The 3 Most Dangerous Letters in the Financial World

Description

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Dear Fellow Fools,

One of the unfortunate but enduring legacies of the late 1990s tech bubble is the excitement of "getting in" on an initial public offering (IPO).

This ongoing thirst for IPO glory was recently on full display in the U.S. when **Twitter** (NYSE:TWTR) became a publicly traded entity.

On day one of Twitter's life as a public company, the stock soared from its $26 IPO price to close at $44.90, a 73% one-day gain (the current price is right around $41). Those who were lucky (i.e., connected) enough to garner a piece of this deal before it hit the open market made a fast and substantial return.

Who wouldn't want in on this kind of action?

In this week's Take Stock, I want to explain why the answer to this question is "you"!

Background

In case you're fuzzy on the specifics, an IPO stands for "initial public offering". (If you already have the basics down, feel free to jump ahead.)

There are a number of reasons why a company goes public (as a verb: "IPOs"), but at the core, it represents a change in the company's ownership base.

The pre-IPO ownership group, which generally consists of a collection of founders and individual investors as well as venture capital firm(s) and/or private equity players, is looking to sell at least a portion of its stake of the firm in question.

No value is created or destroyed for the underlying company – this is strictly an event that sees party A (the pre-IPO owners) selling to party B (the public).

Rife with conflicts

In between Party A and Party B is a very well-compensated collection of investment bankers. This group takes a cut out of whatever proceeds Party A receives from Party B — and we're not talking chump change here. The bankers who led the Twitter IPO were awarded 3.25% of the $1.82 billion worth[IB1] of Twitter that was sold, which works out to a tidy $59.2 million for the **Goldman Sachs**-led team.

The more interest the bankers can drum up amongst potential investors (i.e., you, me, and the rest of the public market), generally, the more they can sell that company for, and, the more money they make. Where do you think the incentives lie under this kind of scenario? Obviously, the bankers aren't on our side!

But boy do they ever try to make it seem like they are — at least in person. In my past life working on the "buy side" of the Canadian investment industry, I was part of numerous "pitch meetings" that involved a team of investment bankers trotting around company management attempting to drum up interest for that company's upcoming sale.

It didn't take long for me, even as a young analyst, to recognize what was going on and to be on high alert whenever this kind of scenario cropped up.

The key to keep in mind

It's the job of the investment banker to make it appear the potential buyers are getting an outstanding deal. Imagine the kind of salesmanship that has to go into creating this illusion. The tricks of the trade include fancy presentations, lavish dinners, and worst of all, weak disclosure that oftentimes makes the company's financial past look far rosier than it actually was.

To be clear, essentially every successful publicly traded company that exists has had an IPO at some point and therefore we're not completely discounting this process. However, though there are plenty of success stories, the risk of swinging at a bad pitch is significant enough to give us Fools pause whenever we see those three letters appear.

Check it out

To help illustrate why a degree of skepticism is warranted, have a look at the following two tables, which summarize the performance thus far of the Canadian companies that have IPO'd in the past two calendar years.

I'll admit that before finding this data, I knew the picture was going to be bleak. But when I saw the actual results, a knot formed in the pit of my stomach. Canadian investors have been buying into subpar businesses.

Again, the main beneficiaries of most of these deals are the sellers (Party A) and the bankers/intermediaries.

2011	**IPO Value**	**Return Since**
Gibson Energy	$500	61.5%
Parallel Energy Trust	342	-62.4%
Dundee Int'l REIT	270	-17.2%
Longview Oil	150	-48.6%
EcoSynthetix	100	-63.7%
Condor Petroleum	80	-78.7%
Bauer Performance Sports	75	83.2%
Legumex Walker	65	-53.1%
NexJ Systems	44	-79.7%
Midas Gold	40	-77.9%
	Average	*-33.7%*

Source: PWC, Google Finance, Capital IQ

2012	**IPO Value**	**Return Since**
Hudson's Bay	$365	21.7%
Ivanplats	301	-59.0%
Dundee Industrial REIT	155	-22.2%

KP Tissue	140	0.7%
HealthLease Properties REIT	110	-2.6%
Crius Energy Trust	100	-43.7%
Morguard North American Residential REIT	75	-7.6%
FAM REIT	59	-12.4%
Potash Ridge	15	-80.8%
Braeval Mining	10	-84.0%
	Average	*-29.0%*

Source: PWC, Google Finance, Capital IQ

Those are some ugly returns!

One more thing

The chain of conflict doesn't stop with the investment bankers and their lucrative fees – it extends right down to the individual retail advisor level.

You see, oftentimes the investment bankers will use this sales force – err, advisory network – to move the product out the door. How do they do this? Well, they pay the retail sales force a pretty penny to stuff these IPOs into their client's accounts.

Twitter isn't a great example because institutional demand would have soaked up the offering, leaving nothing for the average Joe. However, let's use the 3.25% fee that the investment bankers received for dealing Twitter to the public. In a less publicized, harder-to-sell IPO, where institutional investors earn their moniker as the “smart money” and rightly take a pass, the bankers turn to the retail advisory network that they are typically affiliated with – at least when it comes to Canadian banks.

To entice the advisors to move the IPO out the door, the bankers will give them a cut of this 3.25% fee. Let’s say this cut amounts to 1.75%. What this means is that if an advisor can sell $1,000,000 worth of an IPO into their client’s accounts, that advisor stands to earn $17,500 in a very short period of time.

If you ever wonder why your advisor only calls when they have something “new” to pitch – this is the reason.

This dynamic stands as reason #973 why we Fools aren’t all that keen on the way individual investors are treated by the established financial profession (and why we’re trying to do something about it with our conflict-free *Stock Advisor Canada* advisory service!).

The Foolish Bottom Line

As illustrated by the tables above, for every good IPO that goes out the door, there are a whole bunch of bad ones. If you’re ever offered the opportunity to participate in a stock offering before it hits the public market, get your guard up. There’s a very good chance that the only reason that you’re being given that opportunity is because a whole pile of other investors have already taken a pass. You probably should, too!

Ask a Fool

We love hearing from our community of Fools and want to remind you that you can utilize our “Ask a Fool” service to put forward whatever might be on your mind. Simply e-mail us at CanadaEditorial@fool.com.

‘Til next time … happy investing and Fool on!

Sincerely,

Iain Butler

Chief Investment Advisor

Motley Fool Canada

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Date
2025/06/28
Date Created
2013/11/29
Author
tmfohcanada