PARAMETRIC™

March 2019

Anecdotes Versus Evidence: The Institutional Case for IPO Participation

Mahesh Pritamani, PhD, CFA
Senior Researcher

Raewyn Williams
Managing Director, Research

Everyone likes a good news story. For large superannuation fund equity portfolios, a favourite topic is the value Australian equity managers can add by participating in initial public offerings (IPOs). Powerful anecdotes like the gains recorded by new listings Exopharm (175%) and Adriatic Metals (188%) last year[1] and Ardea Resources (850%) the year before[2] do indeed create a sensation.

This paper looks behind these anecdotes to the evidence around manager participation in IPOs on behalf of their large super fund clients. We explain the institutional IPO process and examine years 2011 through 2018 to test the assertion that managers access IPOs in ways that add value to fund clients. Unlike other studies, we try to capture the true costs to the superannuation portfolio of IPO participation to better determine the value added. The costs relevant to this analysis are broader than many super fund investors may realise.

While leaving room for exceptions,[3] our findings cast doubt on whether managers, leveraging relationships with lead IPO managers (brokers), are really adding value to superannuation fund portfolios. Even when the manager is highly skilled in selecting which IPOs to participate in or can secure a surprisingly generous allocation to new shares, it is difficult for IPO participation to add meaningfully to performance once all costs are factored in. This takes much of the gloss off racy IPO anecdotes the industry loves to share and reveals a much more reliable, evidence-based alternative path available to a super fund: to pursue simple, nuts-and-bolts best execution and transactional efficiency, without favour or generosity to any particular broker.

Parametric Portfolio Associates LLC
Suite 6502, Level 65
MLC Centre
19-29 Martin Place
Sydney NSW 2000
Australia
T 61 2 8229 0222
F 61 2 8229 0249
www.parametricportfolio.com

[1] HLB Mann Judd, 'IPO Watch Australia: Australian IPO Activity in 2018' (January 2019), https://www.hlb.com.au/media/2019/01/IPO-Watch-2019-Online.pdf.

[2] HLB Mann Judd, 'IPO Watch Australia: Australian IPO Activity in 2017' (January 2018), https://hlb.com.au/media/2018/02/IPO-Watch-Report-2018_ONLINE.pdf.

[3] In particular, focusing only on the small-cap universe (broadly, companies with market capitalisation of between $61 million and $8 billion) may identify more exceptions to these general broad-cap findings.

How institutional access to IPOs works

An IPO reflects a company's decision to raise capital from the public—institutional and retail investors—by issuing shares in exchange for capital from these investors. An expanded share register is created, and the company's listing on the stock exchange creates a liquid, public market for investors to buy and sell the shares on and after the IPO date.

The IPO issuer (listing company) will likely have amongst its IPO objectives not just to raise a certain amount of capital but also to attract certain types of investors with favourable attributes. Institutional super funds tend to find favour by having large amounts of capital to invest and a long-term investment horizon—and this favour extends, naturally, to the institutional managers who manage their money.

Key success measures are whether the IPO is fully subscribed (target capital is raised) rather than undersubscribed, with the shares allocated at maximum issue price. To help with these objectives, the listing company appoints a lead manager, sometimes called a lead underwriter or bookrunner (usually an investment bank with a broking arm) to promote the IPO and advise on and run the IPO process. Often, through a book-building process, bids are solicited from investors on price and quantity of shares, which helps gauge investor appetite and set final pricing and other terms in the IPO offer documents.

The final offer price and allocation are usually set after a specific institutional investor bookbuild. The lead IPO manager has some discretion over who should participate in the final bookbuild and what allocation of IPO shares each bidding investment manager receives (on behalf of clients). Brokerage commission is charged on the shares allocated to the institutional manager/investor. The lead manager's discretion is important to understanding IPO access in the institutional world. Some Australian equity managers assert that access to IPO 'deal flow' is a valuable component of their management style, and they seek to benefit from the discretion lead managers exercise around IPO access. We will return later to this important aspect of institutional IPO participation, for the way that managers seek to nudge discretion in their favour is not a cost-free exercise.

Valuing IPOs net of participation costs

Base case with average selection skill and fair allocation

Impressive anecdotes about IPOs aside, let's explore the evidence of IPO participation value in the institutional market. First, we ignore measures of price movement between the listing day and the end of a period such as calendar year or financial year-end. An institutional manager does not need to access an initial capital-raising process in, say, July to benefit from an IPO stock that rallies through to the end of December. The manager can simply buy the stock on-market on or after the listing day, like any other investor. This, then, becomes a question of the manager's general stock-picking skill rather than whether and how the manager accesses the initial offer.

