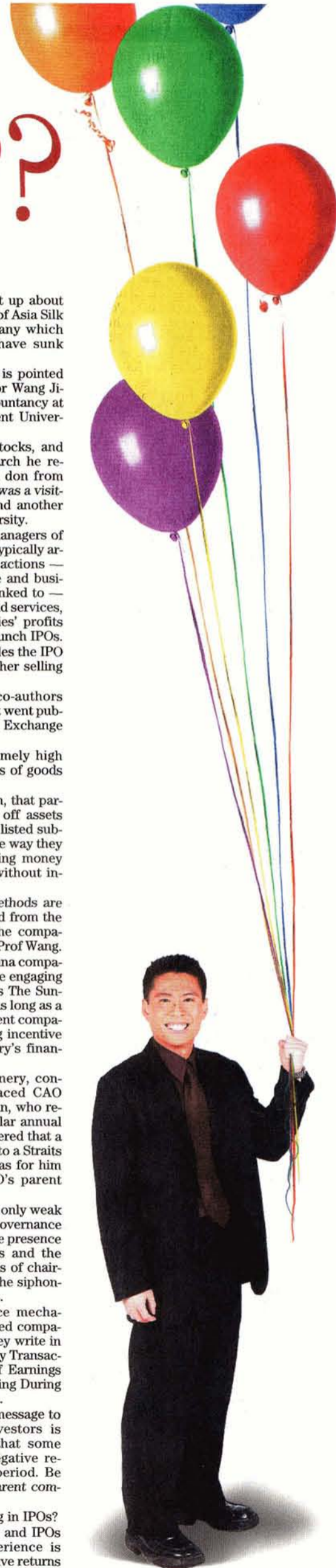


IPO market Will it POP?



Sentiment expected to remain positive in short term, but valuations may prove dampener in long run

► **Leong Chan Teik**

SHARES of China company Hengxin Technology, which makes cables for the telecommunications industry, rocketed 94 per cent last week on their debut on the Singapore Exchange.

Soon, hotel group Banyan Tree will offer its shares to the public.

These initial public offers (IPOs) come hot on the heels of 27 others since the start of the year.

IPOs of companies, especially China firms, are on fire — something that would have been unthinkable last year in the aftermath of the collapse of China Aviation Oil (CAO).

The IPO boom is back for myriad reasons. For example, the Singapore and regional economies are strong, and corporate earnings are strong, too.

In the past few months, you would have been most unlikely to lose money by applying for IPO shares and selling them shortly after their listing. In fact, you may have landed big gains such as China Fishery, which shot up from its IPO price of \$1.25 to \$3.58 by Thursday's close.

What gives? And will the good times keep rolling?

Probably not, say some observers. "IPOs are very susceptible to market sentiment," says Mr Gabriel Yap, a senior dealing director at Phillip Securities. "From past experience, the sentiment will not last beyond a year."

Mr Christopher Cheong, vice-president of the Securities Investors Association of Singapore (Sias), says: "In the near term, market sentiment is expected to remain positive towards IPOs."

But pricing is also key.

"Most IPOs at their offer prices are still underpriced at between seven and 10 times earnings," he says, referring to the ratio between a share price and earnings — that is, profits — per share. The lower the ratio, the better value the share price in terms of profits generated.

"Investors should be careful if the stocks are chased up subsequently to beyond the market average of 15 times earnings," he adds.

Mr Yap of Phillip reckons that as market enthusiasm over IPOs continues to develop, companies aspiring to list their shares will demand higher valuations, which in turn will cool investors' ardour.

Already, it is happening. He notes that the best performing China companies that were listed last year — China Hongxing Sports, China Sky Chem Fibre and Longcheer — sold their IPO shares at between five and eight times earnings per share.

This year, companies with similar sales and profits — such as Luzhou Bio-Chem Technology, China Milk, Sun East and Jiutian Chemical Group — sold their shares at between seven and 12 times earnings per share, he says.

As the IPO fever spreads, something else happens: a rapid succession of companies will launch IPOs.

Investors will not have the time or resources to quickly differentiate between good-quality IPOs and the

lesser ones. "In 2000, many technology-related stocks performed badly because they could not be differentiated by investors due to too many IPOs," says Mr Yap.

Mr Terence Wong, chief investment analyst at Sias Research, agrees that the IPO fever will cool down eventually, and suggests that investors sell any IPO shares which are no longer bargains.

