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Pricing the Rewards

IPOs have been prone to irrational behaviour on the part of investors. Frantic buying and excited, emotional market participants have often led to overheated markets, unreasonable valuations and eventually, panic selling. Anju Govil speaks to leading investment bankers and lead managers on the existing trends and changes that would make the regional capital markets healthier in the medium to long term.

Commercial and investment banks in the region have had a lot of benefit from the initial public offering (IPO) process, mainly due to the leverage that they extend to their clients for subscription for these IPOs and also the lead managers through the fees. For instance, according to a recent report by EFG Hermès, First Gulf Bank's (FGB) assets grew by 593 per cent in first quarter of 2006 over the same period last year. Stripping out the IPO related deposits reduces the number to 117 per cent.

Similarly, Emirates Bank International's (EBI) total assets grew, 248 per cent from Dhs43 billion in the first quarter of 2005 to Dhs148 billion in the first quarter 2006. However, this figure reduces to 94 per cent if Dhs66 billion in loans extended by the bank to finance customer's subscription in IPO is excluded.

The same report has stated that bank profitability in the first quarter of this year was boosted by the strong growth in interest and fee income from IPO financing, mortgages, personal loans and credit cards, which has outweighed the decline or reversal in investment income. It estimated IPO related earnings for FGB at Dhs240 million; for Abu Dhabi Commercial Bank (ADCB) at Dhs370 million; for National Bank of Abu Dhabi (NBAD) at Dhs170 million; Union National Bank (UNB) at Dhs220 million; Mashreq Bank at Dhs80 million; National Bank of Dubai (NBD) at Dhs30 million and for EBI at Dhs260 million.

"Growth has been quite satisfactory and last year we recorded 500 per cent growth in revenues from IPO related activities," confirms Hisham Al-Saie, head of corporate finance at Bahrain-based SICO Investment Bank.

"This is mainly a result of the regulatory process that banks and issuers have to go through – the valuation that is controlled by the government, as well as the required pro rata allocation," says Makram Kubeisy, managing director, Investment Banking Advisory, Shuaa Capital. Doing away with the pro rata allocation and allowing discretionary allocation would protect companies from too much speculative pressures.

Most believe that the current regulatory environment governing IPOs has proved to be inefficient from an investor's point of view. People need excess liquidity to subscribe at higher levels in order to get a small allocation. For instance, the subscription proceeds of du (or Emirates Integrated Telecommunications Company) came in at 167 times the sales offer worth $660 million, grossing $109 billion, greater than the country's GDP. Tamweel's IPO of $150 million was oversubscribed 484 times, generating $73 billion in proceeds.

If discretionary allocation is allowed, ensuring investors a reasonable allocation, they would not be compelled to subscribe at such high levels and it would take a bit of ebb and flow out of the market, perhaps breaking the cycle of liquidity drain with each IPO.

Also, the process has substantially raised the financial cost for investors post allocation. "The extensive use of leverage has reduced investors' return and inflated perceived market demand," says Salvatore Alioto, head of capital markets, Al Mal Capital PSC.

THE IPO MIRAGE

In the absence of leveraging, the financing cost per share would be closely aligned to the par value or the issue price. According to a spokesperson for Bahrain Islamic Bank, price concern is the main reason behind weak demand for the IPO of the Bahrain-based Albaraka Banking Group (ABG). ABG is offering 188.9 million shares at a subscription price of $3.08 per share with a face value of $1. "Frustrated by very small allocations in earlier issues, small investors are shying from raising money for somebody else to benefit from," he said. Besides, in the face of recent market volatility, many investors are also holding funds to invest in major upcoming IPOs.

Pro-rata allocation has also led to the dominance of retail investors in the IPO market, which, some bankers believe, has led to increased speculation. "The question is not retail vs. institutional," says Al-Saie. Institutional investors have a medium to longer-term view, but it is the retail investors seeking short-term gains who provide liquidity.

"A 70:30 composition of wholesale vs. retail investors should do well for the regional market as the greater number of institutional investors will act as market makers in the future," says Sandeep Kadwe, director and managing consultant, Mitcon International. His company is trying to convert LLC into PJC by bringing family owned businesses to the market.

