basis,” says KPMG Partner David Willis, National Head of Private Equity. “Good quality businesses coming from high quality financial sponsors that have a strong track record of trading post-IPO will always be in demand.”

Wight agrees, adding: “Obviously institutional investors’ memories are long and therefore the track record of these private equity houses is critical. That includes their skills in building and rebuilding businesses and launching them with strong growth positions, robust capital structures, strong boards and governance and clearly a sustainable capital allocation framework.”

At the same time, however, investors are looking for more certainty around how these deals are being structured. Escrow periods and conditions for release, for instance, have become more stringent.

“There is no doubt that the first private equity firm to test the market post-Dick Smith, Affinity Equity Partners with Tegel Foods, had to increase their shareholding on IPO to 45 percent,” says Willis. “The typical investment held by private equity shareholders on IPO over the past two and a half years has been approximately 10 to 25 percent, to make sure there’s an alignment between incoming and exiting shareholders. It will be interesting to see where the retained shareholding lands over the next 12 months for new issuers.”
In an alternate approach to majority/significant minority IPO sell down, when PEP floated Veda in 2013 and almost did a compliance listing which meant they didn’t actually sell down anything. However, this simply meant they held it for a bit more time and in the long run it was a great outcome.

The ASIC effect

There are other changes up ahead that will impact private equity firms however – and issuers in general. The Australian Securities and Investment Commission (ASIC) released a consultation paper in May 2016 which aims to ramp up the requirements for historical financial information in prospectuses. The paper proposes that those companies listing, access at least three years of audited accounts for all their separate businesses, including those acquired in the run up to an IPO.

Willis considers this a response to some rather disastrous rollups of companies in recent times. “A lot of people over the past couple of years have tried to roll up four or five businesses together which have been spectacular failures – like Vocation and Affinity Education Group. While ASIC hasn’t singled them out, it does appear they want to get harder on these rollups by ensuring all the businesses have an audited three year history.”

The new regulations could well stymie private equity firms’ ability to do bolt-on acquisitions prior to an IPO. “Historically, pre-IPO, a number of private equity houses have undertaken bolt-on acquisitions. Some of them are strategic, some of them for multiple arbitrage. It will make that style of acquisitions more scrutinised by the institutional market, particularly if growth forecasts are driven by recent acquisitions relative to limited pre-acquisition growth.”

Getting active

Despite some negative press, however, the majority of private equity floats over the past few years have enjoyed considerable gains – if less media scrutiny. These include Mantra Group, Aconex, APN Outdoor, Burson Group and Appen. “If you plot their share prices, they’re phenomenal outperformers,” says Willis.

Nevertheless, new private equity floats have been few and far between in 2016 and with good reason. After a spate of private equity backed IPOs in 2014 and 2015 they have more or less “cleaned the cupboard out,” says Willis. “And I think that while there are many good, high quality companies that are held by private equity, there are not a huge number of them that are ready to come to market.”
That’s not the case for many other companies. Despite a more subdued 2016, various sectors will remain buoyant. These include financial services, technology, healthcare and consumer products.

The REIT market also continues strong, the inevitable result of lower interest rates and a thirst for higher yield investments. “Good quality simple REITS with reasonable yields are currently being well supported.”

There is a good deal of inbound activity as well, because of where the Aussie dollar is at the moment, says Mennie. “Not just from the United States and China but also Europe where growth is a bit slower.”

**New kids on the block**

Then there are the start-ups. A number of newly fledged businesses are planning IPOs in the next 12 months. “There seems to be a lot of start-up companies that are looking for capital that are loss making,” says Willis. “Rather than tapping traditional series A, series B fund raising, they are now trying to do an IPO – although I’ve seen a number of them pulled over the last short period of time.”

Tech start-ups are a clear theme – one of the most recent being the float of online art gallery RedBubble in May this year. Willis puts this down to a number of factors including the maturing of the Australian market and of its funding sources, namely Square Peg and Blackbird Ventures. “We’ve moved from angel investing to quite reasonable sized venture capital funds investing in the technology space, although funding sources are still rather limited in Australia compared to, say, the US.”

He adds: “The great thing in Australia is you’ve now got two success stories at the highly profitable end of the tech space. We hear so much about Atlassian but there’s also WiseTech and Aconex which are great products and have been around a long time. They are Australian based but they’re world leading and making a lot of money. That’s helping attitudes. Australian investors are also starting to get their head around the fact that they need to pay up for these businesses, high multiples despite the historical revenue.”

**Pricing to the fore**

In all sectors there has been some change in the dynamics around pricing for floats, says Mennie. Rather than doing a traditional back-end book build, where issuers tend to approach wholesale investors a few weeks before listing, more and more companies are adopting a front-end approach.

This makes use of cornerstone investors “to keep the Australian fund managers honest,” says Willis. “A lot of floats over the last number of periods have gone offshore, come back with their cornerstone investors, and asked the Australian fund managers whether they want to be in at a certain price, rather than the Australian fund managers dictating to them the price they will be in at.”

However, that only works in periods of low volatility in the market. “The issue there is that cornerstone investors are committing to up to almost a month before the IPO actually lists and commences trading. That means you’ve got a month of exposure where you lock in a certain price and if there’s volatility in the market you could be a sizeable amount out of pocket.”