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‘After the Love Has Gone’

Earth, Wind & Fire, 1979

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Or post-IPO liquidity – how bad is it, does it matter and what can companies do about it?

By Keith Hiscock CEO and Yingheng Chen, Hardman & Co Analyst

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'After the Love Has Gone', *Earth, Wind & Fire, 1979*

Or post-IPO liquidity – how bad is it, does it matter and what can companies do about it?

After a while, we all get bored with the familiar, and our attention turns to the new and unfamiliar. The same is true of the capital markets; this month's new issue soon fades into the background, and the attention of investment banks, brokers and investors moves onto the next thing. As the months roll by, liquidity dries up. Given the shift in economics from secondary revenue to primary, brokers and investment banks have little incentive to support their recent deals, other than the hope that the company might come back for another fundraising soon.

Weak liquidity is a disincentive for investors to get involved in the first place, since they can become trapped in a stock, making it difficult to get an Initial Public Offering (IPO) away in the first place. And, of course, it also makes it more difficult for the company to raise further money from investors, or for the original shareholders to sell down. Liquidity is, after all, what markets are all about.

Most commentators would expect liquidity to dry up after float. However, we are not aware of any research in the UK that seeks to confirm or assess this. This article will assess whether this hunch is true, before considering whether it matters, and the ways in which companies and their advisors can address the challenge.

Examining post-IPO liquidity seems particularly apposite, since new rules set by the Financial Conduct Authority (FCA), 'Reforming the availability of the information in the UK equity IPO process' [1], come into force on 1 July 2018.

Background

If questioned, most people involved in the capital markets would assume that, after a short flurry of excitement in a company's shares post-IPO, things die down. Is this true, and does it matter?

We have analysed three years of LSE data to answer the question, looking at 206 floats. Our findings might surprise many commentators.

What we found – by LSE market

Our analysis of 206 IPOs confirms the suspicion that post-IPO liquidity rapidly drains away

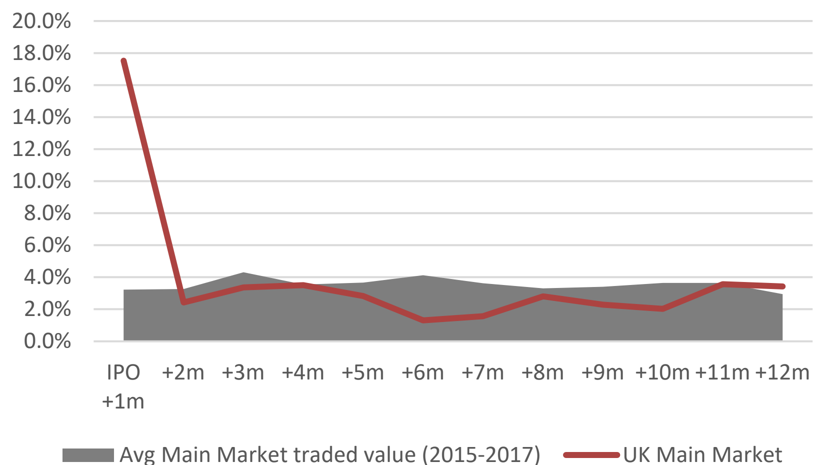
As most commentators might expect from anecdotal evidence, after the flurry of excitement in the first couple of months post float, liquidity falls away. Just how much it recedes, nobody can tell you. Our analysis shows that the reality can be shocking. Perhaps the 'worst' example is companies with an IMCAP in the £500-£1,000m range.

[1] FCA 'Reforming the availability of the information in the UK equity IPO process'; PS17/23, October 2017

Post-IPO liquidity for companies with an IMCAP of £500-£1,000m

New £500-£1,000m floats see huge turnover in month one, but, thereafter, trade less than existing companies…

Volume traded as % of initial mkt. cap. (Main Market, £500m-£1bn)