"The valuations of many recent IPOs have run ahead of business fundamentals. It may be time to take profit," he says.

Valuations can take forms such as the price-earnings (PE) ratio, as mentioned above; the price-to-book value, which is the ratio between the share price and, broadly, the value of a company's assets per share; and price-to-sales, which is like PE, except that it looks at revenue instead of profits.

Impact of foreign listings

ON MAY 5, a milestone was reached with the listing of the 100th China company, plastics firm Midsouth Holdings, on the Singapore Exchange (SGX).

SGX aims to attract more foreign companies, especially from China, to list in Singapore.

More IPOs are good for Singapore retail investors if the companies are of good quality. They enable investors to profit from booming businesses in faraway places, and diversify their investments.

"Quantum leaps in their revenue and earnings are not uncommon," says Mr Wong of Sias Research.

IPOs enlarge the variety of industries that Singapore retail investors can invest in. Consider Fabchem, a China company which makes explosives for use in hydro-electric construction and oil exploration.

Its shares have shot up from the IPO price of 32 cents last month to 76 cents on Thursday.

Investing in IPOs, however, is also fraught with risks.

Mr Wong describes the basic challenge: "IPO investors should have a good grasp of the business as well as valuations of their investments."

He adds: "Do not overpay even if the company possesses solid fundamentals."

But to begin with, it is a challenge for Singaporeans to gain a good understanding of foreign businesses such as those that make textile fibres, soybean products and agricultural equipment.

"Many businesses can be difficult to understand unless one pays regular visits to China or gets constant updates from management," says Mr Yap.

To complicate matters, it is never crystal clear how long a business' solid fundamentals may last.

What is obvious is that companies tend to launch IPOs during the good years. And typically, an IPO is one big hype job as the company in question calls on potential big investors and organises press conferences to put the best possible spin on its prospects and latest rosy earnings, say observers. Post-IPO, the business and stock performance can range from exhilarating to depressing.

Consider two IPOs from last year: The shares of Sarin Technologies, an Israeli maker of products that pro-

cess diamonds, have shot up about 200 per cent, while those of Asia Silk Holdings, a China company which makes spun silk yarn, have sunk about 50 per cent.

A more insidious risk is pointed out by Assistant Professor Wang Jiwei of the School of Accountancy at the Singapore Management University (SMU).

It pertains to China stocks, and was the subject of research he recently conducted with a don from Tel Aviv University (who was a visiting professor at SMU) and another one from Shanghai University.

The dons found that managers of China parent companies typically arrange related-party transactions — that is, deals with people and businesses they are closely linked to — such as trades of goods and services, to inflate their subsidiaries' profits before the subsidiaries launch IPOs.

An inflated profit enables the IPO company to ask for a higher selling price for its shares.

Prof Wang and his co-authors used data of 198 firms that went public on the Shanghai Stock Exchange from 1999 to 2001.

They found "an extremely high level of related-party sales of goods and services".

They found, in addition, that parent companies siphoned off assets or profits from the newly listed subsidiaries after the IPO. One way they may do so is by borrowing money from their subsidiaries without intending to pay it back.

Evidence that such methods are being used can be gleaned from the financial statements of the companies' annual reports, says Prof Wang.

Does he think some China companies listed in Singapore are engaging in such activities? He tells The Sunday Times: "I believe so. As long as a to-be-listed firm has a parent company, the latter has a strong incentive to 'package' its subsidiary's financials to get it listed."

As for post-IPO chicanery, consider the case of disgraced CAO chief executive Chen Jiulin, who received a multimillion-dollar annual salary. It was later discovered that a large part of it, according to a Straits Times report last year, was for him to quietly divert to CAO's parent company in Beijing.

Finally, the dons found only weak evidence that corporate governance mechanisms — such as the presence of independent directors and the separation of the positions of chairman and CEO — reduce the siphoning off of assets or profits.

"Corporate governance mechanisms among Chinese listed companies are questionable," they write in a paper titled Related Party Transactions: A "Real" Means Of Earnings Management And Tunnelling During The IPO Process In China.

Prof Wang says: "The message to Singapore long-term investors is they should be aware that some IPOs may experience negative returns in their post-IPO period. Be careful with IPOs with parent companies in China."

Does he avoid investing in IPOs? "I bought some stocks and IPOs in Hong Kong. My experience is most IPOs will have negative returns in one or two years post-IPO period. So buy the IPO and then sell it soon."

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