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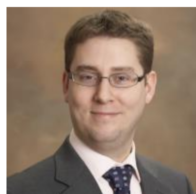
European Equities
EUROPEAN SMALLER COMPANIES—NAVIGATING SMALL-CAP IPOS



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KEY POINTS

- An improved political and economic environment in Europe along with higher valuations has encouraged a pickup in initial public offering (IPO) activity recently, with the trend especially pronounced at the smaller end of the market.
- The appeal of investing in IPOs is not hard to understand: They provide investors with early access to exciting young companies—the potential industry leaders of tomorrow. One needs only to look to some of the high-profile success stories in the technology sector, for example, to see the substantial rewards that can come from identifying a quality business early and investing at IPO.
- However, for every successful company IPO there are many that are not. Academic literature that focuses on broad IPO aftermarket performance, looking across multiple markets and time periods, supports the view that investors are not generally well served by the process in the medium to longer term.
- Our experience suggests that the best medium- to long-term performances from IPOs tend to come from well-established, “reasonable growth” companies rather than from hot “concept” stocks or lower-quality companies. A clear cyclical pattern has been observed in the past, and we believe that this will remain the case—at certain times the environment will be more favorable, at others a far more cautious stance should be taken toward such offerings.
- However, while there are many risks associated with IPOs, with experience, resources, and a willingness to do the necessary research, it is indeed possible to find quality young businesses and, in so doing, capture the long-term growth potential at an early stage.

The improved political and economic environment in Europe has encouraged a pickup in initial public offering (IPO) activity over the past 18 months, especially at the smaller end of the market, as companies look to capitalize on the upbeat market sentiment. Some €28.3bn in new company listings have been launched during the first three quarters of 2017.[1] However, investing in companies at IPO is a subject that divides investor opinion.

[1]PWC IPO Watch Europe, as of October 2017.

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For some, an IPO offers early access to exciting young companies and the potential for substantial rewards. For many others, the risks associated with investing at IPO are perceived as being stacked against investors, limiting any prospective rewards. This raises the key question: What is it that investors should look for when investing in a company IPO?

EARLY ACCESS TO EXCITING YOUNG COMPANIES

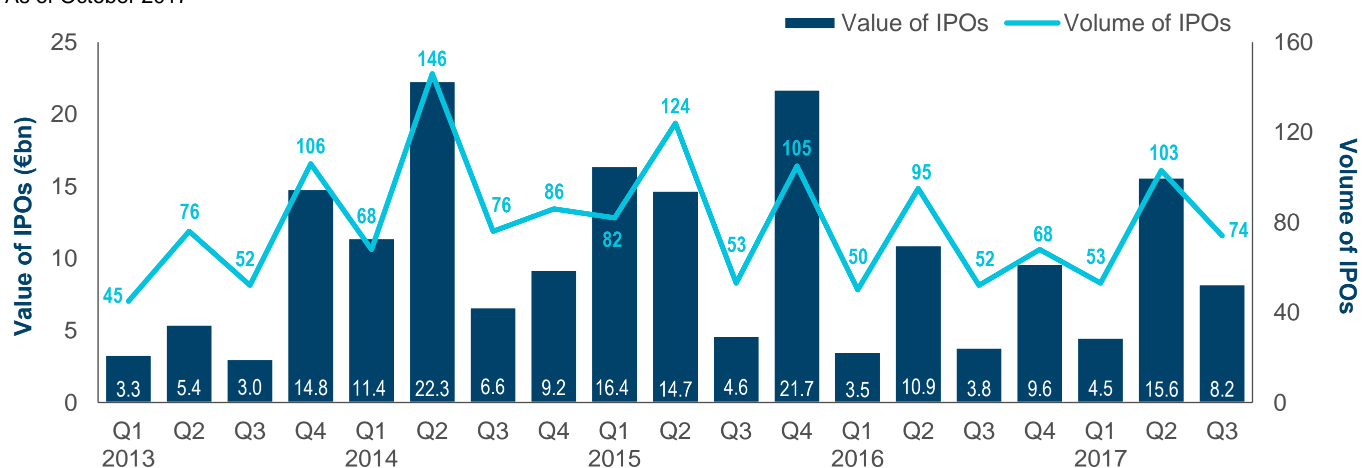
The appeal of investing in IPOs is not hard to understand: They provide investors with the opportunity to “get in on the ground floor” of exciting young companies with high growth potential. High-profile success stories in the technology sector, for example, companies that are now household names, are often cited as the kind of rewards that can come from identifying a good growth story early and investing at IPO.

