The IPO apocalypse

Extracting value from the new issue slump

Edison themes

5 October 2022

A toxic cocktail of slowing growth, rising inflation and belatedly hawkish central banks has resulted in the current dire performance of risk assets. During risk-off periods, capital tends to flow to larger, liquid assets. Initial public offerings (IPOs) are generally more illiquid than longer-established peers due to lock-ins and newly established share registers. It is therefore no surprise that the share prices of companies that listed in 2020 and 2021 have struggled, but what is surprising is the magnitude, with 84% of IPOs trading below their issue price. Moves of this scale often present opportunities. The move to liquid assets tends to lead to illiquid names getting mispriced quickly. In this report, we endeavour to identify value and investment potential against a valuation screen of companies that have listed in the US, European and UK equity markets since the beginning of 2020.

84% of 2020 and 2021 IPOs trading below issue price

The IPO fallout has been both broad and deep. Our analysis of 1,205 non-special purpose acquisition companies (SPACs) IPOs launched since the start of 2020 (in the US and Europe) suggests that, as at 31 August 2022, c 84% are trading below their issue price and almost 50% have at least halved. We have identified 94 public offerings that are down at least 90%.

Screening the IPOs for names to revisit

Our screen focuses on valuation using two ratios (EV/EBITDA and EV/sales) and two balance sheet-related metrics (Price/book and net cash to market cap) and ranks 975 stocks that passed qualitative and quantitative screening. Attractive valuations and a financial position to weather the near-term economic headwinds were used as a basis for looking for businesses which, on a medium-term basis, could be revisited by investors. Our screen of the top 30 pan-regional stocks on an unweighted average, forward-looking basis trades at EV/sales of 0.6x, EV/EBITDA of 3.7x, Price/book of 0.6x and at 104% net cash to market cap.

As with all screens, more work would need to be done to assess the fundamentals of the businesses, but the objective of the exercise was to identify names which we should look at with a fresh perspective. The names identified inevitably face near-term headwinds, and in some cases go against current investor sentiment. Examples include:

- **THG** (THG.L, £469m market cap), which listed at 500p, is today trading at 38p, and recently lowered guidance. A medium-term perspective might focus on governance issues at the time of the float, which have been addressed with the appointment of a new chairman. There is scope to grow the beauty business through M&A and improvements to the ESG standing of the business.
- **hGears** (HGEA.F, €84m market cap), which listed at €26 and is now trading at €8. The company manufactures high-precision gears and components for e-mobility drive applications. While supply chain and inflationary headwinds might put near-term profitability under pressure, long-term growth potential is attractive given its exposure to the fast-growing e-bike and e-vehicle segments.

Edison themes

As one of the largest issuer-sponsored research firms, we are known for our bottom-up work on individual stocks. However, our thinking does not stop at the company level. Through our regular dialogue with management teams and investors, we consider the broad themes related to the companies we follow. Edison themes aims to identify the big issues likely to shape company strategy and portfolios in the years ahead.

Top 10: UK screening

THG	Victorian Plumbing
Ignitis Grupe	Lords Group Trading
Deliveroo	Kitwave Group
SourceBio International	Alphawave IP Group
Pod Point	Dianomi

Top 10: European screening

Mister Spex	LINK Mobility
Ariston Holding	Purmo Group
Cherry	Storskogen Group
Montana Aerospace	hGears
Wastbygg Gruppen	Volvo Cars

Top 10: US screening

Outbrain	iTeos Therapeutics
Vaccitech	Stronghold Digital
Polished.com	Gan
Vasta Platform	DoubleDown Interactive
Zenvia	ZIM Integrated Shipping

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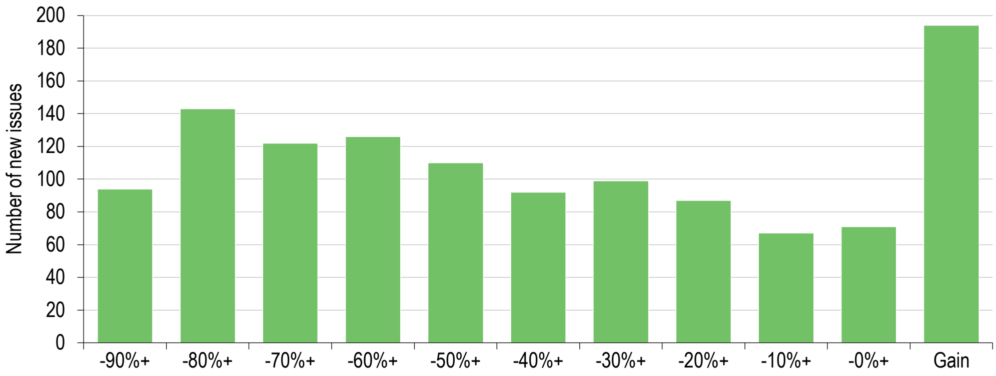
Surveying the wreckage

