



3 Reasons to Keep an Eye on This Monster IPO

Description

There's a reason why Warren Buffett doesn't like to buy initial public offerings. Whenever you find a seller willing to pay a steep commission to bankers, it usually means they're getting a good price from whoever's buying. A common joke is that IPO should really stand for "it's probably overpriced" or "insiders profit only".

Which brings us to **EnCana** (TSX: ECA)(NYSE: ECA), Canada's largest producer of natural gas. The company is planning an IPO for 6.3 million acres of "Fee Lands", which will generate royalty revenue. EnCana is seeking to raise as much as \$1.5 billion from the offering, which would make it the largest IPO since **Sun Life Financial** in 2000.

The odds are against Mr. Buffett buying a stake in the new company, to be called **PrairieSky**. But there are some reasons why this offering is worth considering when it becomes available. Below are the top three.

1. A great business model

The business of collecting royalties is a great one to be in, because there are practically no expenses. PrairieSky is a perfect example; the company expects operating margins of 96%! And if growth comes as expected, expenses will not grow as quickly. Cashing bigger cheques doesn't require any more effort than cashing smaller ones.

As a result, royalty companies tend to trade at big multiples. For example, **Franco-Nevada** ([TSX: FNV](#))([NYSE: FNV](#)) made \$2 per share in operating cash flow last year. Yet despite a declining gold price, Franco still trades above \$50 per share. Strong growth prospects are a contributor to this high multiple, but it also underscores how much people like royalties (and for good reason).

2. Dividends

This is something that income-focused investors will love: PrairieSky plans to pay out about 85% of earnings as dividends, a very high number for any publicly traded company. This means that management will not be able to waste any money by reinvesting earnings into low-return areas,

something that happens all too often with other companies.

This payout ratio also underscores how strong a business model royalty companies are; most companies need to spend lots of money in order to grow. And this doesn't always work to the benefit of shareholders. But PrairieSky doesn't have to endure these costs, which is why it can afford such a nice payout.

3. The motivation

Which brings us back to Mr. Buffett. After all, he makes a good point that sellers must be getting a good price if they're willing to sell. But EnCana has other motivations. Ever since new CEO Doug Suttles took over last year, he has been charged with trimming down the company in an effort to clean up the balance sheet. In plain English, this means selling assets.

So EnCana may be a willing seller even without getting an egregiously high price. That price has yet to be determined, but there's a good chance this will be a great opportunity for investors. Time will tell.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:FNV (Franco-Nevada)
2. TSX:FNV (Franco-Nevada)

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Author

bensinclair

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