While it is important to have a mix of both, the judgement has to be made based on how much the market can absorb from the retail investor's perspective once the trading starts. Not everyone agrees. "I don't think we can prevent any one from investing in the market," says Kubeisy. According to him, not all retail investors are speculators. Some have an appetite for a longer-term and these should get a fair allocation. "Now everyone is treated in the same way and that is not to the benefit of the issuers," he says.

These regulatory requirements and other factors create an environment where the banks stand to benefit by inducing or convincing their clients to borrow to get maximum allocation. Although the UAE's Central Bank has issued limitations on leveraging for IPOs, according to Kubeisy, it is like clapping with one hand. Limiting the leverage has to be accompanied by doing away with other drivers that make people want to oversubscribe so much.

"As long as there is liquidity in the market (which I believe is still there – just that the sentiments have changed), the banks would continue to lend for investment through various ways," says Shailesh Dash, senior vice-president, head of strategic investment group, Global Investment House. Easy leverage is, in fact, only symptomatic of the actual problem, which is the way that companies are currently brought to market. In Bahrain there is even a law against leveraging. But how effective the law proves to be will depend on the banks. "What the law will do definitely is to raise an alarm," says Al-Saie.

LEADING THE CHARGE

As opposed to receiving banks that rely on excess subscription money, lead managers are earning revenue from the 2 per cent fees considered high especially when the current laws haven't made underwriting mandatory, at least on the Dubai Financial Market (DFM). "Made to bear risk, underwriters will force the issuer to answer some hard questions and help in regulating the market," says Kadwe. Opinions vary.

"A year ago, if a company was going public I would have advised against underwriting as there was ample liquidity in the market and a hugely bullish sentiment. Today, because people are unaware as to where the market is heading and nobody can measure investor response at this moment, I would recommend to go public with underwriting," says Al-Saie, adding yet another perspective.

"We would be happy to underwrite, but the current laws don't allow us to. Now we have to allocate pro-rata – you cannot say that you will undertake a portion of this as that would mean violation of the law," argues Kubeisy. In the Dubai International Financial Exchange, however, underwriting is permitted.

Besides, most investment bankers argue that the 2 per cent fee is the standard market practice and underwriting is just one part of the whole process. In normal circumstances, when a transaction is done on a best effort basis, a fee is charged because lead managers have to tell the story, present it from a professional investment banker's point of view and put their credibility and name behind it to create an appetite for the issue.

Also, mandatory underwriting in western markets means that lead managers command a higher fee because of the risk they undertake. "What we have seen in the last couple of years is that the competition between lead managers has grown extensively impacting on the fees charged. For instance, due to fierce competition in Saudi Arabia, the fees in some cases have been less than 1 per cent," adds Al-Saie.

Some of this, as banks argue, could be corrected if markets are left to price themselves. "There are a number of things that we would like to see happen – the top of the list would be allowing the market to price the public offerings and not be controlled by the authorities," confirms Kubeisy.

It is an unattractive proposition at present for a company to move forward with an IPO as they leave so much money on the table. In certain cases, premium is already built in due to good will over the years and the companies should be able to cash in on it. Also, the issuer will have to do proper book building to ensure that the premium is correct.

"In other markets IPOs are done on a book-building basis and has been successful. Our regulators and issuers should start looking into this issue as well. This will also take care of flippers and address the issue of selling pressure and hence on price premiums in the initial trading days," adds a senior TNI spokesperson. "We should at least expect the local stock exchanges to come up to the level of some of the developed emerging markets," adds Dash.

SCOUTING FOR SECTORS

The market also needs more intermediaries who originate transactions that would be useful to the market by bringing under represented sectors to the market. Of special interest would be the family-owned businesses. The way to do this would be to provide the market with enough information to set a price so that each individual investor can make an informed decision on what to invest in and at what price.

"But regulating the number of issues or valuation of the companies can only be a short-term measure," says Kadwe. The regulatory authorities should instead focus more on investor's education and protection. Issuer should also be able to decide on a date in a given band and should be allowed to defer their issue. "In the current set up, investor protection is being compromised," he says.

"There is, no doubt, a role for regulatory authorities to protect all investors and the proper way to do that is by providing as much disclosure and information as possible to the investors," says Kubeisy. More so because retail investors, not as conversant with the matters of finance, can possibly be more vulnerable than wholesale investors. More disclosure would definitely enable them to make a rational investment decision in the face of prices being fixed by market forces. More importantly, both regulators and practitioners should provide comprehensive information to all investors – be it retail or institutional.