To capture the value of securing institutional access to the IPO before its listing, we measure price movements of stocks with IPOs listed in calendar years 2011 through 2018, from initial issue price to the closing price of the stock on the first listing day. We assume (for now) that the manager holds an S&P/ASX 300-like portfolio, participates in every IPO, and can secure a fair, but not generous, allocation of the IPO stocks for its super fund clients.[4]

[4] We relax the 100% participation and fair allocation assumptions later in this paper.

Allocation is important here. We assume an allocation of IPO shares is fair if the parcel, as a percentage of the manager's portfolio, reflects the size of the IPO in the Australian equity market. So if an IPO raises capital representing 1% of the Australian market's aggregate capitalisation, then a fair IPO participation allocation for the manager is 1% of the portfolio. What a fair allocation is in real-life IPO scenarios will, of course, be very case specific. Anecdotally, some traders report a kind of adverse selection in which allocations are higher for IPOs that perform worse and lower for (in-demand) IPOs that perform better. In that sense our fair-allocation methodology is somewhat kind to managers in ignoring this adverse-selection effect.

Figure 1 shows the size of the IPO relative to market, listing day price moves (to close) and the impact of a fair IPO allocation on portfolio performance each year. We see that the IPOs generally had a positive day-one return, except for the first two years (2011 and 2012), with a healthy average return of 5.80%. However, this headline performance is only a small fraction of the aggregate Australian equity market by capitalisation (and similarly, only a small fraction of our hypothetical manager's portfolio). This mutes the performance impact IPO participation can have, given that the IPO allocation represented at most only 1.24% of portfolio capital (2014) and on average only 0.49% of the portfolio over the analysis period.

Figure 1: Australian IPO market, 2011–2018

	2011	2012	2013	2014	2015	2016	2017	2018	Yearly average
IPO listings									
IPO capital raised ($MM)	723	666	5,954	17,003	8,585	7,906	6,700	8,440	**6,997**
IPO capital raised (as a % of the equity market)	0.07%	0.06%	0.47%	1.24%	0.60%	0.55%	0.43%	0.48%	**0.49%**
IPO performance on day 1 close	0.10%	-0.20%	3.30%	5.50%	11.80%	9.50%	11.40%	5.00%	**5.80%**
Impact of IPO allocation on portfolio performance									
Fair allocation	0.000%	0.000%	0.015%	0.068%	0.071%	0.053%	0.049%	0.024%	**0.035%**

Sources: Deloitte IPO Report (2015, 2016, 2017, 2018), HLB Mann Judd (2019), FactSet, Parametric. For years 2011–2013, IPOs of less than $75 million in market capitalisation are excluded.

This muted effect plays out in the portfolio performance analysis: We see that holding a fair allocation of the IPO stocks on listing day sometimes made a small return contribution to the portfolio (around seven basis points [bps] for the 2014 and 2015 years), but in some years any value added was negligible (2011, 2012). In our last year of analysis (2018), IPO participation would have added 2.4 bps in performance for the year, for an average of 3.5 bps[5] of annual performance over the analysis period. (The averages, of course, hide a wide dispersion of individual IPO results within a particular year, a matter we will come to later.) While any performance contribution is welcome to a super fund, these modest results are hardly the stuff of breathtaking anecdotes and do not initially indicate that having institutional access to IPOs is of much value.

[5] Brokerage on Australian equity trades averaged 10–20 bps over the period of analysis (see our later discussion on this). Adding 15 bps in brokerage (to reflect the explicit transaction costs of participating) to these IPO results shaves the average value added from IPOs over the performance period very slightly, to 3.4 bps per year.

Effect of superior selection skill or more generous IPO allocations, after costs

In practice, institutional managers can enhance these lukewarm average IPO participation results in two ways:

- **Selection.** By being skilled in selecting which IPOs to participate in and which to forgo. The opportunity set to add value through skilled IPO selection is large because of the wide dispersion between individual IPO first-day listing results. For example, figure 1 shows an average first-day listing gain in 2017 of 11.4%. This average masks seven IPOs that rallied by 100% or more upon listing and four that recorded losses of at least 25% on listing day.[6]
- **Allocation.** By receiving a better-than-fair (generous) allocation to the IPOs they target as a benefit of their relationship with the lead IPO manager (broker).

Testing the value of these manager attributes requires an important further adjustment to our modelling. This is because the potentially market-beating attributes we list above are not cost-free to the super fund (although the extra costs are not transparent and are difficult to measure).