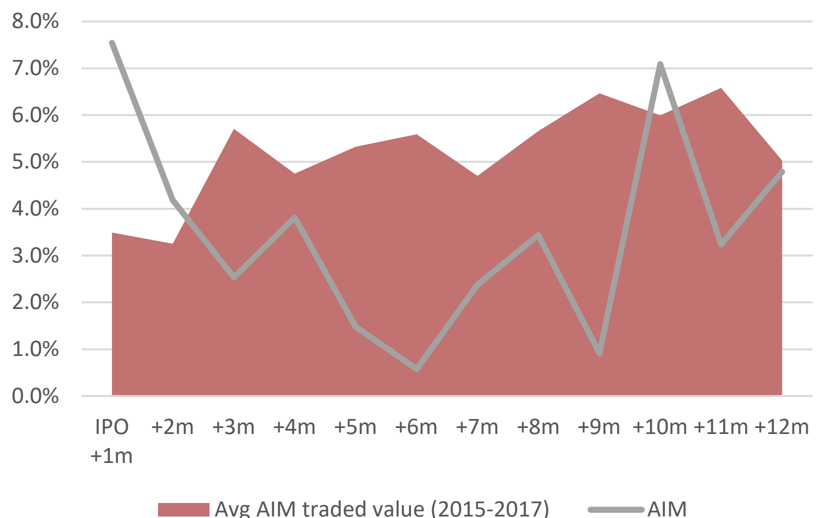


Source: London Stock Exchange, Hardman & Co Research

Main Market companies in this size basket typically see nearly 18% of their shares change hands in the first month after IPO, but this rapidly falls to 2%-4%, and is less for the average of companies that have been on the market for a long while in this size basket (represented by the shaded area in the chart above).

… whilst AIM floats trade less to start with

Volume traded as % of initial mkt. cap. (AIM, £500m-£1bn)



Source: London Stock Exchange, Hardman & Co Research

AIM companies trade less than Main Market companies to start with, but, after month one, there is little to choose between them.

The data for other subsets of our universe are less dramatic, but, nonetheless, significant.

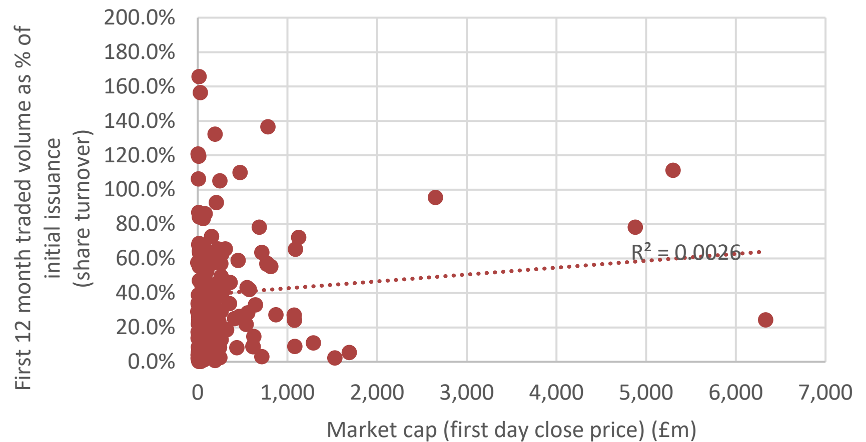
Size matters, doesn't it – surely, the larger the company's IMCAP, the greater the subsequent liquidity? – No

One would assume that the bigger the float, in terms of market capitalisation, the greater the subsequent liquidity.

Surprisingly, there is almost no correlation between the size of an IPO and the % traded in the subsequent 12 months…

First 12-month traded volume compared with IMCAP

12-month trading volume as % of initial issuance with mkt. cap.



