Philequity Corner

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IPOs and Volume Analysis

Last month, we discussed several criteria in evaluating IPOs (*Investments Basics: Initial Public Offering*, December 11, 2006). We mentioned earnings prospects, pricing and valuations, management integrity and credibility as among key factors to consider in evaluating a prospective market debutant.

However, we have also observed that for most newly listed companies, volume analysis is also an indication of the potential of an IPO stock. After analyzing the price behavior of recent IPOs, we noticed that there is a certain point when these stocks could gather sufficient upward momentum.

Pivotal point

In particularly, we are referring to the churn in IPO shares. Simply put, churn measures the extent of "flipping" by investors after listing or post IPO. Upon listing of these shares, many short-term market players will be inclined to sell their shares. These short-term players are usually hedge funds, retail investors, and short-term punters.

Meanwhile, the serious and long-term investors will be accumulating many of these shares. At a certain point, the newly listed shares will already be in the hands of the long-term investors, thus the supply of shares will either stabilize or dry up. With the supply getting to be limited, those who sold early and those who wish to own more of the shares will have to buy up the stock if they are to include the stock in their investment portfolio. With the growing demand, the momentum for a price runup builds up. This is what we consider as the pivotal point.

Justifying the higher valuation

In some cases, the share price appreciates to valuation levels that can initially be deemed expensive if taken against the immediate earnings prospects of the company. However, if the market believes that such prospects are sustainable, there will be investors who will buy even at high valuation levels especially if they are in for the long haul.

At any rate, there are many ways to justify the higher valuation. Alternative valuation benchmarks such as discounted cash flow, replacement value or comparatives of similar companies listed abroad can be employed. But at the end of the day, it is still the law of supply and demand that will prevail. A strong demand pushes the price up if the supply is limited. The pivotal point may vary from stock to stock. For recent IPO's, it took place when about 60% of the IPO shares have changed hands from short term punters to strategic long term investors, from retail investors to institutional investors, from hedge funds to long term dedicated mutual funds.

First Generation IPO

A case in point is First Generation Holdings which offered 180.91 million shares to the public during the IPO and another 27.14 million shares for over-allotment. Based on the chart below, the First Gen IPO hit a pivotal point at a 60% churn before the share price gathered a convincing momentum for a rally. The stock has risen by as much as 23% from the IPO price.

First Gen Daily Chart (February 2006 – January 2007)

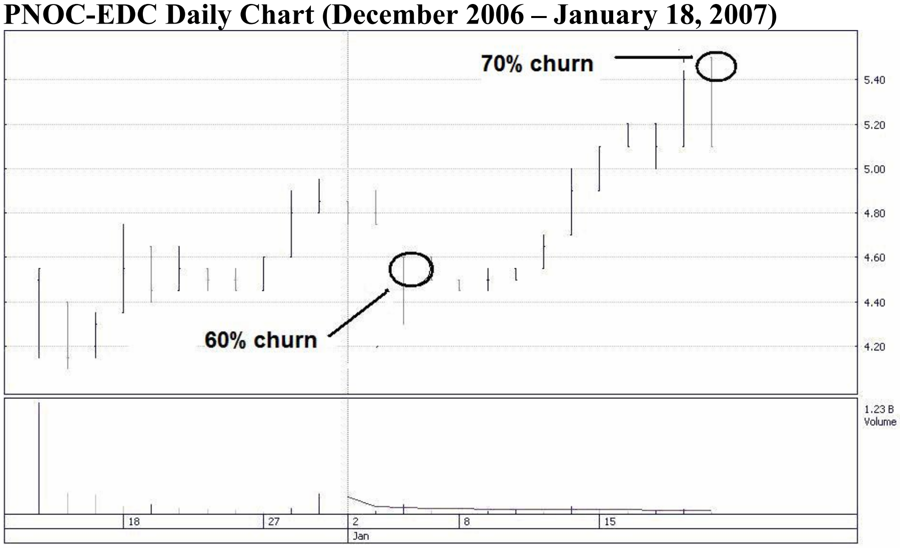
Source: Technistock

The case of PNOC-EDC

Another case is PNOC-EDC which offered a total of six billion shares to the public. The IPO was several times oversubscribed, benefiting from the strong investor interest in companies dealing with alternative and renewable sources of energy. It also benefited from the so-called "green funds" which are dedicated to investments in environment-friendly businesses. But what really provided a big boost to the offering was the entry of institutional investors such as the International Finance Corporation (IFC) and the Government of Singapore Investment Corporation which acquired 5% and 6.28% of the company, respectively. Their investments alone already locked up close to 1.7 billion shares from the market.

EDC's share price opened strong upon listing, encouraging many retail investors to flip the stock and take profits. Its subsequent correction also provided an opportunity for serious investors to further accumulate on the stock. By the first week of January (or about three weeks from the listing date), about 60% of the IPO shares have been churned (see chart below). As of last Friday, 70 % of the free float has changed hands from short-term traders to long-term investors.

PNOC-EDC Daily Chart (December 2006 – January 18, 2007)



Source: Technistock

EDC was able to hit its pivotal point faster and may even be propelled much higher due to the following reasons:

1. Most of the shares have changed hands from short-term speculators to long-term institutional investors. These investors include Government of Singapore Investment Corp. (GSIC), World Bank IFC, mutual funds that invest in alternative energy, clean and green funds, and dedicated Asian funds.

2. PNOC-EDC is a unique alternative energy play, being the second largest producer of geothermal energy in the world.

3. At the current price of 5.10, PNOC-EDC is trading at around 12x compared to Philippine market multiple of 14x. Similar companies listed abroad trade at a much higher multiple. For example, ORMAT is trading at 28x multiple.

4. With its huge market capitalization, free float and liquidity, PNOC-EDC is very likely to be included in the PSE Index.

What can we learn from these IPOs?

1. The dynamics of supply and demand apply to the the stock market. At a certain point, the supply of shares stabilizes or becomes limited and this would provide a good boost to the share price. After the shares are gobbled up by a few large and dedicated institutional investors, the price of the stock begins to advance.
2. Aside from valuation metrics, it is important to pay attention to volume movement and price action. From this, we can discern whether there is an accumulation or distribution happening in the stock. It will also indicate whether the stock is changing hands from "weak hands to strong hands." Long term investors are not easily perturbed by minor issues or momentary distractions. They will continue purchasing the stock if the fundamentals are intact and reasonable. They look further into the company's potentials and will tend to hold the stock for years.

3. Lastly, do not be easily tempted by easy profits. Do as the big investors do. If you invested in companies with solid fundamentals, it is prudent to hold on to such investments unless the fundamentals change. The biggest gain is made by people who hold on to a good stock for the long term.

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Our congratulations to Pasig Rotary Club president Raffy Garcia III for leading the group to a great 2006.

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