Running, carefully, with the bulls

By Iain McCormick

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Let's raise a toast to both the current New Zealand Stock Exchange (NZX) chief executive Tim Bennett and former chief executive Mark Weldon. The NZX50 Gross Index rose 24.2 percent last year and has started 2013 with a roar.

These two have done some excellent work in building the credibility and presence of the market. And investors are now benefiting. The result is an increase in the number of trades, up nearly 22 percent in 2012, and the value of trades rising six percent. This is exactly the type of capital market development that our country needs to assist its economic progress.

The year ahead looks good too, with a number of initial public offerings (IPOs) likely to come on stream. New IPOs are the lifeblood of a stock exchange. We might see Mighty River Power float and there is speculation about a public offering from technology firms Arria, Orion Health, Mega, 2Degrees and a possible back door listing of the Mad Butcher. This activity is welcome as very few offerings have made it to the board in the last five years.

Sam Stubbs, chief executive of Tower Investment has, however, expressed some concern that New Zealand is headed for a sharemarket bubble and investors need to be careful of overvalued listed companies. Stubbs is starting to see signs of "irrational exuberance" from investors and a herd mentality developing.

There are, he claims, two factors that point to a pending bubble. The first is that investors are starting to drive prices above where a company's value should be, based on a multiple of its earnings. The second indicator is that low interest rates are driving a change in investor attitude with more people becoming interested in purchasing shares.

Other senior advisors from other investment firms disagree. Hamilton Hindin Green's client adviser James Smalley, for example, sees no signs of a bubble. Smalley believes three factors typically point to a bubble. They are price to earnings ratios well above the historic average; dividend yields similar to what savers can get at the bank and, a raft of new, poor quality public listings. He doesn't see these happening in the current market.

Time will tell who is right. Meanwhile, when there is risk of a bubble about directors must be prudent. There are two key areas where directors need to demonstrate due care – IPOs and acquisitions.

Directors must be mindful of the risks involved in IPOs. Let's not forget that Cavalier Corporation is the only 1983 listing remaining on the NZX today. Between 1984 and 1985 there were 64 IPOs, including Equiticorp and Euro-National, and none of them survived the 1987 crash. In 1986 there were 50 IPOs and none have survived. The tragedy of the crash was not so much the wealth destroyed but the souring of public attitudes towards the market, business as a whole and the investing public's appetite for investment in productive assets.

I'm not suggesting that IPOs aren't worth careful consideration. Investors in 42Below and Xero know they can be very rewarding. It's just that the quality of the governance and senior management of IPOs sold in bull markets should be very carefully assessed.

Directors must also be prudent with mergers and acquisitions (M&A). We have witnessed the saga at mining giant Rio Tinto. In 2007, at the top of the market, Rio Tinto bought the Canadian aluminium producer Alcan for US$38 billion. It might have appeared a brilliant strategic acquisition then but, in 2013 it looks like a disaster. Rio's chief executive, Tom Albanese, suddenly resigned in January over a US$14 billion write-down of the company's assets following this and other bad deals.

The aluminium industry is now the victim of over-capacity, strong currencies, expensive raw materials and the rising costs of energy, making many operations uneconomic. More than five million tonnes of aluminium is held in official London Metal Exchange warehouses and the same volume probably lies stacked in unofficial storage. All this points to a large surplus and consequent falling prices.

Global consultancy KPMG suggests directors can deliver successful M&As. Their research suggests:

• cash-only deals have higher returns than stock-and-cash deals, and stock-only deals;
• acquirers with lower price to earnings ratios complete more successful deals;
• the number of prior deals undertaken by an acquirer is important, with those that have closed three to five deals being the most successful.

The research also found that transactions motivated by increasing "financial strength" were most successful. Deals motivated by a desire to purchase intellectual property or technology or to increase revenues were less successful. And, the size of the acquirer (based on market capitalisation) has no impact on the M&A outcome.

So let's raise a toast to the success of the NZX50 but, let's also drink our fine local methode traditionelle with prudence!

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