Most recent IPOs have performed dismally

Our analysis of post-IPO performance covered the 1,205 non-SPAC companies listing on exchanges in the UK, US and Europe from the beginning of 2020 to the end of August 2022. The distribution of performance ranges is illustrated below.

Exhibit 1: Average post-IPO performance by sector

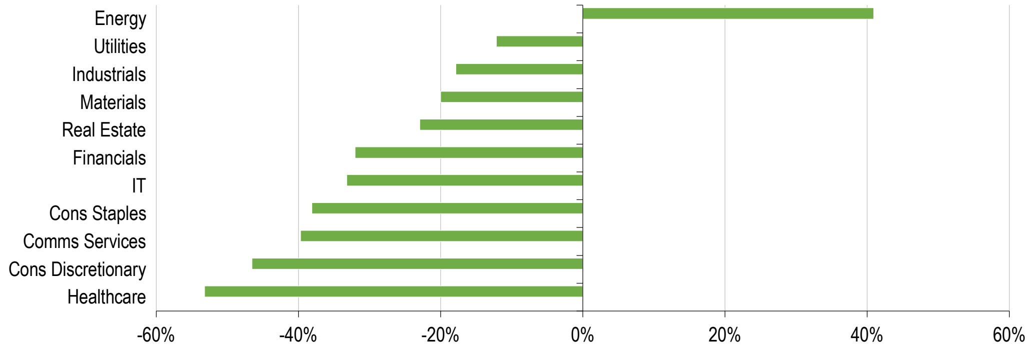


Source: Refinitiv, Edison Investment Research

Not all about a tech bust…

A popular narrative is that the IPO apocalypse has largely been caused by IT companies listing at lofty valuations that have subsequently plummeted. Our analysis suggests otherwise. The unweighted average performance of our sample IPOs by Global Industry Classification Standard is illustrated below.

Exhibit 2: Average post-IPO performance by sector



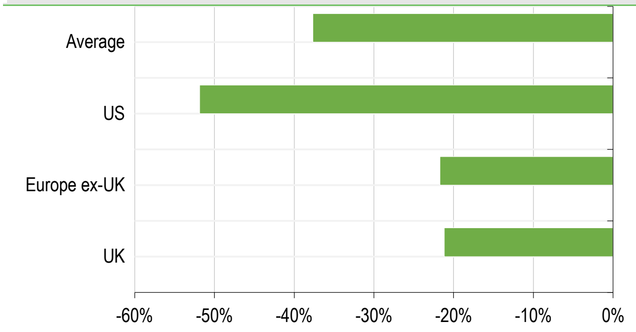
Source: Refinitiv, Edison Investment Research

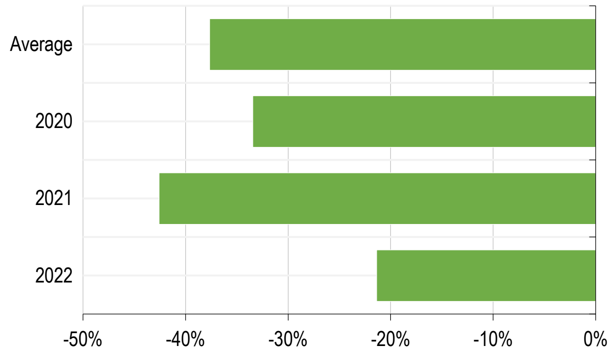
Unsurprisingly, energy IPOs have generally been the standout performers, while utilities have also proved relatively defensive. However, even consumer staples have, on average, performed more poorly than IT offerings. While we note that many companies which would have been considered IT have now been reclassified in the (poorly performing) communications services and consumer discretionary sectors, it is healthcare that has, on average, performed the worst. While this sector is often considered to be defensive growth, the IPO slate was very heavily tilted towards early-stage R&D pipeline companies, undoubtedly helped by the rapid roll-out of COVID-19 vaccines.

