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HD **Equity capital markets live large**

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Roundtable Equity capital markets are full of life again, but the mid-point of 2014 is a crucial juncture for investment bankers, who hope healthy volumes will continue the stimulus, writes Joyce Moullakis.

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After several years of hiatus, local equity capital markets (ECM) transactions have kept investment bankers on their toes this year. Activity is frenetic across new listings, block trades and follow-on raisings and many are expressing optimism that momentum will be sustained in the latter half of 2014. The volume of Australian initial public offerings (IPOs) is at a year-to-date record at almost $5 billion this year, and while there is fatigue among some fund managers, the pipeline is bulging with the likes of companies such asHealthscope and Fleet Partners. The Australian Financial Review asked ECM bankers and lawyers to canvas their views on the window for floats, the coming expiration of escrow arrangements for many newly listed companies, the outlook for activity and recent criticism about underwriting fees.

Sean Walsh, Goldman Sachs's head of ECM: The success of recent IPOs and generally positive after-market performance has been a key driver of sentiment towards the IPO market. To the extent IPOs continue to perform well in the secondary market, we expect that the IPO market will continue to remain open.

Volatility remains at historically low levels while valuations are well above long-run averages. From an issuer's perspective, these factors reduce the risk of testing the IPO market and increase confidence in achieving an attractive price.

From an investor's perspective, liquidity on the market continues to fall … IPOs represent one of the best opportunities for institutional investors to establish a position in a stock.

Angus Firth, Macquarie's co-head of ECM: At the most simplistic level the "IPO window" relies on issuers and equity investors being able to find a point where valuations are at a level where both parties are willing to transact. In the past 12 months, this common ground has been found and we see no reason for this to change in the near term.

Second, confidence from both the buy and sell side is critical. With long lead times, issuers need confidence that the IPO market will support their transaction in order to pursue the IPO path. Investors require continued confidence in the outlook for equity market conditions to be willing to take the risk of investing in a new opportunity. This leads to the third key factor – a continued pipeline of companies coming to the IPO market that provide investors with interesting investment opportunities and diversification. The fact that we have seen such a variety of new opportunities – following four or five years' of minimal IPO activity has been key in the IPO issuance levels seen in the past 12 months.

Jeremy Blackshaw Minter Ellison partner: We think that, most importantly, we need continued solid Australian economic conditions and benign global economic conditions, including continued supportive monetary policy by global central banks and the absence of significant external shocks.

Equity markets need to remain relatively stable to enable IPOs to be able to be appropriately priced and for offerers and their advisers to be able to properly assess demand. A low interest rate environment is generally favourable for equity markets, as investors seek higher returns. Of course, to attract investors there also needs to be a supply of good businesses with a track record of strong and growing profitability and quality management. Speculative or higher-risk investments are unlikely to be back in favour for some time. While strong performance by recently floated companies would help to ensure that the IPO window remains open, it is not a necessary precondition – for example, particular instances of underperformance may be referable to sector or entity-specific factors that do not affect the market as a whole.

Simon Cox, co-head of ECM at UBS: Market valuation – because forward P/E (price-earnings) multiples for the market need to remain at current levels or better to create an environment where buyers are looking for new fairly priced opportunities

Liquidity – returns on competing asset classes, including cash rates, are at historic low rates, resulting in inflows into equities from both institutional and retail investors

Risk appetite– exogenous shocks are kept to a minimum. Candidates for "shocks" include Australian politics, the Middle East and rates of growth in US and/or China.

Walsh: IPOs represent a natural exit alternative for private-equity owners and with IPO conditions remaining robust we continue to expect to see private equity representing a large proportion of the IPO universe.

Firth: We would expect to continue to see a balanced mix of private equity and non-private equity IPOs this year. Rather than broadly generalising about IPOs from private equity, the market has matured into assessing each deal, regardless of its source, on its merits. This means it is not just about who the vendor is, but it also needs to consider the intentions of management. Is there a founder who also has ongoing involvement in the business and how much of the company is being retained by the vendor?

