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Fueling the IPO Engine

Strong gains in equity markets over the past year, coupled with ample liquidity in the financial system, has led to a sharp rise in initial public offerings (IPOs) as of late. IPO-bound companies are in a race to make hay while the sun shines on the back of favorable investor sentiment, an improved economic outlook, and abundant liquidity. Typically, bull markets first start in secondary equities and after a span of around a year or so, fuel a boom in IPO issuances. We are at about 12-15 months into this bull market and the number of IPO offerings is encouraging to say the least.

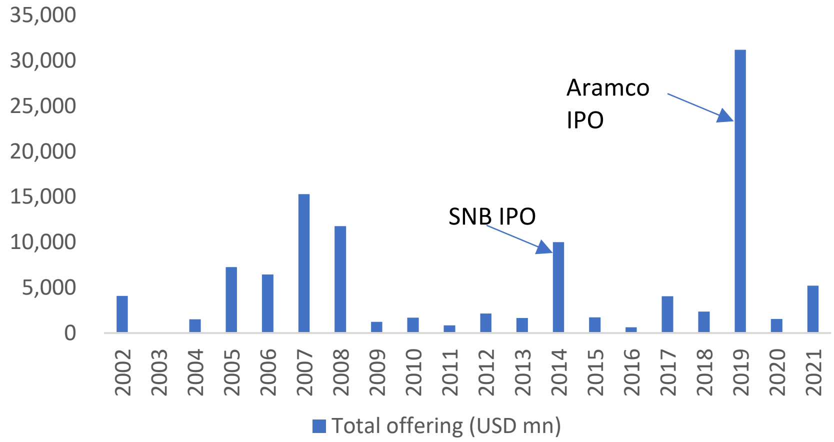
Companies list in public markets to raise money from external investors for growth or to allow early shareholders to monetize some of their ownership. IPO issues tend to be oversubscribed during times of positive sentiment, meaning strong demand leads to lower probability of allotment, encouraging investors to overbid for a meaningful allocation. IPO institutional applications in our region except Bahrain do not require prefunding (in short: apply now, pay later), allowing institutional investors to place bids significantly higher than their capacity and requirements. Some recent IPOs were over a hundred times oversubscribed, notably ACWA Power at 248x and STC Solutions at 130x. ACWA Power's approximately USD 1 billion IPO drew bids worth around USD 250 billion — a value close to a third of Saudi Arabia's GDP. This highlights the tremendous interest the IPO market has generated among investors. The Saudi stock exchange IPO, Saudi Tadawul Group, is currently open for subscription and is slated to list next month. We expect strong response from both institutions and individuals, especially with rise of individual tranche to 30% from 10%.

An amateur investor may believe an IPO offers a first-mover advantage and an opportunity to buy shares at a lower price for guaranteed future gains. The IPOs of 2021 have thus far mostly validated this belief, trading above their issue prices and some having gained as much as 30% on the first day of listing. However, investors need to understand that just like securities, or any investment for that matter, IPOs too come with a fair share of risk, and due diligence is required before investing in them. In good times, even poor-quality businesses can demand expensive valuations, often cashing in on market sentiment and then posting listing gains. They may also trade above their IPO price for some time, but their share price eventually sinks as fundamentals catch up. Examples of oversubscribed IPOs that ended up eroding wealth over time include Arabtec, DSI, Al Khodari, Dubai Parks, Saudi German Hospitals, Emaar Development, and Integrated Holdings.

In the GCC, IPO success stories are skewed towards Saudi Arabia and have contributed to the overall breadth and depth of the public equity market, generating wealth for investors over time. The listings, especially in regulated sectors, come at attractive valuations to distribute wealth among the population. In hindsight, we see many examples in Saudi Arabia where these primary listings have delivered on growth and returns: Jarir, Saudi Telecom Co., Ma'aden, YANSAB, BUPA, Mouwasat, and Almarai are notable examples. In the UAE, Aramex, Aldar, and ADNOC Distribution also follow this trend. In contrast, Dubai heavyweights such as DP World and Dubai Parks have delisted while others such as Emaar Malls and DAMAC Properties are in the process of doing the same.

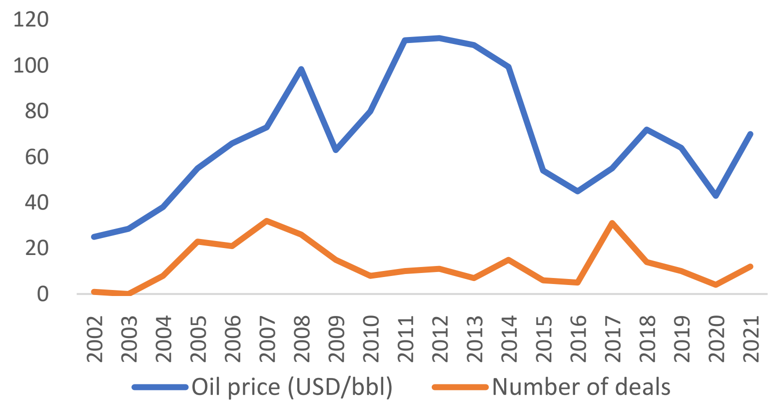
As an exercise, we examined day-one and post-day-one returns of ten IPOs on GCC equity markets in FY 2020/21. The IPOs yielded significantly abnormal returns on day one, where nine out of ten delivered double-digit returns. In contrast, the performance of IPOs excluding day-one returns has been poor, where only three out of ten IPOs delivered double-digit returns. This shows that investors are initially over-optimistic during the subscription period, driving a short run in stock prices above their fair value, then returns are normalized over time when mis-valuations are corrected.

Money Raised (USD mn): *IPOs often provide only short-term buoyancy to equity markets*



Having said this, the IPO market is likely to sustain its momentum in 2022 if the secondary market remains buoyant, and governments continue to revitalize their bourses. The Saudi government took the lead with the historic 2019 Saudi Aramco IPO, which encouraged others to explore equity markets as a fundraising source. Government initiatives and policy reforms also support and encourage family business to take the IPO route; Saudi Arabia's CMA relaxed traditional IPO requirements to list at least 30% of a company in a bid to encourage more family-owned companies to go public. At the same time, a parallel stock exchange NOMU was set up that focuses on SMEs and has lighter listing requirements than Tadawul. Moreover, the private-equity industry is maturing, and some big-ticket investments are ready to exit with rich valuations in the secondary market giving private owners an attractive exit avenue. Finally, ample liquidity with institutional investors due to near-zero interest rates, a rise in oil prices, and accumulation of investable funds by retail investors during lockdown will also contribute to the successful subscription of potential IPOs.

Oil Price Impacts: *A strong oil price environment has historically led to more IPO deals as strength in oil drives favorable economic outlook in the region, translating to rich secondary-market valuations.*



In saying this, even as we head into IPO rush going into the year ahead, investors should exercise caution: not every IPO is worth subscribing to in a bull market. Investors need to gauge the true worth of a business and if there is money to be made at the IPO price before making their investments.

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