…but the US is still at ground zero

However, further analysis presented below points to significant underperformance of US IPOs relative to overseas peers. A glut of questionable US offerings in 2021 did serious damage.

Exhibit 3: Average post-IPO performance by market and vintage





Source: Refinitiv, Edison Investment Research

It is interesting to note that many listing jurisdictions, eyeing their falling market share of IPOs in recent years, are relaxing their listing rules to compete more effectively with US markets. Meanwhile, the Securities and Exchange Commission in the US has led a push to tighten the rulebook, principally through greater disclosure around pre- and post-merger SPACs.

Although our analysis largely excludes SPACs, it seems clear that SPAC listings helped enable valuation spill over into the broader US IPO market. Together with other factors such as ultra-loose fiscal and monetary policy and the rise of retail 'meme' traders, these were probably also contributors to the IPO boom – and bust.

Looking for value

Some IPOs might now actually be attractively valued

With economic momentum still apparently slowing, valuation catalysts remain unclear. However, there are signs that market inflation expectations are now moderating. Moreover, much of the broader equity market has already suffered a significant de-rating.

In addition to potential macro and valuation catalysts, there appears to be significant liquidity available to exploit value opportunities. Such liquidity arises from diverse sources such as private equity, corporate balance sheets and institutional investor cash balances.

Nevertheless, we would also suggest that secular themes such as digital transformation, net zero and healthcare innovation will continue to be elements in forming an investment decision. These are now likely to be supplemented by supply chain management and energy security considerations. Collectively, these themes will cut across many listed sectors.

We have applied qualitative and quantitative valuation screens to an initial universe of more than 2,000 companies that have launched an IPO in the US, European or UK equity markets since the start of 2020. We have used this process to generate a list of highly ranked eligible stocks on a pan-regional basis, together with geographic subsets.

We have not explicitly applied qualitative screens to the stock universe, although we have selected investment ratios that we feel are reasonably indicative of a solid financial and operational position.

With growth prospects currently far from clear, we believe it likely that most asset acquirers will exercise greater capital discipline and a preference for cash flow visibility.

We find that the top 30 pan-regional stocks on an unweighted average basis have an EV/sales ratio of 0.6x, EV/EBITDA ratio of 3.7x, Price/book ratio of 0.6x and an average net cash to market cap of 104%. Moreover, we note that the unweighted average post-IPO performance of this top 30 list has been -60%.

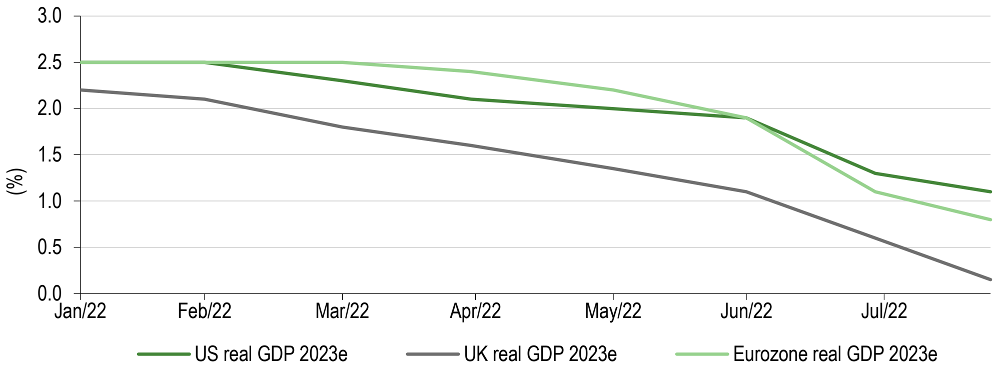
A more detailed description of the screening process and the resulting output is presented later in this note (see page 7).

Fundamentals look shaky – but what's in the price?

Growth expectations are still falling

Equity markets still face significant headwinds as post-pandemic supply shocks, exacerbated by the conflict in Ukraine, which has significantly boosted inflation and prompted a cycle of monetary tightening, led by the US Federal Reserve. As illustrated below, economists' consensus forecast of GDP growth next year is still in decline, with the US expected to fare rather better than Europe (ex-UK). The growth outlook for the UK seems particularly poor.

