A Cautionary Tale: Why You Shouldn't Buy Shares in a Private Equity-Sponsored IPO

Description

The Globe and Mail's David Milstead recently wrote an article about **CPI Card Group Inc.** (TSX:PMTS)(NASDAQ:PMTS), the biggest credit card maker in the U.S., a company that went public in October 2015 at US$10 a share and is now closing in on penny-stock status.

Why am I talking about a company whose current market cap is one-third the size of the IPO proceeds it received back in 2015?

It's a cautionary tale of what can happen when you invest in an IPO sponsored by private equity.

Their interests are not your interests

The whole point of private equity is to buy overlooked or undervalued companies, clean them up, and then sell them off for a substantial profit for their investors, which include some of Canada's largest and most successful pension plans.

Remember how Toronto Maple Leafs's fans despised the Ontario Teachers Pension Plan when they owned the team because the pension's investment managers only cared about one thing — big returns for its membership — with no regard for winning championships?

Thankfully, Brendan Shanahan and the rest of the Maple Leafs's management trust is allowing fans to forget that horrible period in the team's history.

10 years and counting

Tricor Pacific Capital, now known as Parallel 49 Equity, bought CPI Card Group in July 2007 with proceeds from its fourth private equity fund, which closed in August 2006.

“We are proud to partner with CPI and its management team,” Brad Seaman, managing director of Tricor, said at the time. “CPI brings over 20 years of experience in the industry and a commitment to providing market leading products and services.”

Unfortunately, what he didn’t say was how much Tricor paid for the maker of credit and bank cards. I dare you to search the internet and CPI Card Group’s IPO prospectus to find the acquisition price; I’ve looked, and it can’t be found.

It’s not unusual for terms of a purchase to be left out of a press release announcing a deal, particularly between two private entities, but it is poor form to leave it out of the IPO documents.

The fact is, Tricor likely didn’t want IPO investors to know what it paid for two reasons.

First, it bought CPI Card Group at the height of the markets just before the correction and didn’t want to publicize that it overpaid for the company.

Second, and more importantly, despite overpaying, it was ready to move on from its investment. It had already achieved a good return on its investment from preferred shares that paid 20%, and the markets were starting to get a little overheated.

Keep in mind this is just conjecture on my part; it’s not based on any facts readily available, so don’t take my words as the gospel truth. It’s just an opinion.

The typical pattern

If you look at CPI Card Group’s IPO prospectus, you’ll see that leading up to going public, it had two-and-half years of really nice growth.

Revenues went from US$183.8 million in 2012 to US$345.6 million on an annualized basis in 2015, while operating profits increased to US$62.8 million on an annualized basis in 2015 from US$19.9 million in 2012.

Who in their right mind wouldn’t want to invest?

Look more closely, you’ll also notice that CPI Card Group’s total debt went from US$122.3 million in 2012 to US$300.0 million as of December 31, 2015, the company’s first report as a public company.

So, it sold US$150 million of its shares to the public, and yet its debt almost tripled once it became a public company, because it ratcheted up the debt to pay back the preferred shares, including Tricor.

It’s private equity to the core.

Bottom line

Milstead’s arguments for why now might be the time to buy CPI Card Group’s stock have some merit. However, given that its level of debt hasn’t come down, and it no longer makes money, it’s hardly the investment for your retirement portfolio.

Buy **Ameriprise Financial, Inc.** (NYSE:AMP), once a subsidiary of **American Express Company** (NYSE:AXP), which owns 6% of its stock. AMP's run up quite a bit in 2017, but it makes money and has an excellent position within the asset management business.

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