

It's Australia's biggest initial public offering since the privatisation of telecommunications giant Telstra and it's eating up acres of newsprint...

But is the impending \$6 billion float of Queensland Rail National a good deal?

The Queensland state government is selling the majority of its freight rail operator with the pitch that it provides retail investors exposure to the booming iron ore and coal industries that account for most of its business.

A slick \$15 million national advertising campaign has promoted the “discount” price to retail investors and the productivity and margin improvements likely to be made under private ownership. The brokers distributing stock, of course, describe the offer as a “fantastic opportunity”.

Others, though, are not so impressed. Fund managers quoted in the media have said the \$2.50 to \$3.00 a share asking price does not take adequate note of risks associated with QR National's growth plans.¹

So what is the truth? The answer is that like most IPOs, the push and pull of supply and demand will eventually settle on what the market sees as a fair price for the freight operator, but it may take some time to emerge.

In the meantime, before the stock lists on the exchange later this quarter, the respective parties are involved in a noisy and extended public bargaining process. The government needs the revenue, the brokers and underwriters are hanging out for their fees and the fund managers want to pay the lowest possible price. In the meantime, the marketing hoopla provides plenty of fodder for the media, as well as a nice dollop of advertising revenue.

So what is the “right” price? For the issuer of the stock, there is a dilemma between pitching the offer at a sufficiently attractive price to attract strong demand, while not leaving too much money on the table. On the other hand, prospective buyers must balance the opportunity of making a quick profit from buying into the float at a perceived discount with making a poor long-term investment decision.

This noise around IPOs is one reason Dimensional often chooses to let market mechanisms work for a year or so before buying into a newly offered stock. As well, experience shows that the most sought-after offers tend not to be widely offered, while institutions are flooded with stock in the less popular floats. Alongside these practical short-term issues are a myriad of studies pointing to long-run underperformance of IPOs notwithstanding any “stag” profits made by speculators who sell quickly on-market after receiving discounted stock in the offer period.

Among the most cited was a 1995 US paper by Tim Loughran and Jay Ritter,² which looked at IPOs issued in the preceding 25 years. During the five years after the issue, investors received average returns of only five percent.

Ritter recently updated that data to take in the period 1980-2008.³ He found firms with sales below \$50 million tended to make a bigger splash on debut, but underperformed their larger counterparts over three-year periods. Both smaller and larger firms underperformed average market buy-and-hold returns over three years - smaller firms by a substantial margin. Adjusted for size and book-to-market value factors, three-year average returns for the smaller firms were also negative, while the larger firms were slightly positive (see table below).

US IPOs 1980 - 2008

Firm Sales	No. IPOs	Avg. 1st Day Return	Average 3 year Buy & Hold Return		
			IPOs	Market Adjusted	Style Adjusted
0 - \$50m	3,893	23.60%	5.00%	-35.20%	-16.60%
\$50m & up	3,421	12.00%	38.80%	-2.40%	3.70%
All Firms	7,314	18.10%	20.80%	-19.80%	-7.10%

A paper on the UK market, released in June this year, came up with similar findings.⁴ The authors examined 2,499 UK IPOs launched between 1975 and 2004 and found what they called “compelling evidence” of long-run underperformance persisting for three to five years.

In Australia, the evidence is more mixed. A 2006 study of 419 local initial public offerings from 1996 to 1999 found substantial underperformance, although a more recent study, released in 2010 and covering the period 1995 and 2004, found no evidence of general long-term underperformance.

For its part, Dimensional chooses to disqualify IPOs from its list of eligible securities for 12 months or so after debut to ensure as much as possible that the securities are offering the risk-return characteristics being targeted.

Queensland Rail National may indeed turn out to be a good investment, but this will not be determined by the level of marketing hype or by blanket media coverage but by the judgment of the market itself. And that takes time.

Article taken from DFA Australia Limited

- [1.](#) ‘Analysts Cast Doubt on QR National’s Starting Price’, Sydney Morning Herald, Oct 18, 2010
- [2.](#) Loughran, Tim and Ritter, Jay R., The New Issues Puzzle. JOURNAL OF FINANCE, VOL. 50, NO. 1, MARCH 1995
- [3.](#) Ritter, Jay R., Some Factoids About the 2009 IPO Market, University of Florida
- [4.](#) Gregory, Alan, Guermat, Cherif and Al-Shawawreh, Fawaz, UK IPOs: Long Run Returns, Behavioural Timing and Pseudo Timing (2009-11). Journal of Business Finance & Accounting, Vol. 37, Issue 5-6, pp. 612-647, June/July 2010