However, disclosure standard in each of the GCC markets is different. "Steps are being taken across GCC markets, but things are not moving fast enough," laments Al-Saie. When companies come to the market, they carry some operational and market risks and investors would not be aware of these unless they are disclosed in the prospectus.

So far, companies have taken shelter behind their greenfield status for offering limited disclosure. "Every company that goes to the market should disclose a minimum amount of information whether it is established or greenfield," argues Kubeisy. His company, Shuaa Capital, doesn't typically handle greenfields because one of its working guidelines is to work with companies that have a proven track record.

He believes that the public market should be for established companies and that greenfields shouldn't be going to the public as they have a certain risk that is very difficult to measure. "Considering the performance of many recent IPOs, regulators will need more justification to let greenfields go public," agrees Al-Saie, adding, "the halt on greenfields in the UAE is a good move as it will regulate the quality of issues." His bank lead managed Al Salaam Bank, a greenfield project that recently went public. But according to him, the company had proper justification to do so. The company had a deal pipeline in stand by, had committed to work more closely with the regional players in the real estate sector which is only one of the activities, and had a sound business model. In any case, even a greenfield company has to disclose the basis of its viability, of its business plan and strategy – and more than what the market has seen them disclose in the past.

THE IPO HUSH

Irrespective of the process, the bigger question facing investment banks and lead managers is whether the market correction would lead to fewer local IPOs. DFM has slid down by 164 per cent in the last year alone from its 52-week high of 1,267.32. The UAE's banks have been directly, through equity holdings, and indirectly, through margin lending to individuals and institutions, exposed to a sharp 53 per cent correction in the Dubai Securities Index and 34 per cent in the Abu Dhabi Index year to date.

The answer depends on the ministry. Right now, the ministry is holding back a little on local issues. Apparently, following the market correction, the launch of IPOs has been slowed down to protect the market from losing liquidity to newer issues. The other speed breaker is the much awaited company law. "The proposed new commercial companies law will enable companies to extract greater value from public offerings, and also encourage more family businesses to pursue, potentially, an IPO track," hopes Alioto.

For now, some companies have backtracked from the IPO market following the market correction, while some others have paused, believing that authorities are not going to allow more IPOs.

For the stock markets to mature and offer the required depth in the secondary market, the listings in the UAE, Saudi Arabia and Qatar need to significantly improve. Holding back IPOs, one could argue, is actually holding back some new and exciting companies from being made available to more investors. "Clampdown on IPOs is not good as there is enough liquidity in the market and not enough issues to absorb it," argues Kubeisy.

So, the need of the hour is more and more IPOs. "It helps in unlocking the value for several investors/funds and thereby improve the overall shareholder wealth," explains Dash. With a more open and liberal system, more companies listing and greater choice for investors, research will naturally enter the picture as an offshoot of this greater choice as competition among banks for client business increases.

"This is a virtuous cycle witnessed in other emerging markets, and it is time for this region to move to that level," says Alioto. Clearly, the fact that liquidity goes in and out to oversubscribe is not a function of too many IPOs, but of the process.

Last year saw not only a huge deal of cash flow coming into the market, but also concurrent timing on a regional basis. This impacted the liquidity and the secondary market as the same leverage is being used for the secondary market as well. In any case, the liquidity that comes out of the market for IPOs goes back to the same market after a lag.

WAITING IN THE WINGS

However, most banks believe that the performance of IPO related business would continue to improve as there is a huge demand for IPOs. This is in spite equity market underperformance in the first quarter of 2006 having a direct impact on the banks' NBAD's fee and non-interest income. NBAD's fee and non-interest income, for instance, declined 22 per cent over the same period in 2005. Stripping out IPO related balances leaves many banks with a loan/deposit ratio higher than 100 per cent.

The moderate growth banks are even more exposed to negative surprises due to greater equity holdings. The higher the positive cumulative change in fair values that is recognised in equity, the greater the analysts expect a negative surprise resulting from reversal in these previously booked gains, either through selling for cutting losses or through a lower marked to market valuation.

"Today, the sentiment could be slightly negative due to material losses, but most of the companies are on the sidelines to see when the big players make a move and gain from the rally," says Al-Saie. Whether the activity happens on the local market or the DIFX would depend on how the regulators approach the issue of licensing IPOs.