Earlier, we explained the institutional IPO bookbuild process and the discretion lead IPO managers (broking firms) have in granting IPO access to managers before the listing date. This creates an incentive for the bidding institutional manager to be known to, and viewed favourably by, these lead managers. A common approach, acknowledged by the Australian Securities & Investments Commission (ASIC)[7] and the UK's Financial Conduct Authority,[8] is to build up a trading history with these firms, using their broking services to create favourable profiles by directing trade volumes, or 'flows', and paying higher than execution-only brokerage rates to these brokers. Goldstein et al. go so far as to call these a "long-term implicit contract" between the parties.[9] This is a legal practice,[10] and we do not suggest otherwise. However, we note it because many institutional managers cite IPO participation as a justification for directing trade volumes to particular brokers, with increased churn sometimes evident in the lead-up to IPO deals,[11] and for paying higher than execution-only brokerage rates on equity trades in their super fund client portfolios.

This additional trading cost is no frivolous or immaterial matter: According to informal interviews we conducted with eight global broking firms, all of which are well known and trade significant volumes in the Australian equity market, for the 2011–2018 years of our analysis, brokerage costs in the Australian equity market averaged 10–20 bps—that is, for every $1,000 of shares traded, $1 to $2 were paid in brokerage costs. Over this same period execution-only brokerage on Australian equities averaged five bps[12] ($0.50 for every $1,000 of shares traded). For a super fund with a $2 billion alpha-seeking Australian equity portfolio and modest 50% one-way turnover each year (100% two-way), this alpha-chasing 'round trip' is the difference between paying $2 million–$4 million a year in brokerage costs versus $1 million.[13]

Let us now explore the value an institutional manager could add through superior selection of or allocation to IPO participation with eyes wide open about this broader cost structure. The manager is systematically deploying some client capital to an 'investment' in the relationship with the lead managers of future IPOs through trading volumes and brokerage paid. We cannot sensibly gauge IPO participation value without conceding that some of this is a cost of trying to beat an average (underwhelming) IPO experience.

6 HLB Mann Judd, 'IPO Watch Australia: Australian IPO Activity in 2017' (January 2018), https://hlb.com.au/media/2018/02/IPO-Watch-Report-2018_ONLINE.pdf.

7 Australian Securities & Investments Commission, 'Report 65: Allocations in Equity Raising Transactions' (December 2018), https://download.asic.gov.au/media/4972674/rep605-published-20-december-2018.pdf.

8 Financial Conduct Authority, 'Quid Pro Quo? What Factors Influence IPO Allocations to Investors?' (October 2016), https://www.fca.org.uk/publication/occasional-papers/occasional-paper-15.pdf.

9 Michael A. Goldstein et al., 'Purchasing IPOs With Commissions', Journal of Financial and Quantitative Analysis 46, No. 5 (October 2011): 6, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=890868.

10 ASIC's December 2018 paper called out certain practices that may fall short of best practice but did not suggest any of these strategies were illegal.

11 Goldstein et al.

12 Sourced from transaction cost analyses compiled for clients who engaged Parametric to trade significant volumes of Australian equities on an execution-only basis over the analysis period.

13 These are explicit brokerage costs. There are also implicit costs (bid-ask spreads and price impact costs) of trading that we have not included in this analysis. For detailed research on how much it costs (explicitly and implicitly) for a large super fund to trade equities, see Mahesh Pritamani and Raewyn Williams, 'Under the Spotlight: How Much Does It Cost to Trade Equities?', Parametric (February 2016), https://www.parametricportfolio.com.au/insights-and-research/under-the-spotlight.

Extending our base case (figure 1), we now show in figure 2 the value of superior selection of or allocation to IPO participation by institutional managers—from double up to five times more than what one might expect under an all-in fair allocation approach. Our more generous scenarios each cover two possibilities—that the manager participates in only a limited basket of IPOs that are two to five times more valuable than participating in all the new listings in the market (superior selection) or that the manager, participating in all IPOs, receives allotments two to five times more generous than fair (superior allocation). We also attribute some manager trading and excess brokerage commissions (one-fifth in our 50% turnover manager example above) to the 'investment' the manager has made to cultivate a favourable relationship with the lead IPO managers and assume a direct linear relationship between these excess commissions and the size of the IPO participation payoffs.

