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IPO-It's Probably Overpriced or Inapparent Pocket of Opportunity?

As a general rule we tend to view Initial Public Offerings (IPOs) with a good deal of caution at QV. Our wariness is derived by a good body of empirical evidence which shows that in general, long term returns associated with investing in IPOs are subpar. One explanation for these poor results is that an IPO is, in finance jargon, a liquidity event (AKA huge payday) for the original owners of the company and as profit maximizers they naturally want to extract the highest price possible for their shares. Additionally, investment bankers who sell the deal to investors are incentivized by the commissions they earn on the IPO; the higher the offering price, the more they earn. This creates a conflict of interest which can lead them to promote overly optimistic expectations for the company's future operations. The result is that IPOs are often executed near market peaks with high valuations and big expectations. As investors who seek out stable companies with strong track records and low valuations this generally leads us to eschew investing in IPOs.

Much as in life however, few things are ever entirely black and white in the world of investing. The privatization of a government corporation via IPO is occasionally one of these exceptions. Unlike typical IPOs, the motivations for privatization IPOs are diverse, the offering price is often attractive, and most importantly, the potential for value generation through operational improvements as a private company are typically great. In fact, an academic study of 158 privatizations spanning 33 countries from 1981-1997 found that the average five year holding period return for a company following privatization was 176%.*[1]

In recent years there has been a trend across Europe to privatize national postal services. The British Government has been the most recent to follow suit with the October privatization of Royal Mail. Although an institution of British society for over 500 years, Royal Mail has been under pressure in recent years. This has been due to declines in traditional letter sending, pricing based on affordability for the populace at the expense of profitability, and bureaucratic red tape weighing down operations and earnings among other factors. Struggling with its own problems including persistent deficits and the highest level of debt to GDP since the 1960's, the British Government finally came to the dual realization that it needed to shed assets to repair its balance sheet and that if given the autonomy that accompanies privatization, Royal Mail could prosper in a changing market environment.

As an investment, the privatization of Royal Mail was intriguing for a number of reasons. First, the IPO was priced at £330, equivalent to a 0.45x Enterprise Value to Revenue valuation multiple. This was roughly half the valuation of publically traded European peers Bpost and Austrian Post. Since the privatization was a very polarizing political issue in Britain, the government needed to ensure the IPO was successful. As a result they priced the IPO accordingly low to ensure a satisfactory outcome. Second, the management team has a history of success in privatizations. Previous to her tenure at Royal Mail, CEO Moya Greene led a transformation of Canada Post where she successfully cut costs, increased automation and significantly improved profits despite a drop in revenues. Prior to that, she oversaw the very successful privatization of Canadian National Railway and the deregulation of Canada's airline and port systems as the Assistant Deputy Minister of Transport Canada.

Third and most importantly, as a business franchise Royal Mail has a lot going for it. The company has a dominant market share and an enviable nationwide distribution network. Trends in online shopping offer the parcel business interesting growth opportunities that should more than offset declines in the letter business. Letter and parcel pricing has been much too low, leaving significant room for increases (this has already begun). Finally, as a for profit enterprise there are huge opportunities to improve operational efficiencies and lower overhead.

After considering all of these factors, we decided to purchase Royal Mail on the first day it began trading (high investor interest and low allocation to foreign investors excluded us from participating directly in the IPO). After listing at £330 and rising to £455(+38%) in the first day of trading, Royal Mail has since risen to £585 (+77%) within two months. While this has been a good win in the portfolio we believe Royal Mail's growing parcel business and potential for operational improvements offer further upside in future years. So despite our general wariness regarding IPOs, in this case and in our purchase of the recently privatized Information Services Corporation in Canada, we defer to the words of legendary investor Peter Lynch who said, "Whatever the Queen is selling, buy it."

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[1] Schwartz, Netter, Nash & Megginson, 1999.
*The authors considered this number necessarily conservative because it used the opening trade price to calculate returns. In general, a privatization's opening trade price is significantly above the IPO pricing.