The choice of the market would also be a function of the nature of the business and the size of the business. Very local companies with local businesses would be properly listed on the DFM, which operates along the local standards. A cross border company with cross border business or regional multinationals would be better off on the DIFX. DIFX has higher disclosure requirements and is very much in accordance with international best practices in terms of corporate governance, reporting and disclosure, etc.

So, even if the IPOs close in on the local market, there would be a lot more IPO activity on the DIFX. That apart, on the DIFX side, there is a huge demand and is itself very keen to have new issues. "But it is only six months old and it needs time to earn more liquidity and maturity," warns Kubeisy. Although they are completely different structures the underlying liquidity that would feed one would feed the other as well. According to published reports, more than 130 companies are awaiting approval from the authorities for their IPOs.

Others believe that IPOs will not slow down, but more quality issues will hit the market. "Structuring of some of the IPOs, particularly documentation, has not been impressive," says Al-Saie. The market already has instances where an IPO of an otherwise sound company with an excellent business model has gone bust due to structuring issues in terms of pricing and due diligence. Jawad group is a good example.

Although overall investors demand could be less buoyant, it is difficult to generalise the impact on the banking sector as different banks would have different impact. In the end, the better players would emerge as winners over time as the quality of deals improve. At the same time, most players are diversifying their revenue streams to ensure that growth is more balanced. "The IPO work that we do is not the bulk of our results over the past two years. They have contributed significantly but not most of it," says Kubeisy.

At SICO, for instance, corporate finance, which includes advisory and IPO activity, contributes only 15-20 per cent of its revenues. Although fees from private placement/IPOs forms a significant portion of Global's total fee income, which accounts for almost half of its total income, the company is involved in several activities and its income base is very diversified.

TREADING CAUTIOUSLY

However, the impact of IPO does significantly split over into other departments as well. Also, negative surprises could be there for the banks that rely heavily on leverage. If the Central Bank tightens the guidelines on leverage, there will be a big change in the revenue basket of some banks. The safety valve in this case will be provided by the revenue from issuers that will not change.

Also, banking sector and the future primary market activity would be driven by the strong macro-economic fundamentals, consumer boom and the large direct investments lined up in various sectors of the GCC economies. IPO is a fairly small market and the level of economic activity in the region is driven by other factors.

“The region should be judged by the infrastructural, oil and gas, tourism and real estate projects that have been announced by various regional governments. Moreover, the improving prospects of the region are clearly evidenced by the rating agencies upgrading of the regional institutions during the past year and declining cost of funding to local institutions due to improved credit spread,” says Cyrus Ardalan, vice-chairman and head of investment banking in the Middle East, Barclays. “The securities market has been growing at an impressive pace and there has been a very rapid growth in the volume and diversity of securities issued in the region,” he adds.

To support the process, capital market authorities could perhaps screen all the potential lead managers coming to the transaction. DIFX is a good example. Others expect more. “I think that the Central Bank should not allow audit firms and commercial banks to lead manage IPOs. Only licensed lead managers and investment banks with a track record should be allowed to do so,” says Al-Saie.

“In our view, the regional market needs proper investment banks whose diversified revenue model, while different from traditional commercial banks, remains resilient to specific product or market downturns,” says Alioto. His company, Al Mal Capital, has a wide range of products, thus permitting the company to smoothen its return profile over time.

Investment banks would then enjoy greater flexibility in structuring and executing transactions, and achieve higher valuations for clients in the initial sale of shares. The result would generate fairer valuation of companies, resulting in increased appetite for public listings, and encourage more innovation and different types of solutions being implemented, serving investors and companies alike.

Their confidence is not unfounded. Correction has been accepted as a good move as it has tampered down expectations and taken away some of the exuberance of the past which was not necessarily healthy. But the underlying factors that drove the market in the past are still there – liquidity, high oil prices and healthy growing economies. Once this correction finds its consolidation level, the region can still have sustainable healthy capital markets.

As Dash of GIH says, “only the UAE banks have had a significant amount of their fee and commission income coming from the IPOs – but in the other GCC countries, it has been primarily related to consumer boom, capital market activity, improvement in non-funding business and increasing interest rates which has helped improve the spread.”

“We are already seeing a lot of quality international houses setting up offices and the existing ones diversifying. They can see the huge potential and don’t think that there would be a slow down,” concludes Al-Saie, confident that the growth from IPO related business in 2006 and 2007 at his bank would outperform that of 2005.