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Market Ethos

The latest market insights from the Richardson GMP team

IPO Renaissance

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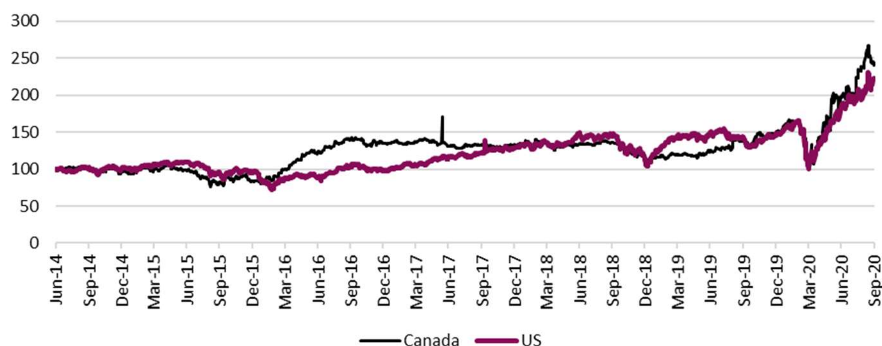
It was hard not to notice the excitement surrounding initial public offerings (IPOs) last week as we saw SNOW in September. In fact, IPOs are having a banner year with businesses rushing to raise capital and provide liquidity for early-stage investors given the ample appetite for speculation and new stocks. The pandemic has changed the world, and investors are looking for the leaders of tomorrow. The big headline grabbing stock of last week was Snowflake (SNOW), a data warehousing company. On the first day of trading, it rose as much as 165%, making it the biggest tech IPO of the year with a valuation of $67.9 billion. This is a tough feat to follow for future IPOs, but it did garner a lot of attention, further fueling the enthusiasm.

The Renaissance IPO Index, which tracks U.S. companies that have recently listed, is up 58% year to date, quite an accomplishment compared with the S&P 500's measly 4% return. "Prince" *(of the Purple Rain variety)* would be happy as the market for IPOs is partying like its 1999! Ok, that might be a stretch, but 2020 has rekindled a similar amount of excitement, with the strong performance. The first chart details the recent impressive gains for both Canadian and U.S. IPOs. The average one-day gain for U.S. IPOs so far this year is 23.7%, compared with 12.8% in 2019 and 13.4% in 2018, according to data provider Dealogic.

Based on the Renaissance IPO indices that track performance of new listed companies, it has been a very friendly market of late in both Canada and the US.



This year has been a busy year for investment bankers. Activity completely dried up in March, but so far in 2020 the U.S. has seen more than 348 companies go public. While the deal size is smaller in Canada, the IPO market is similarly hot with 105 IPOs.

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Chart 2 shows that U.S. companies have raised over $400 billion (in CAD terms) in IPOs and secondary offerings so far this year. This is a dramatic increase, particularly considering we remain in recession. After interest rates fell to nearly zero, there has been a clear shift in investors' appetite for risk to seek better returns. The "Weekly" portion of Chart 2 breaks this down further, revealing the complete drought in activity during March and the boom that ensued. Proceeds in that last week of August were over $14 billion – the biggest week since May 2019 when Uber went public.

Sector breakdown

Health care has been the most active sector YTD, accounting for over half of the deal activity in the U.S. (**Chart 3**). This should not be surprising considering we're in the midst of a global pandemic, but worth noting a large amount of that capital raised is going not just to vaccine development but a variety of sources. Technology has been trying its best to play catch up, and with September and October normally a busy time of the year for IPOs, there is still plenty of time for tech to finish the year in the lead. While the Canadian IPO market has been similarly hot, it's a wholly different experience. Vaccines be damned! Gold public offerings are at an all-time high. Miners, including gold, precious metals and diversified minerals, have accounted for 66% of total proceeds.

Nuances to the IPO market

In recent years, special purpose acquisition companies (SPACs) have re-emerged as a cost-effective alternative to traditional IPOs. Needless to say, this vehicle has also become one of the most polarizing topics within both institutional and retail investing communities. SPAC financing died off during the 2008/2009 recession but has recently experienced significant growth over the past few years, with such transactions reaching a record annual haul of ~$12 billion in 2019. Last year, the 59 SPAC IPOs represented 25% of total IPOs; YTD, SPACs have raised roughly half of total IPO proceeds. Despite the contentious dialogue, the effects that this asset class is having on equity financing behaviour and euphoria enablement are undeniably compelling and well documented.