Figure 2: Impact of IPO allocation on average annual portfolio performance, 2011–2018

	Performance impact (before excess commissions)	Excess commissions	Performance impact (after excess commissions)
	(i)	(ii)	(i) – (ii)
Fair allocation	0.035%	0.010%	0.025%
2 x fair	0.070%	0.020%	0.050%
3 x fair	0.105%	0.030%	0.075%
4 x fair	0.140%	0.040%	0.100%
5 x fair	0.175%	0.050%	0.125%

Source: Parametric, 2019. We assume investors need to direct a 10% one-way (or 20% round-trip) turnover to brokers to gain a fair allocation to IPOs. For a 2x fair allocation they need to direct 2x turnover, for a 3x fair allocation they need to direct 3x turnover, and so on. Further, we assume they pay commissions of 15 bps, which is 10 bps higher than execution-only commissions of 5 bps. For the first 20% round-trip turnover, the 10 bps in additional commissions can be equally attributed 5 bps each for research and for a fair allocation to IPOs. For any additional turnover beyond 20% round trip, all of the 10 bps in additional commissions can be attributed to gain IPO access. *Excess Commissions Paid for IPO Allocation = (Directed Round-Trip Turnover up to 20% x 5 bps) + (Directed Round-Trip Turnover in Excess of 20% x 10 bps).*

As expected, we see benefit in having an institutional manager with better-than-average selection of or allocation to IPO participation, with the performance contribution rising the more the IPO allotment beats a fair-market basket. But, strikingly, factoring in the excess brokerage commissions keeps the payoff fairly marginal—the manager must be at least four times better than a standard IPO participant (through selection or allocation) just to get the annual basis-point performance contribution to the portfolio into double digits. An IPO participation experience five times better—implying very favourable relationships with all lead IPO managers in the Australian market or a very different take on the information publicly available about each IPO—adds only an average of 12.5 bps in annual performance to the super fund's equity portfolio.[14]

This leaves very little gloss on the IPO participation story. The evidence suggests that exceptional attributes are required to selectively participate in IPOs or secure very generous allocations in a way that moves the dial for the manager's super fund clients. Add to this the seasonal, unpredictable size of the IPO opportunity set, which means that even the best institutional manager (best IPO selection skills, best allocations) simply cannot add value in years when there is little company appetite to raise public funding and few IPOs on offer. Recent industry commentary suggests calendar year 2019 to be one such year.[15]

[14] To test our research results, we also applied an alternative methodology similar to the US equity study of IPO-related trading between 1999 and 2005 reported in Goldstein et al., which detected a $2.20 IPO payoff for every extra $1 in 'abnormal commissions' directed to the lead IPO manager (albeit for 'transient' investors rather than long-term institutional investors). Results were very similar to those in figure 2, with the net performance contribution from the IPO participation strategy ranging from around three (fair allocation) to 13 (5x) bps per year.

[15] See, for example, Greg Bright, 'IPO Market Profits as Stag Profits Turn Negative', Investor Strategy News, 3 February 2019, https://ioandc.com/ipo-market-softens-as-stag-profits-turn-negative, and James Mitchell, 'Failed IPOs and "Sceptical" Tech Floats Weigh on ASX', InvestorDaily, 14 January 2019, https://www.investordaily.com.au/markets/44260-failed-ipos-and-sceptical-tech-floats-weigh-on-asx.

Conclusion

Institutional managers should be advocates of IPO participation if they believe this is valuable to their super fund clients. Without specific manager data, this is not something we can prove or disprove definitively. But managers' advocacy must move beyond sensational anecdotes into a genuine assessment of IPO participation value that focuses only on the initial listing day, covers all IPO participation (no cherry picking), nets out explicit costs and speaks to the manager's special selection and bookbuild allocation qualities.

Then there is the wider story to consider: The way IPO selection and access is pursued by institutional managers has a cost to their super fund clients embedded in day-to-day equity trading, albeit one that's hidden and hard to measure. This cost eats into institutional IPO participation payoffs and must be included in any intelligent attempt to assign true value to IPO participation. Funds may not even be aware that managers pay higher than execution-only brokerage on Australian equity trades or understand to whom they direct these trade volumes and why.

Beyond committing to more informed, evidence-backed discussions with managers, what stronger course of action is available to super funds? To adopt, as a default position, simple, nuts-and-bolts best execution and transactional efficiency, without favour or generosity to any particular broker, every day on every equity trade. This opportunity set is always available (not seasonal), does not require sophistication to implement and has payoffs that are measurable and consistent. This surely is a more sensible starting point for funds. It then falls to institutional equity managers to build the case that moving away from this position can add even more value to a super fund, including through superior IPO participation payoffs. Our research leaves open the possibility of the case for institutional IPO participation being made, at least by certain managers. However, given the headwinds we have identified, it is a case to be made not through racy anecdotes but through solid evidence.

With additional insights and contributions from Lee Thacker, managing director of trading for Parametric.