Source: London Stock Exchange, Hardman & Co Research

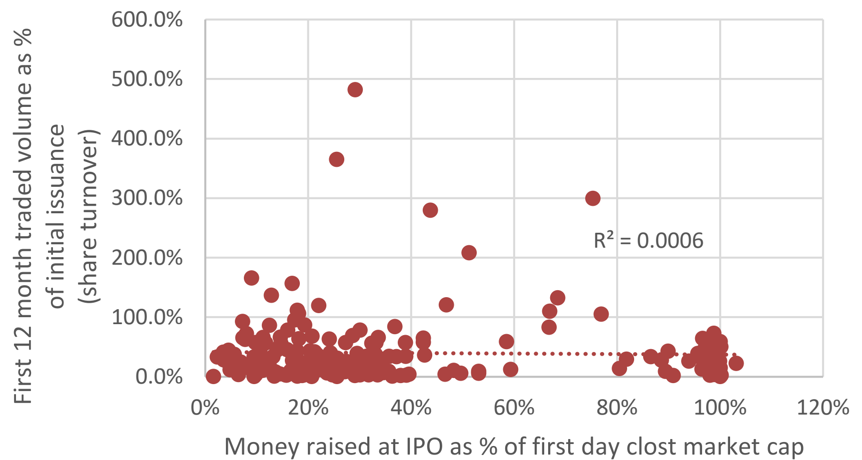
The data displayed above show that there is very little correlation. The coefficient of determination for this data, (R^2=0.0026), suggests that there is virtually no relationship between the axes.

…nor does the percentage raised in new money seemingly make any difference

Then, surely, the greater the percentage of IMCAP raised in new money, the greater the liquidity? – No

Again, one would assume that the greater the percentage of IMCAP raised as new money, the greater the subsequent liquidity, since new shareholders will not be locked in.

First 12-month trading volume as % of initial issuance with money raised



Source: London Stock Exchange, Hardman & Co Research

Again, the data show no real correlation. The coefficient of determination for this data, (R^2=0.0006), suggests that there is virtually no relationship between the axes. Most companies raise up to 40% of their IMCAP in new money. There is also a bunching near 100% – these are generally new funds and investment companies that did not exist before IPO.

Does weakening post-IPO liquidity matter? – Yes

We say 'yes' for two reasons.

Large investors prefer an active after-market

First, if larger investors anticipate that there will be little after-market in a company's shares, they will be more reluctant to become involved in the first place. Anything that might improve after-market liquidity will most likely encourage these investors to participate in the IPO.

If managements want to use the market to raise further money, or sell existing holdings, they need liquidity

Second, if the management wants to come back for a further fundraising, or pre-IPO shareholders want to sell down, liquidity will determine how successful this might be. As an example, academic studies suggest that there is a positive correlation between liquidity and rating, and an inverse one with the spread (the difference between the price at which investors can buy and sell shares – a key component of the total cost of owning shares).

Indeed, one might ask, 'Why bother listing if you don't want a market in your shares?'. As we wrote in our previous note on liquidity, 'A market without goods or services changing hands, i.e. liquidity, is not a genuine market' [2].

What can companies do to boost post-IPO liquidity (or, what should investors encourage companies to do)?

Managements of companies that have just IPO'd are often grateful to get back to the day job, to the one they are most comfortable with, i.e. running their business. This is understandable, but a mistake. Successfully completing an IPO is not the end, but

[2] Hardman & Co, October 2017, 'Liquidity – little understood, even before MiFID II'

just the beginning, of a long-term engagement with the capital markets, investors, brokers, IR houses and the press.

One of the authors of this paper recently attended the maiden results meeting for analysts after a company's IPO. It was a strange experience, in the sense that, if attendees had known no more, they would have got the impression that things were a little tough, but broadly fine. There was very little clue from management's attitude that the share price had halved that morning and was down 60% since float. Investors are unlikely to appreciate this approach.

Above all engage with as wide a ranger of investors as possible, not just institutions

To get the full benefit of being quoted on the capital markets, companies need to engage. They need to understand that the market for investor airtime is very competitive (and trying to pull the wool over investors' eyes is pointless). Investors have a huge choice regarding where to deploy their money (the LSE alone has 2,025 quoted companies), and managements must gain their attention – and, perhaps more importantly, earn their trust.

