Some Factors that you should consider when investing in an Initial Public Offer

An Initial Public Offering (IPO) is a way for raising capital for companies who have plans of business expansion and growth. As the name indicates, in issuing an IPO, a company offers its shares for the first time to the general public. An IPO is the process by which a private company becomes publicly traded on a stock exchange. Seeking listing on a stock exchange is also called 'going public' or 'flotation'. At present there are many IPO's in the market and it is very important to study these companies in order to make a correct investment decision. Some companies coming up with IPOs do not have any past market trends or broker research reports which you can use to base your decision upon, therefore before buying an IPO make sure to do a detailed study of the company.

- Read the Prospectus

Your analysis of an IPO company should start with the "Prospectus". A prospectus is essentially an invitation or offer to the public to subscribe for or buy the securities of a company. A prospectus contains all relevant information about the company making the IPO, and must be filed with the Colombo Stock Exchange (CSE). Therefore the information that is disclosed in the prospectus relates to the terms on which the invitation or offer is made.

It is important for an investor to read and understand these terms in the prospectus in order to be able to assess for himself the risks or merits in investing in the company. The prospectus is a very important document. For an investor, the prospectus is the means by which you can judge how profitable and viable the company is before you decide whether or not to part with your money. You must therefore go through the prospectus very carefully and understand what is really at stake before you make your decision. You should carefully assess the fundamentals of the company seeking listing by studying the information in the prospectus. Though IPOs appear to be a good investment option because of the general expectation of earning high initial returns, called premiums, risks do exist and there is no guarantee of premiums or that the premiums would be what you had hoped for. Go over the prospectus with a fine toothcomb for hints on the company's growth prospects.

The prospectus will give you sufficient information about the Company and its share issue. Given below are some of the most important factors that you should go through in a Prospectus:

- Objectives of the Issue
- Underwriting Arrangements (if any) and Minimum Subscription (if any)
- Investment Consideration and Associated Risk Factors
- Future outlook/strategies of the Company
- Assumptions on which future plans/strategies are based
- Industry Analysis
- Particulars of Debt and Loan Capital
- Litigation, Disputers and Contingent Liabilities of the Company
- Degree of dependence on key customers and suppliers
- Dividend Policy of the Company
- Ten Largest Shareholders of the Company
- Changes to the Capital structure and Changes to the Shareholding Structure

- Expertise of the Corporate Management of the Company
- Who are the Independent Non-Executive Directors
- Accountants' Report for Inclusion in the Prospectus
- Independent Auditor's Report for the latest financial year

After studying the prospectus, some of the questions the investor should ask himself or herself are:

- ➢ Does the company have a consistent good financial performance as a private business enterprise?
- ➢ Is this a sector that has likelihood of good returns for investment - that is can it give good dividends?
- ➢ Is the company likely to achieve its growth objectives?
- ➢ Is there good likelihood of investments to appreciate in value – i.e. will the share prices rise?

Make sure to spend some time to go through the prospectus and apply only if you are satisfied with the information included in the prospectus. You can also obtain the assistance of a stock broker to help you to understand the prospectus and assist you with the investment decision.

- **Use of proceeds**

  Is it going to be used for development/expansion project that will yield more returns? Or is it going to be used for debt servicing?

- **Indebtedness**

  This is very important because, if the company is highly in debt or if the financial condition of the company is not reflected in the balance sheet. It can really turn out to be a serious problem to investors since such invested fund could end up being sunk into debt payments.

- **Issue Price of a Share**

  Remember that the issue price of a share in an IPO is determined by the company issuing shares and not determined by the Securities and Exchane Commission of Sri Lanka (SEC) or the CSE. Companies may decide the issue price based on net asset value of a share, expected future cash flows, companies future expansion and goodwill of the company etc. It is upto the investor to evaluate these factors and apply for the share issue. If the investor thinks that the issue price is high he has the option of not investing in the share issue. The company is taking a risk if the issue price is over estimated since the investing public might not apply for the entire share issue and the share issue may not get subscribed. Then the company's objective of raising capital through a share issue may not be successful.

- **Changes to the Shareholding Structure of the Company**

  An investor has to carefully study the prospectus and look for changes in the shareholding structure of the company as well as the period in which it has happened. Investor has to be mindful of the shares issued prior to the IPO and the price at which they have been issued. The source of obtaining such information is the prospectus. Since the decision to buy shares at an IPO is not forced (it is an offer made by the company), the investor has the option of applying for the share issue or not.

- **Legal matters**

  You must cross check that the company does not have legal or court case that may lead to its closure, liquidation or even bankruptcy. There can be instances where litigation concerning board members, investors or even rival companies has led to the closure, liquidation or even bankruptcy of the company.

- **Weigh the company's offer price with their earnings per share**

  This is to determine the company's profitability. Offer price is the price at which the company is selling shares to the public, whereas earnings per share (EPS) is the company's net profit over its total shares. To determine profitability, compare the offer price with the EPS and determine how many times the offer price is a multiple of EPS; if the multiple is more, it means you're paying more, and if it is lower, it means you're getting a better deal.

- **Consider the company's industry**

  What they are selling is the core of whether they'll be successful. Are their products targeted towards the future? Are they using or providing innovative technology and focusing on environmentally friendly practices? These are some of the qualities of company you should look for.

- **Historical background**

  The history and business of the company right from inception should be well studied. It is important to know the changes and developmental phases of the company, track records of its board of directors, how the company was started, they company's relationship with clients, clients and the society in general. This information can be obtained in business sites online.

- **Board members**

  What is the track record of the board members? The better the track records and experience of the board members the better and more secure is your investment.

- **Financial position of the firm**

  What is the share capital and reserve of the company. What is their authorized share capital? Do they have reserve? and how large is their reserve? Because this likely determines bonus issues and dividend declaration.

- **Financial summary**

  This helps you to study the company's financial history and growth rate for a number of years. The financial summary includes Gross earnings, profit before tax, profit after tax, share capital, net assets, dividends, earnings per stock, and dividends per stock.

- **Subsidiaries and associated companies**

  For the purpose of business stabilization this enables you to know whether your investment is on a thin rope or not. Diversification is a major ingredient to the growth and security, because earnings will be generated from subsidiaries and associated companies to boost the profit margin of the parent company.

  Risks are inherent in any form of investment. Neither the Securities Commission and Exchange Commission nor the Colombo stock exchange can protect an investor from losses associated with normal investment risks, such as changes in the value of an investment resulting from market volatility. It is extremely important that you exercise vigilance yourself.

  During the post war period a large number of companies conducted IPOs and shares of most of these companies started trading at the CSE at a significantly higher price than the issue price. With this backdrop some investors did not realize the importance of going through the prospectus before applying for shares and also assumed that applying for an IPO is a risk free investment. In any investment there is an element of risk involved. Share price of a company will depend on the supply and demand for the share at the time of trading. The most important thing that you have to understand is that investing in the stock market is a long term investment.