The Economics of IPO (and other) Markets

The famous British politician, Benjamin Disraeli once said, “What we learn from history is that we do not learn from history.” Disraeli said this in the context of British politics. He might as well have been talking about the market for initial public offerings (IPOs).

Memories are truly short in the IPO market. Having seen scores of people lose their shirts in the IPO bubbles of 1992 and 1994, I now find that it is the same story all over again. IPOs are again the hottest sector in India’s financial markets. The reason is simple: too much money has been made in the IPO market in the last few months. Too much money will be lost in the coming months. What we learn from history . . .

Any kind of rational comparison of long-term returns in the IPO market and the secondary market would show that investors do far better in the latter than in the former. Indeed many such comparisons have been done which cover data taken from several countries spanning over decades. The conclusions are always the same: that IPOs are one of the surest way of losing money in the long run. But these conclusions are not as interesting to me as an analysis of the reasons thereof. In other words what I find interesting is that there are certain characteristics of the IPO market which makes it unattractive for long-term investors.

To understand how the underlying economics of a market can affect its prospects, let us look at three different markets: (1) the IPO market; (2) the market for entire businesses or the mergers and acquisitions market; and (3) the secondary market. All the three markets are essentially dealing in the same “merchandise” i.e. shares. However, the economics of each market are very different from each other.

The IPO Market

It is only to be expected that in a bull phase of the stock market, there will *always* be a sector, or a group of sectors which are viewed extremely favourably by the investment community. In the 1992 and 1994 Indian bull markets, financial companies were viewed very favourably by the investment community. In the early 1980s, in the US, biotechnology companies were viewed very favourably by the investment communities. In the 1999-2000 Indian bull market it is technology (particularly the software and internet-related) and media companies that are viewed very favourably by the investment community. These favourable views of the investment community are expressed by it in the form of high price/earnings, price/book value, price/sales and price/cash flow ratios commanded by the stocks of publicly owned and quoted companies.

At this time, privately-held companies in such sectors find that they possess an unlimited supply of extremely desirable “merchandise” i.e. their own shares. Naturally, merchant bankers scramble to advice these companies on how to raise a large sum of money from the equity markets at inflated prices. (The recent development of book building for IPOs is nothing but an artful form of pitting one bidder against another in an attempt to create a high clearing price for the shares being offered).

Four characteristics of the IPO market makes it a market where it is far more profitable to be a seller than to be a buyer. *First,* in the IPO market, there are many buyers and a only a handful of sellers. *Second,* the sellers, being insiders, *always* know more about the company whose shares are to be sold, than the buyers. *Third*, the sellers hold an extremely valuable option of deciding the timing of the sale. Naturally, they would choose to sell only when they get high prices for the shares. *Finally*, the quantity of shares being offered is flexible and can be “managed” by the merchant bankers to attain the optimum price from the sellers’ viewpoint.

But, what is “optimum” from the sellers’ viewpoint is not the “optimum” from the buyers’ viewpoint. This is an important point to note: Companies want to raise capital at the lowest possible cost, which from their viewpoint means issuance of shares at high prices. That is why bull markets are *always* accompanied by an surge in the issuance of shares.

It is true that often hot IPOs list at incredible premiums. The reason is simple: the demand for the shares being there, the merchant bankers ensure that only a limited supply is released to ensure a high price on listing. Super profits are made by those who get shares allotted to them in the IPO, so long as they sell them at, or soon after, the initial listing. This is where the trouble begins. Everyone wants a piece of the hot IPO cakes. Everyone thinks that he will get out at the top. Mathematically speaking, obviously this cannot be true. Moreover as time goes by, the investment quality of the issues tends to deteriorate. Ben Graham put it in these words:

"Somewhere in the middle of a bull market the first new issues make their appearance. These are priced, not unattractively, and some large profits are made by the buyers of the early issues. As the market continues to rise, this brand of financing grows more frequent; the quality of the companies becomes steadily poorer; the prices asked verge on the exorbitant. One fairly dependable sign of the approaching end of a bull swing is the fact that new issues of small and nondescript companies are offered at prices somewhat higher than the current level for many medium-sized companies with a long market history."

Because of the above characteristics of the IPO market, it is rare to find shares of companies being offered at bargain prices. History tells that over the long run, it is far better to be a seller in this market than to be a buyer. Indeed, it can be shown that over the long-run, more than 100% of the total wealth created in the IPO market accrues to the sellers. Buyers, on balance, lose money.

The Market for Entire Businesses

The mergers and acquisitions market (M&A) consists of generally well informed buyers dealing with well informed sellers. Like the IPO market, in the M&A market too, it is extremely difficult to find entire businesses being sold at bargain prices. The competitive nature of corporate acquisition activity almost guarantees the payment of a full - usually more than full price when a company buys the entire ownership of another company. Therefore, while it is easy to find businesses being sold at inflated prices in the M&A market, it is rare to find bargains.

Again, history tells us that 80% of all mergers and acquisitions fail to create value because the buyers tend to overpay for the businesses they acquire. Like in the IPO market, it is far better to be a seller than to be a buyer.

The Secondary Market

The secondary market, or the stock market, is like a giant auction house where millions of buyers compete with each other to buy securities offered for sale by millions of sellers. Prices in this market are set at the margin by the most optimistic non owners of stocks and most pessimistic owners of stocks. Because of the auction-like characteristics of the secondary market, prices often diverge far away from the underlying intrinsic values. That is why we have bull markets and bear markets.

In bull markets, the most optimistic non owners of stocks are willing to exchange their cash for shares at higher and higher prices. In bear markets, the most pessimistic owners of stocks feel that cash is worth more than the shares they are holding. So they offer them to buyers at lower and lower prices. In bull markets, therefore, prices tend to overshoot underlying intrinsic business values and in bear markets prices fall below the underlying intrinsic business values.

Unlike the IPO market, and the M&A market, the secondary market is not necessarily a market where it is better to be a seller than to be a buyer. Depending upon the prices in relation to underlying intrinsic business values, there are times when it is better to be a seller and there are time when it is better to be a buyer. Over the long run, however, it is better to be a buyer than to be a seller in the secondary market. This is because stock prices tend to rise over the long run.

Another interesting characteristics of the secondary market is that it acts as a giant relocation centre where money is moved: (1) from speculators to investors; (2) from the active to the patient; and (3) from the people who buy the most popular stocks to the people who buy the most unloved ones.

Note

Sanjay Bakshi works with Capital Ideas India Limited, a New-Delhi based investment advisory firm. He can be contacted at sanj@vsnl.com.