Exhibit 4: Growth forecasts for 2023 still falling



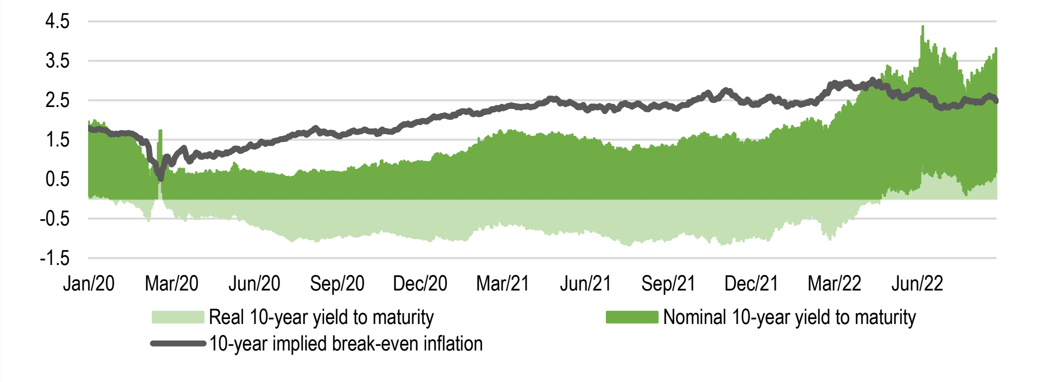
Source: Bloomberg, Edison Investment Research

However, we note that economic forecasts are typically lagging indicators. This is particularly likely when real economies have suffered an unexpected shock and the policy response has yet to be fully integrated within forecast revisions. Typically, market-based estimates of future economic variables are more accurate and timely indicators. Markets will also try to anticipate inflection points.

Inflation expectations may be turning

The US bond market may be indicating that we have at least seen peak inflation expectations, with rising policy rates and demand destruction eventually proving to be disinflationary. As illustrated below, elevated long rates are now a function of higher, positive real rates and lower implied inflation compensation that was being priced in just a few months ago.

Exhibit 5: Market expectations of inflation off highs (%)

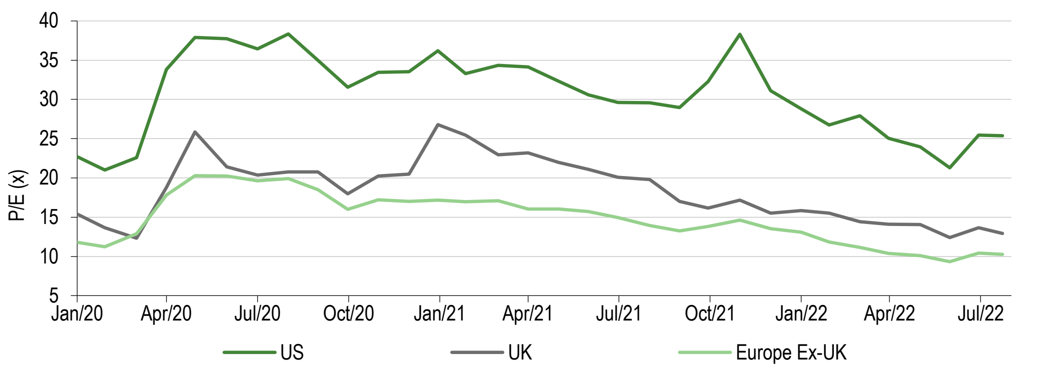


Source: US Treasury, Edison Investment Research

Much of the market has de-rated significantly

Given the economic stresses we have already outlined, it is hardly surprising that risk assets, such as equities, have often struggled. To some extent, this has been mitigated by rising earnings in the materials and energy sectors. Indeed, earnings estimates for the latter have essentially trebled since the start of the year. However, the consumer discretionary sector – arguably one of the most exposed to current headwinds – has been substantially de-rated since the beginning of 2021.