Engagement can take many forms:

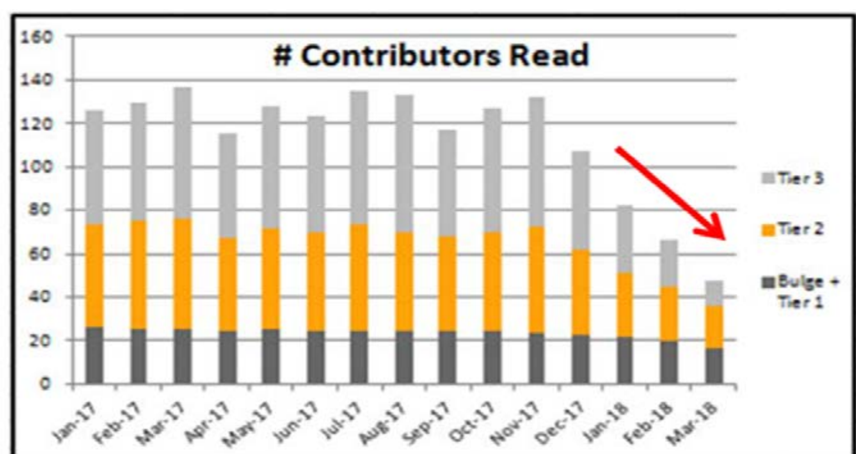
1. Work more closely with investor relations advisors – choose a good one and trust their experience.

2. Get the press to write about you. This is getting trickier, particularly for anything outside the FTSE100. The *Financial Times* has a column on UK small-caps once a week.

3. Hold a capital markets day to explain your business – these are becoming increasingly popular, often following on from an AGM.

4. Get some more research written about you – MiFID II is reducing the volume of research written, particularly about small companies, as well as the effectiveness of broker distribution. The chart below shows how the average top-12 Thomson Reuters clients have cut the number of brokers from which they take research by 60%.

Thomson Reuters: decline in entitled sell-side contributors



Source: Thomson Reuters

Make sure that research is widely available. The research of a sponsored house, such as Hardman & Co, mirrors the institutional distribution of a broker or

investment bank, but goes far wider, reaching out to family offices, wealth managers, private client brokers and retail investors.

5. Find ways of interacting with wider audiences than just with institutions. For example, some advisors may have better access to wealth managers and private client brokers than is the case for institutional brokers. Consider one of the retail investor shows (the *Financial Times* wrote up the recent Mello event in Derby for its effectiveness).

6. Allow retail investors into your thinking more often than at just the AGM. Perhaps it is understandable that managements are reluctant to allow retail investors to attend the analyst results meetings (primarily, they invite analysts with a deep knowledge of the company and sector to drill down), but there is no reason why a recording of the meeting, and slides used, cannot be put on the company website.

7. Remember, the retail investor is more important than most commentators and market professionals understand. Our note earlier this year highlighted both the importance of small investors to share price formation and how dangerous it can be to ignore them[3].

[3] Hardman & Co, 22 January 2018 'ONS survey underlines importance of the retail investor'

About the authors

Keith Hiscock is the Chief Executive of Hardman & Co.

He is personally responsible for the firm's relationships with its corporate clients and also for corporate finance.

Keith has over 35 years' stockbroking experience and has developed long-standing relationships with many major institutional investors, including Private Client Brokers and Wealth Managers. He started his career at James Capel, at the time the top-ranked research house in London. He was a founding member of Schroder Securities and of Agency Partners, a leading research boutique and a member of the 5-man securities board at Evolution. Keith has also advised companies, large and small, on their relationships with the capital markets. Keith was part of the group of investors that acquired Hardman & Co in late 2012. He holds an MA in Philosophy, Politics & Economics from the University of Oxford.

Yingheng Chen is a Senior Financial Analyst at Hardman & Co.

She also works alongside Doug Hawkins at Hardman Agribusiness which was founded in 2009 as a joint venture with Hardman & Co and provides capital market advisory services for businesses and investors in the agriculture supply chain.

Yingheng has particular experience in the markets for palm oil, cocoa, citrus, coconut, Jatropha and sugar. She worked as a corporate finance analyst at the Agricultural Bank of China and is fluent in Cantonese and Mandarin. She has a thorough understanding of the Chinese financial and business markets as well as of those in the UK. Yingheng joined Hardman & Co in 2008. She holds the Chartered Financial Analyst Level 2 qualification together with a BSc in Economics from the London School of Economics.

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The fact that we are commissioned to write the research is disclosed in the disclaimer, and the research is widely available.

The full detail is on page 26 of the full directive, which can be accessed here: http://ec.europa.eu/finance/docs/level-2-measures/mifid-delegated-regulation-2016-2031.pdf

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