Within the European Smaller Companies Equity Strategy, we have been an active participant in the European IPO market, taking part in 12 new IPOs in 2016 and a further 19 so far in 2017 (as of the end of October). These have been across a range of industries, such as disruptive online consumer-facing companies (in fields as varied as pharmacies, fashion, and mattresses), innovative health care providers, and multiple companies looking to capitalize upon recent technological and service breakthroughs. This gives an indication as to the number of quality European businesses that are now looking to list on the stock market.

While a lot of IPO investors have short-term ambitions, hoping to make quick gains before “flipping” their holding, we take a longer-term view. Once we identify a quality company with good growth potential, and that is reasonably valued in our view, we look to support that company and so fully capture the long-term growth opportunity.

Figure 1: European IPOs are on the rise

As of October 2017



Source: PWC IPO Watch Europe, Q3 2017.

BUT NOT WITHOUT RISKS

However, for every successful company IPO there are plenty more that are not, where share prices quickly sink below the IPO issue price, sometimes dramatically, and investor capital is destroyed. This high rate of disappointment highlights the multiple risks associated with the IPO process.

1. ***The seller decides when to exit***. The person or people selling the company are the ones deciding when to exit their investment and take it public. During an IPO, the owners of the business—founders, private investors, venture capital firms, etc.—are generally looking to either raise cash in order to continue growing the business or to cash out of their investment altogether. Whatever the motive, both are ultimately targeting a premium price for their investment. What separates the good sellers from the bad, however, is that they recognize that an IPO still needs to be priced reasonably to be successful. An overpriced IPO, resulting in a

sharp decline in the share price, can be difficult to recover from. Setting a more reasonable issue price at the outset means that a company is better placed to begin building a consistent record of meeting or beating expectations. This is especially relevant when the sellers remain investors in the business and need to be mindful of follow-on offerings.

2. ***Managed for the short term***. The decision to take a privately owned company public is often made years before an IPO is ultimately announced. In the case of venture capital ownership, for example, this kind of investment will often have a finite time frame, so the decision to sell the company, and the timing, are essentially known from the outset of the investment. This can sometimes lead to businesses being managed with a short-term focus, purely with the aim of creating a positive veneer ahead of the IPO, and extract as high a value as possible. However, the good sellers are those that continue to focus on long-term growth, rather than short-term results. They do not see the IPO as simply the end goal, but rather as an opportunity to raise finance to continue the next phase of the journey as a public company. It can also be the case that actions taken to improve performance in the shorter term—such as improved corporate governance or more focused performance monitoring—can also have persistent—and underappreciated—positive effects on longer-term performance.

This is where experience and research capabilities are key, helping to filter the market “noise” and remain focused on what is most important, namely the quality of the business and its longer-term growth profile.

Meanwhile, the investment banks that underwrite IPOs are also incentivized to achieve a “good price” when a company goes public. Investment banks usually receive a percentage of the gross IPO proceeds as a fee, so it is in their interests to create as much excitement and demand as possible in the lead up. Like any sales effort, success hinges on the demand for the product you are selling—strong demand for the company will lead to a higher IPO price. This is where a lot of investors come unstuck, getting drawn in by the hype and excitement and the “once-in-a-lifetime opportunity” on offer. But there are also important reputational considerations, both in the eyes of the investor and the client.

Analysis of past decades shows that there is a clear cycle—buying IPOs at the peak, when the market is “hot,” typically generates poor results over the medium term (although it can provide good short-term returns). In our experience, it is better to buy IPOs during more measured periods, although there can still be a very wide dispersion of returns. History also shows that when things go wrong for these newly listed companies, they go very wrong—many go bust or are forced to delist, or perform very poorly, and only a minority will go on to outperform the market. This is where experience and research capabilities are key, helping to filter the market “noise” and remain focused on what is most important, namely the quality of the business and its longer-term growth profile.

3. ***The information advantage is against investors***. It is hard enough to gauge the fundamental quality of an established company, with years of public accounts to pore over, let alone a private company where little information or historical records tend to be available. Investors are at a clear information disadvantage when it comes to an IPO, with the accompanying prospectus as the only real source of information. However, even here, the amount and quality of this information varies from one company IPO to the next.

So, the odds can be fairly well stacked against investors when it comes to finding a quality company IPO that is offered at a price that will ultimately prove to be an attractive discount to its fundamental, intrinsic value. Renowned value investor Ben Graham famously avoided IPOs, suggesting that a more accurate expansion of the acronym might be “It’s Probably Overpriced.” However, this view reflects Graham’s value-focused mantra and probably also serves as a warning to individual investors without the skill, experience, or resources required to research individual IPOs in detail.