Exhibit 6: Consumer discretionary has already been significantly de-rated



Source: Bloomberg, Edison Investment Research

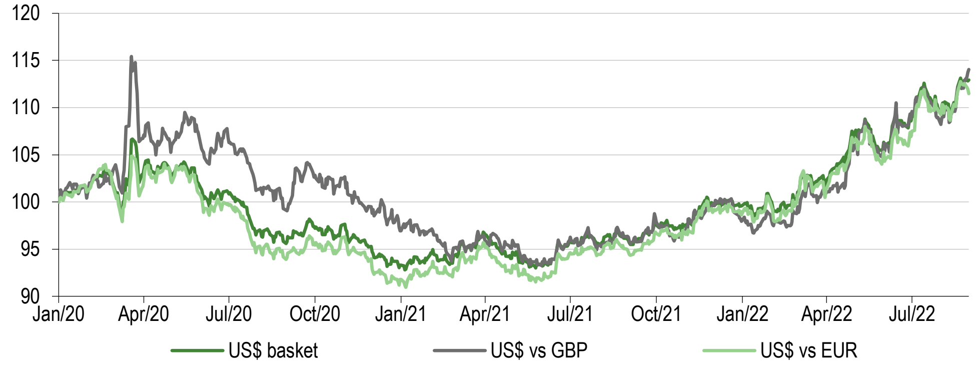
While this sector in the US maintains a significant premium over its European and UK peers, it has been de-rated by some 35% from peak values, with the other regions now trading at a three-year low blended forward P/E multiple. As these metrics are essentially weighted averages, it is reasonable to assume that a stock screen geared specifically to identify value within the broader market is likely to deliver candidates that offer a more substantial valuation buffer on acquisition and higher prospective returns.

Where are the buyers?

The dollar buys a lot more

A factor often overlooked in the discussion of financial asset prices is the impact of relative currency movements. We believe this is relevant in the current environment, which has seen the US dollar reach multi-decade highs against the GBP, the euro and a broader 'dollar basket' of developed economy currencies. As illustrated below (which is before the impact of the 23 September 2022 UK mini-budget), the US dollar is currently trading 10–15% above where it was against both GBP and the euro than at the start of 2020 and fully 20% above the dollar lows seen in H120.

Exhibit 7: The dollar has surged



Source: Bloomberg, Edison Investment Research. Note: Rebased year-end 2019 = 100.

This is significant, because the US is home to almost half of global managed assets, with most managed in dollars. Many US investors are likely to find a combination of attractive multiples and a dollar-discounted entry price for non-dollar assets an attractive proposition. This view is supported by recent UK takeovers by North American firms, with Biffa, Diurnal, EMIS, GB Group, HomeServe, Micro Focus and RPS Group examples from the Takeover Panel's disclosure list.

Cash on the sidelines can be put to work

While there are clearly macroeconomic headwinds to a revival of the broader equity market, there are certainly significant pools of liquidity present to capitalise on value opportunities.

More than a decade of accommodative monetary policy has allowed many corporates to secure inexpensive, long-term funding. Indeed, the market conditions that prevailed in the early part of the COVID-19 pandemic presented a relatively recent, if not unparalleled, opportunity to access cheap term capital. This is in marked contrast to the position in 2012, when most companies were actively de-leveraging and credit was scarce. This should lend support to corporate M&A going forward and we anticipate that secular themes such as digital transformation, net zero and healthcare innovation will continue to be M&A drivers. These are now likely to be supplemented by supply chain management and energy security considerations. Collectively, these will help drive corporate M&A activity across most sectors.

We also believe that alternative investors could continue to support equity markets, with specialist data company Preqin estimating buyout dry powder of $870bn as at 1 June 2020. We screened out a number of the companies that were in our initial universe of IPOs because they had already been acquired, the most significant of which was the $12bn (equity) acquisition of cyber security company McAfee by private equity and sovereign wealth funds.

Finally, it does appear that institutional investors' sentiment towards equity markets might also be taking a more positive turn, albeit from a low base. The most recent Bank of America *Global Fund Manager Survey* (August 2022) saw portfolio cash levels fall to 5.7% from 6.1% in July and against a long-term average of 4.8%. Additionally, a net 47% of survey respondents said they were taking lower than normal portfolio risk, down from an all-time high of 57% in July. Given that the survey polls institutional investors that collectively manage $836bn in assets, it is reasonable to suggest that any further revival or risk appetite would be supportive of equites.

