Philequity Corner
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Investment Basics: Initial Public Offering (IPO)

The enthusiastic response to our past two articles dealing with investments basics has encouraged us to come up with one more article as part of our continuing investments education series. This time we would like to delve on the basics of something that is now again in vogue: Initial Public Offering or IPOs.

The country last had its IPO glory days during mid-1990s when the stock market was most active amid a resurging economy. However, IPOs became few and far between after the 1997 Asian financial crisis as the country lulled into economic inactivity and was plagued by political disturbances. Following the successful implementation of various reform measures, however, the economy and the capital markets have found their bearings. For this year alone, four companies have made their IPOs worth about P25.4 billion while two firms raised P33.6bn in initial listing proceeds last year. Last Monday, geothermal energy company PNOC-EDC (the fourth to go public this year) commenced what is generally seen as a fitting conclusion to a winning season for IPOs.

What is an IPO?

Simply put, an IPO refers to the first time that a company offers its securities to the public. The shares being offered can be newly issued (more commonly known as primary shares), those that are currently held by existing shareholders of the company (or commonly called secondary shares) or a combination of both. A company would like to go public because this is one mode by which it can raise funds for expansion, acquisition of equipment or plant construction, debt repayment and financing working capital.

With its shares listed in the stock exchange, the company will then be subjected to more stringent disclosure and corporate governance rules. This is good for the investing public because they are provided access to more information which could guide them in their investment decisions. More IPOs also expand market liquidity, giving local and foreign investors a wider range of investment options. This makes the market more attractive to investors on one hand, and encourages more non-listed firms to go public. With more funds, companies can pursue plans for expansion thereby benefiting the real economy.

What to look for?

We can not overemphasize the importance of the company's fundamentals as far investment decisions are concerned. Evaluate the prospects of the company and the industry it is in as well as the risks facing the company, the industry, the market and the country. It is a good thing that regulators and the PSE have taken the first steps in scrutinizing IPO applicants and have set the initial parameters (in terms of profitability history and minimum offer size) before approving the company's application to publicly list its shares. Part of the regulatory requirement is the **prospectus**, a document containing the pertinent information about the offering and the company issuing the shares. Pore over it as it is a rich source of information.

There are numerous things that one should look for in a company going public but we will just name a few important ones given space considerations. These include the following:

- **Earnings prospects**: consider the company's prospects in terms of sales and profitability. Is there really good demand for its service or product? Is it a high-growth company or does it thrive in a high-growth industry? How realistic are its business plans (given economic and even political circumstances)? Is the company really competitive (leader or laggard) in the industry? In terms of profitability, what are its margins like and how sustainable are they? How are the margins vs. those of comparable companies?

- **Risks facing the company**. Is the company subject to regulatory risks such as those vulnerable to public or political pressure? What are the risks concerning its profitability and how vulnerable is the company to forex volatility, commodity or raw material price fluctuations, wage changes, oil price movements, and technological changes? Are there potential substitutes to its products or services? Is it a beneficiary of political patronage such that a change in government or laws and regulations would adversely impact its operations and profitability? Is it beholden to just one or few buyers or suppliers?

- **Dividend payout**. Does the company have or plan to have a dividend payout policy? How sustainable is this policy given potential cashflows? Note that dividends offer additional returns to investors on top of the share price appreciation.

- **Uses of proceeds**. Will the company use the proceeds of the IPO for productive purposes and will the intended fund usage enhance its prospects, profitability and position in the industry?

- **Management integrity and credibility**. Unfortunately, this is one aspect that is not readily apparent. One needs to do some research on the reputation, qualifications, and experience of the people behind the company's management.

- **Pricing and valuations**. This is probably one of the most crucial aspects in evaluating the company. Valuation skills are necessary to determine if the shares are priced reasonably or attractively. Shares priced at P1 are not necessarily cheaper in terms of valuations than those priced at P100! There are numerous valuation benchmarks used by analysts so it would be prudent to consult the investment analysts of your brokers. Among the commonly used valuation benchmarks are those relating the price to:

  a) earnings per share (Price-Earnings Ratio or PER),
  b) net asset value (or P/NAV which is usually applicable to property and holding companies),
  c) discounted cashflow value (DCF which determines the net present value of cashflows using an applicable discount rate), and
  d) book value per share (P/BV) which is usually applied to banks.

  Note that the lower the multiple of a company (vs. market's, the industry average, or comparable local or foreign companies), the better. A bigger discount to the NAV, Book Value or DCF is also better (assuming a relatively similar financial health of the companies being evaluated) as this provides a further upside potential on the share price.

- **Demand for the shares**. A high demand for the shares obviously indicates the attractiveness of the company doing the IPO. An oversubscribed share offering could be indicative of investors' support for the stock. Try to investigate if there are investors acquiring large chunks of the shares and if these investors are known to hold a stock for the long haul. If so, the stock is bound to find long-term support. The opposite can also be true. An offer that is oversubscribed but by numerous investors holding smaller lots is likely to be flipped or sold soon after listing because certain investors are not long-term holders and are easily contented with a small share price appreciation.

Prospective debutants next year

Given the warm market reception to recent IPOs and the largely positive outlook on the economy and the market for next year, it is reasonable to expect that more companies will go public. Some, such as power, oil and telecom companies, are required to go public by virtue of existing laws. We can also reasonably expect that more mining and BPO companies will do an IPO given the resurgence in activities in these industries. If we go by news articles, the following are touted to be next year's market debutants.

- GMA Network Inc, reportedly the most profitable broadcasting network in the country with the highest audience and market share. The company has been aggressively expanding in new markets abroad and into new media. Its entry into the stock market would provide an interesting play as there is only one other listed broadcasting company at the moment, its chief competitor ABS-CBN Broadcasting.
- Yehey.com. The company is a subsidiary of listed iVantage Corporation and has made a remarkable transformation from being a plain media company to becoming a full-scale online marketing partner to its clients. Aside from being an online advertising medium, it offers online marketing solutions with full creative and interactive marketing services. *(Disclosure: this writer sits on the board of both iVantage Corporation and yehey.com)*.
- M & H Food Corp., the owner and franchiser of dimsum outlet Hen Lin which has about 100 franchised and company-owned outlets. It has been in business for the past 25 years although it is still predominantly in Luzon. This would provide an additional play on the expected consumer spending rebound next year.
- Century Properties Group. It is one of the country's top developers and is reportedly planning to go public until 2008 but might likely take advantage of the current strong interest in property counters. It won a 12.5 acre plot in Makati in June this year and plans to develop the property primarily for retail and office buildings and tap into the high-growth outsourcing industry.
- Zambo Norte BioEnergy Corp which is into ethanol production. If ever, it will be the first listed ethanol company and should benefit from the growing interest in companies venturing into renewable sources of energy.
- Pacific Online Systems Corp, a subsidiary of listed Belle Corp, is engaged in leasing of online equipment to the Philippine charity Sweepstakes Office for the latter's lotto operations in the Visayas and Mindanao.

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