As a dedicated asset manager, T. Rowe Price has these requisite attributes, not least being an extensive global research platform. With the information edge that this provides, it is certainly possible to find outstanding new businesses that we believe have the potential to compound growth rates in excess of the broader market. And while it might be true that few IPOs appear to be outright “bargains,” we are still able to find a number that appear reasonably priced, based on our assessment of the company’s growth profile and our long-term investment horizon.

ASSESSING QUALITY REQUIRES TIME AND RESOURCES

While there is less information available on a private company, compared with publically listed counterparts, with experience and resources it is still possible to gain a good level of understanding of a company in the lead-up to an IPO. Comparisons with similar public companies in the same industry or sector can provide a good baseline of information, particularly as a guide to valuation multiples being assigned to competitors. In addition to company comparisons, an IPO valuation depends heavily on the company’s future growth projections. Growth is a significant part of value creation, so an assessment of the company's plans and projections for future growth is critical.

We can also assess a “good seller effect”—typically when an IPO is offered by the company founders or if the purpose is to raise growth capital. At T. Rowe Price, for example, we have a better experience with certain private equity firms than with others, where some offerings have been misrepresented to us. Although there is often a consensus opinion that, collectively, private equity companies are “bad sellers,” this is not borne out by a number of studies. Some private equity companies are also skilled investors—hence, they can identify fundamentally attractive, long-term industries—and they put in place strong corporate governance and more professional systems and structures. They also value their reputation in the marketplace. The seller should have the right motivations and long-tenured management, while a good and disclosed track record is also a key element. Management pedigree is not always easy to gauge, and this is where doing due diligence and learning about the company’s leadership team is critical.

Other factors that are pivotal in building a view of a company, such as its potential valuation and its long-term prospects, are more qualitative in nature. A company might have a new product or a cutting-edge business model that has the potential to be industry disruptive, or perhaps it offers a unique service where there is high potential demand. These qualitative elements that make up a company's story can be powerful drivers and just as important as financial projections. The harsh truth about IPOs is that the actual fundamentals of the business are often overshadowed by the hype and excitement around the business. It is important for IPO investors to have a firm and through understanding of the facts, and the associated risks, and not be distracted by a flashy story promising great rewards.

History shows that the best medium- to long-term performances from IPOs tend to come from well-established, “durable growth” companies. Although “concept” stocks can be exciting, they typically do not feature on the list of best-performing IPOs. Lower-quality companies also tend to fare poorly, as do companies with commodity exposures. And as mentioned already, investors should also beware of companies offered at “extreme” valuations, as these have historically rarely been lived up to.

> The growth opportunity does not need to be off the chart either; it is the persistence of the growth, compounded over time, that is important.

INFORMATION EDGE AND A LONG-TERM INVESTMENT HORIZON

At T. Rowe Price, a fundamental part of our investment process is having an information edge, which means rigorous analysis, and we have invested heavily in research personnel and resources in order to gain this potential edge. The fact that we are not short-term investors is also important. We are not looking to make overnight profits, and our longer-term horizon allows us to dedicate the necessary time to find quality growth opportunities and then

fully leverage that growth over time. The growth opportunity does not need to be off the chart either; it is the persistence of the growth, compounded over time, that is important.

At a practical level, our approach in the European Smaller Companies Equity Strategy is to initially start with small positions in new companies and gradually build an increasingly detailed and comprehensive due diligence of the company. If the investment thesis fails to pan out as we hope and expect, then there is little damage done, but it allows us to not miss out on potential opportunities, particularly when a lot of IPOs are being launched, as is currently the case. An important theme that we have been building in the portfolio for some time is that of innovation, something that we see as a potentially key long-term driver of portfolio returns. We have spent a great deal of time and resources on identifying companies that are truly innovative, offering something unique within their particular field or industry and, as such, have the potential to be disruptive. It goes without saying that, if these innovative companies can be identified and invested in early, the long-term growth potential is considerable.

BEYOND PERCEPTION, IPOS CAN POTENTIALLY DELIVER EXCEPTIONAL REWARDS

There is still a general perception among investors that IPOs provide the inside track to exciting, high-growth companies at discount prices. In truth, history shows that a large percentage of these companies go on to underperform their peers and the broader market, mainly due to being overpriced at launch. The risks associated with the IPO process, and the short-term mind-set of many investors, means that the potential for value destruction is high. That is not to say that good, even great, growth opportunities cannot be found, but investors must be prepared to do the research, assess businesses on their merits, and value them accordingly. With a longer-term investment horizon, we believe investing in quality companies at IPO can potentially deliver exceptional rewards.

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T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

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