Screening for IPO value

Methodology

Our initial sample of 2,157 securities encompassed all companies that made an IPO on exchanges in the US, UK and continental Europe in the period January 2020 to August 2022. We then subjected this sample to a number of quantitative and qualitative screens:

- Pre-merger SPACs and similar 'shell' and 'blank cheque' companies were excluded from the initial sample. Such entities typically have no operating assets and thus we consider a valuation in excess of net asset value (NAV) to be a highly subjective option value. Moreover, it is often difficult to assess to what extent notional liquid assets held within these vehicles are effectively pre-committed to unidentified investments. A total of 659 vehicles were excluded on this criterion, with the vast majority (620), being listed on US markets.
- Open- and closed-end investment funds, trusts and similar vehicles were also excluded from the initial sample. While we acknowledge that such vehicles may represent value to the investor – particularly if trading at a significant discount to a reliable NAV – their structure does not lend itself to analysis against the chosen valuation criteria. Application of the screen to such vehicles would require a pro forma proportional consolidation of the underlying investments held, adjusted for the position of the investment vehicle, and is beyond the scope of this analysis. 118 vehicles were excluded on this criterion.
- Companies with a market cap of less than $50m were excluded from the initial sample. While somewhat arbitrary, we note that many institutional investment vehicles wish to limit individual positions to less than 3% of company-issued capital. Combined with a smaller free float and thresholds for position size, we felt this to be an unreasonable hurdle for investability. A total of 390 companies were excluded on this criterion.
- Companies that are no longer publicly listed – either through acquisition, voluntary de-listing or liquidation – were excluded from the sample. 15 companies were excluded on this criterion.

After applying all the above screens, we were left with 975 companies that we subjected to investment ratio analysis. Consistent with our belief that balance sheet strength and cash flow visibility will be key considerations for investors going forward, we selected two P&L-based measures: EV/sales and EV/EBITDA and two ratios referenced to the balance sheet: Price/book and net cash/market value (MV). Companies were ranked against each of these ratios and each recalibrated to return a score of between 0 (worst) and 100 (best). The four category scores were equally weighted, being summed to deliver a company score of between 0 and 400.

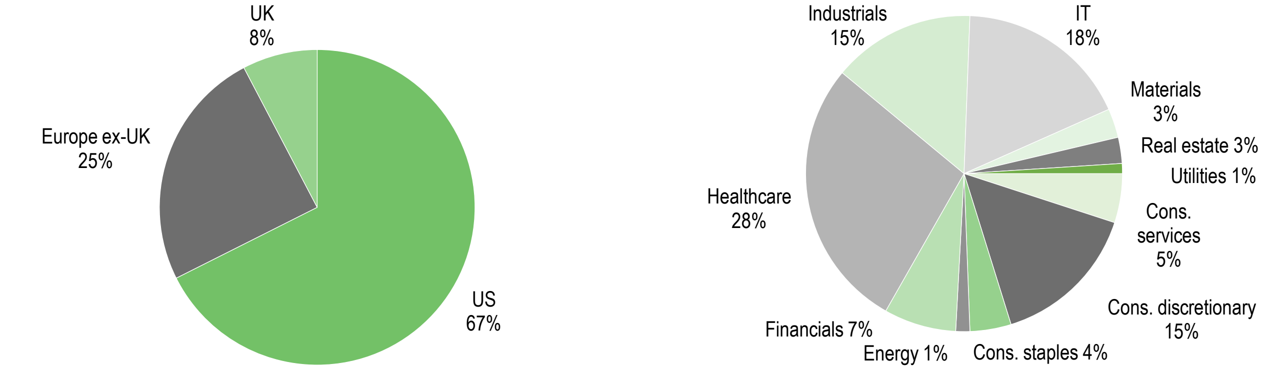
It was not always possible to populate all fields in order to generate investment ratios and derived rankings, despite our best efforts. This was typically due to the lack of availability of relevant data published by authoritative sources. In some cases, financial engineering obscured the value accessible to an investor and this was typical in post-merger SPACs and similar vehicles.

Non-returned data fields were given an equal-lowest ranking. In extreme cases, no analysed fields returned eligible data. Indeed, of the 1,365 companies that passed all screens before the market cap cut-off, 298 already seemed to have no identifiable research coverage.

The results

The final screen output consisted of 975 companies with the geographic and sectoral composition as highlighted below.

Exhibit 8: IPO screen output by region and sector



Source: Refinitiv, Edison Investment Research

There are a few things to note in respect of this output. Firstly, the necessary screening out of pre-merger SPACs and the majority of investment trusts and similar vehicles has had the effect of reducing the representation of the financials and real estate sectors in the final output. Secondly, due to the typically outsize representation of investment vehicles that issue in the UK markets, the screen has also had the effect of reducing the proportion of UK stocks in the final sample on an ex-SPAC basis. Finally, a cross-sectional analysis of sector and geography points to dominant positions of the US in both IT and healthcare IPOs over the period. Europe ex-UK was strong in industrials IPOs, while the UK was strong in financials, despite the exclusions already noted.