SPACs vs. traditional IPO listings

SPACs have proven themselves to be a great alternative, "back-door" method for smaller companies to go public. Firstly, the timeline to go public via a SPAC is significantly quicker: typically, anywhere between 3-4 months compared with the 6-9 month timeline for a traditional IPO. Reporting requirements are also less burdensome for management teams and, in the U.S., the Securities and Exchange Commission (SEC) review process can be deferred until after the closing of a "de-SPAC" (i.e., the reverse merger with a target corporation). Finally, both direct expenses, indirect costs and underwriting fees tend to fall lower than those incurred during a traditional listing. All this is to say that the SPAC model for equity financing makes a compelling case against traditional IPOs. However, investors need to exercise caution, especially when considering the other side of the table.

As you may have surmised by now, sponsors have strong incentives to complete a transaction due to the limited time given to complete a transaction and the significant upside potential (via founder shares) and capital at risk (via private placement warrants) carried on their books. Sponsors will also want to minimize the amount of cash redemptions realized when a deal is announced, a scenario which would occur if the SPAC's common shares trade at a discount to net asset value (NAV) at the transaction date. As a result, many SPAC transactions have been executed in "hype" areas of the market with aggressive stock promotion behaviour being prevalent.

Chart 2: IPO activity has heated up

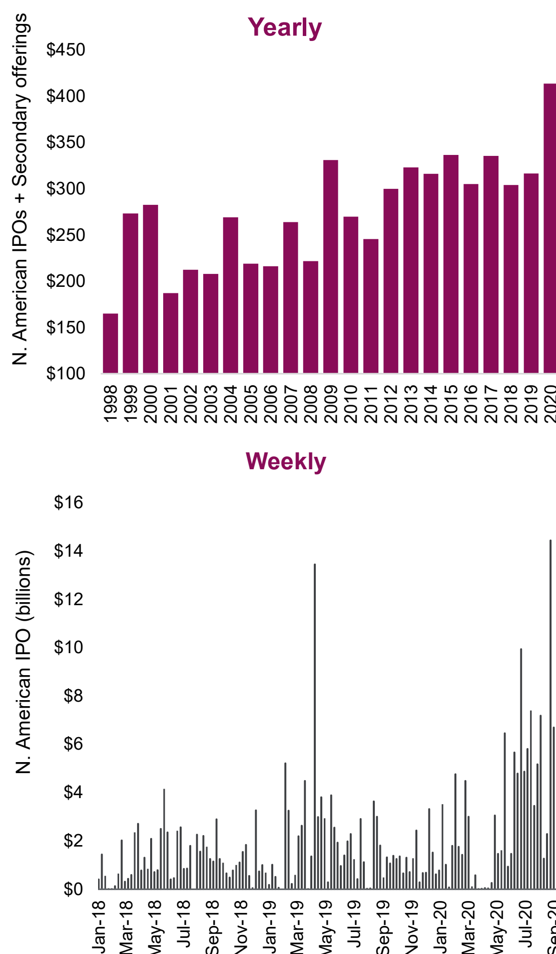
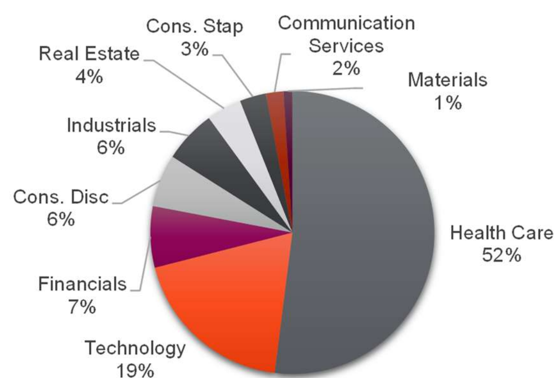


Chart 3: U.S. IPO activity
Health Care is the most active sector YTD



Investment implications

Is a hot IPO market potentially a bad sign for the market? It is tempting to reach this conclusion when you begin seeing comparisons to the dot-com bubble. Money managers don't necessarily have new money coming in, and if you want to buy an IPO you typically have to sell something in order to do so. This alone does not make a market crash as success in one market does not directly mean coming doom. Historical data does not provide a clear answer, but one key difference is that the COVID-19 IPO renaissance is coming right after a bear market.

It's an encouraging backdrop for investors to explore new deals, but make sure to do your research and avoid buying into the hype. Not every slick sales presentation is worth chasing and investors should treat new issues with a healthy dose of skepticism. Remember that the major sellers of the stocks of IPOs are the managers and early investors of the companies themselves. They try to time going public to coincide with a peak in the prosperity of their companies. The true winners in the IPO market are the ones brokering the deals, namely the banks and capital markets. The banks that are best positioned are ones with large capital markets divisions such as Royal Bank. Remember, bankers get their pound of flesh regardless of whether an IPO works out or not. It's the safer way to navigate the hype, and we have recently been increasing our exposure to the Canadian banks.

Source: All charts are sourced to Bloomberg L.P. and Richardson GMP unless otherwise stated.

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