Blackshaw: There are still a number in the pipeline including, potentially, major offers such as Healthscope. Overall, private equity vendors will continue to supply IPO candidates, though perhaps not quite at the same rate as during the past 12 months. Many private equity firms have floated or sold portfolio companies and, having raised funds, are focused on acquisitions. On the other hand, however, recent examples of exits following quickly after the acquisition, such as theDick Smith, Asaleo Care and Spotless floats, show the preparedness of private equity companies to exit earlier than the usual time frame. As long as the market appetite exists, we expect that private equity will continue to be a strong source of IPOs.

Cox: Probably less than you'd think. The cycle is typically one of private equity firms moving early, followed by private companies, foreign corporations and governments.

Can you characterise the environment for activity as escrow periods expire on many floats from last year?

Walsh: Investors still have significant amounts of cash available to deploy, as evidenced by the recent block trade of Shell's stake in Woodside. The block trade market is well bid at the moment so we don't see these potential sell-downs having a major impact. However, as escrow windows approach, investor focus on the potential overhang in these situations will intensify.

Firth: The August reporting season will see a number of escrow periods expire on floats from last year. Our expectation is that some shareholders will look to fully exit their positions – however others who do not need to exit will take a longer term view on the share price outlook and hold onto their stakes.

Blackshaw: Many of the wave of IPOs that completed in November and December of 2013 were priced off financial year 2014 forecasts, so many of the escrow periods (which usually last until the release of results for the forecast period) will end during reporting season. However, there was some variety and innovation in the escrow arrangements put in place. In many instances parties agreed to be escrowed for a longer period for some of their holding. Accordingly, while a significant volume of stock will be coming out of escrow, not all of it will be. In any event, we expect that the market will have priced in any escrow overhang. Overall, we don't think the expiry of escrow periods is likely to have any significant impact on general market activity. Each situation is likely to be viewed on its own merits. We expect escrowed shareholders to be very conscious of the likely impact of any decisions to completely sell down immediately after their shares come out of escrow. This will be particularly relevant to any financial sponsor which has multiple escrowed stakes.

Cox: Good. The market continues to assess block trades on their merits. Investors whose holdings have come off escrow will find plenty of liquidity if the price is right.

Walsh: All IPOs are marketed off a prospectus containing forecasts which have been reviewed by accountants and signed off by the board of directors. There is a stringent due diligence process that is designed to ensure the accuracy of the forecasts and the assumptions underpinning them.

Obviously most of the recent IPOs are not yet through their prospectus forecasts but if you look over the past couple of years, other than iSelect and McAleese, most of the IPOs have met or exceeded expectations with respect to their results.

Firth: Over the past 12 months the market has been quite disciplined in differentiating its approach to high growth versus more defensive IPO opportunities. For example, the IPO's of higher growth companies such as Japara Healthcare, OzForex and Veda Group have attracted premium multiples. The macro drivers of growth in particular sectors have been a key factor in the pricing of IPOs coming to market this year – whether this be the growing online education market in an IPO such as 3P Learning or the ageing population driving growth in the aged care market for Japara.

Blackshaw: Vendors and offerers have an obvious incentive to maximise their returns on an IPO. Equally, investors have an incentive to gain entry into a stock at the best price possible. This tension has always existed. While we don't see too many sellers publicly complaining about mispricing when early trading is at a significant premium to the offer price, they are equally entitled to be concerned if that occurs. Fewer floats successfully completed in the early part of 2014, reflecting some investor caution and scepticism off the back of the rush of floats at the end of 2013. However, as the half has progressed, more IPOs have successfully been priced, reflecting a realistic approach to pricing and an increased confidence in that pricing from investors. Some floats have not proceeded, indicating a considered approach to the transactions, including being mindful of the likely state of the after-market.

Cox: Yes. Companies that are IPO-ed are subject to a very rigorous due diligence process involving many highly qualified external advisors. An investor's ultimate decision on what price they are willing to pay for the **company** is influenced by whether they think the **company**'s growth prospects are sustainable.

Walsh: Conditions for **M**&A – strong valuations, low volatility, cheap credit,relatively stable currency and buoyant **equity** markets – are as strong as they have been in several years and that is translating into increased **M**&A volumes.