The top 30 ranked companies on a pan-regional basis are listed below, with a breakdown of the contributions from each of the four valuation metrics followed by top 10 ranked companies for each region (see Exhibits 10 to 12). Note numbers may not add due to rounding.

Exhibit 9: Pan-regional IPO screen ranking

Company	EV/sales (x)	EV/EBITDA (x)	Price/BV (x)	Net cash/MV (x)	Total score
Mister Spex	100	99	96	95	390
THG	96	94	99	91	380
Outbrain	99	97	82	98	377
Ariston Holding	97	99	88	92	375
Vaccitech	86	100	92	96	374
Polished.com	99	99	98	77	373
Vasta Platform	89	98	100	80	368
Zenvia	97	78	97	94	366
iTeos Therapeutics	98	100	73	94	365
Cherry	87	95	95	87	364
Stronghold Digital	80	98	100	79	357
Gan	93	94	96	73	355
DoubleDown Interactive	88	98	91	77	355
ZIM Integrated Shipping	95	100	84	72	352
RLX Technology	94	99	83	74	350
Lufax Holding	83	98	91	77	349
Montana Aerospace	91	88	85	84	348
Wastbygg Gruppen	94	85	85	83	348
LINK Mobility	85	89	98	75	347
Paysafe	66	86	96	97	345
Dole	98	94	86	65	343
Purmo Group	90	92	82	78	343
Doma Holdings	98	51	95	99	342
Lucira Health	99	47	98	97	341
Codex DNA	98	53	92	97	340
Ignitis Grupe	87	92	90	71	340
Astra Space	93	54	95	97	339
Vroom	95	44	100	100	339
Storskogen Group	87	92	83	76	338
Yalla Group	92	99	65	82	337

Source: Refinitiv, Edison Investment Research. Note: Prices as at 31 August 2022.

On an unweighted average basis, the top 30 pan-regional stocks have an EV/sales ratio of 0.6x, EV/EBITDA ratio of 3.7x, Price/book ratio of 0.6x and an average net cash/market cap of 104%.

We also present the top 10 ranked stocks in the UK, Europe ex-UK and the US for those investors that have a geographic focus.

Exhibit 10: UK IPO screen ranking

Company	EV/sales (x)	EV/EBITDA (x)	Price/BV (x)	Net cash/MV (x)	Total score
THG	96	94	99	91	380
Ignitis Grupe	87	92	90	71	340
Deliveroo	98	43	77	92	311
SourceBio International	77	85	67	75	305
Pod Point	94	36	95	77	302
Victorian Plumbing	95	95	37	64	291
Lords Group Trading	97	95	56	39	286
Kitwave Group	96	94	69	24	283
Alphawave IP Group	54	91	58	76	279
Dianomi	90	87	35	62	274

Source: Refinitiv, Edison Investment Research. Note: Prices as at 31 August 2022.

Exhibit 11: Europe ex-UK IPO screen ranking

Company	EV/sales (x)	EV/EBITDA (x)	Price/BV (x)	Net cash/MV (x)	Total score
Mister Spex	100	99	96	95	390
Ariston Holding	97	99	88	92	375
Cherry	87	95	95	87	364
Montana Aerospace	91	88	85	84	348
Wastbygg Gruppen	94	85	85	83	348
LINK Mobility	85	89	98	75	347
Purmo Group	90	92	82	78	343
Storskogen Group	87	92	83	76	338
hGears	88	94	76	76	334
Volvo Car	94	98	67	75	333

Source: Refinitiv, Edison Investment Research. Note: Prices as at 31 August 2022.

Exhibit 12: US IPO screen ranking

Company	EV/sales (x)	EV/EBITDA (x)	Price/BV (x)	Net cash/MV (x)	Total score
Outbrain	99	97	82	98	377
Vaccitech	86	100	92	96	374
Polished.com	99	99	98	77	373
Vasta Platform	89	98	100	80	368
Zenvia	97	78	97	94	366
iTeos Therapeutics	98	100	73	94	365
Stronghold Digital	80	98	100	79	357
Gan	93	94	96	73	355
DoubleDown Interactive Co	88	98	91	77	355
ZIM Integrated Shipping	95	100	84	72	352

Source: Refinitiv, Edison Investment Research. Note: Prices as at 31 August 2022.

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