There have been many successful ECM transactions to fund acquisitions already this year – Transurban raising $2.3bn to fund the Queensland Motorways **acquisition** being the largest – and investors have generally reacted very positively to these transactions. **M**&A continues to be viewed as a strong source of ECM activity over the next six months.

Firth: **Equity** raisings to fund acquisitions have been well supported by the market this year. Whilst still at relatively low levels, merger and acquisitions do appear to be gradually increasing – we naturally expect to this to **lead** to a pick-up in **M**&A activity related ECM issuance.

Blackshaw: We do expect more merger and **acquisition**-related ECM issuance. As **M**&A activity increases, we expect a substantial increase in related offers to fund cash bids. Appetite is likely to be measured on a case-by-case basis. **M**&A-related ECM activity has steadily firmed up in the last six months, commencing with the Insurance Australia Group **acquisition** of Wesfarmers' general insurance business. As that transaction and some of the subsequent ones show, there is strong appetite for funding for accretive **M**&A transactions. Obviously, any bidder considered to be overpaying for an asset is likely to find it substantially more difficult to convince the market to fund it other than on a discounted basis. We think well priced and good strategic deals will be very well supported.

Cox: Yes. The cost of financing acquisitions for many companies is currently very attractive. With low interest rates and some **company**'s valuations at high levels (which equates to a low cost of **equity** capital), listed companies have access to a broad suite of funding to make acquisitions. In some instances they will be competing with private companies or private **equity** firms who may be willing to take on higher levels of debt to fund acquisitions, so some situations are likely to be competitive.

Walsh: We've had some very large transactions in the first half – Shell's $3.2 **billion** selldown in Woodside, Transurban's $2.3 **billion** entitlement offer, Spotless's $994 **million** IPO – so to say the second half is going to be even more active is hard to predict. That being said, conditions remain favourable and there are a number of large situations, in particular a number of large potential IPOs, which should see activity levels remain elevated through the year.

Firth: Total issuance is typically dominated by a small number of very large transactions. There have already been a number of these in the first six months but we can see a pipeline of IPOs and other transactions for the second half of the year which could see volumes outpace the first six months of 2014.

Blackshaw: We believe that ECM activity in the second half of 2014 could outpace that in the first six months. The main reason for this is several very large IPOs in the pipeline that are expected to announce in the second half, which will have a major impact on total capital raised if they proceed. This, combined with the expected increase in merger and **acquisition**-related ECM issuance, should see volumes rise.

Cox:The IPO pipeline looks very strong, particularly with the likes of Healthscope and Medibank potentially being two of the larger offers. Some businesses have flagged **M**&A financing needs (such as AGL and Origin), and block trade activity should round out a busy second half of the year.

Walsh: Our perspective is that Australia is one of the most competitive investment banking markets in the world. We have all the major global banks here plus some local and regional banks who have expertise in Australia.

We believe this leads to a very sharp and competitive environment for fees – perhaps one of the most competitive in the developed world.

Firth: The report takes a quantitative approach to analysing the risk of an underwrite – looking at factors that can be commonly assessed across deals. As underwriters, we know that there are a number of qualitative and deal specific factors that influence the risk on every transaction that we underwrite.

Shareholders are able to take comfort from the fact that the market for underwriting **equity** offers in Australia is highly competitive. With such a large number of banks covering the market, competitive tension ensures that overall companies will not be overpay for underwriting in the Australian market.

Blackshaw: Underwriting fees in Australia, while higher than in some jurisdictions, are generally lower than in some significant markets such as the United States. The role of underwriters is not solely to put their balance sheet on the line by underwriting the risk of shortfall, but also to project manage transactions, provide financial and strategic advice, make their distribution network available and provide after-market support.

A theoretical analysis of the appropriate pricing of the balance sheet risk being assumed does not factor this in. In our experience there is intense competition for quality IPOs and secondary offers, which isn't generally conducive to overpricing.

The present volume of IPOs would also indicate that at least offerers are prepared to accept the fee/risk balance.

A consequence of the global financial crisis is that risk allocation now gets plenty of attention, while in the pre-GFC environment it may have been less important to underwriters and joint **lead** managers.

Cox: I haven't seen the report, but would note that Australia is one of the most competitive banking markets with fees that reflect that level of competition.

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