Views from the
Japan Equities Small Cap Desk

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Idiosyncratic stocks to take leading role in IPOs

In this column in April 2020, I pointed out that recent IPO stocks, which had suffered from a series of poor public offerings amid the stock market turmoil caused by COVID-19 fears, were attractive investment targets. Immediately after the article was published, the stock market began to rally sharply due to the unprecedented economic stimulus measures taken by various countries, and most of the IPOs whose stock prices had been stagnant recovered faster than the overall market. Even those IPOs that had virtually stalled for some time resumed in June, and since then until this spring, post-IPO price formation has continued smoothly on the whole.

However, since the start of June this year, the IPO market has not been behaving as expected once again. In June, twenty-two companies fulfilled their IPO, of which four companies' initial share price fell short of their public offering price. In July, too, as a result of the slump in the Mothers market where the majority of the IPOs are listed, more than half of the stocks listed at the time of writing in June were below their initial public offering prices. Even for those companies that exceeded their initial public offering price, on the whole, the growth rate has not been high.

The difference between the current slump in the IPO market and last year when stock markets across the world were suddenly reeling from fears surrounding the coronavirus pandemic, is that this time we are seeing IPOs close below the set IPO price despite the market as a whole remaining stable. It's true that Japanese stocks lag behind the European and U.S. markets, and amongst them the Mothers market is becoming the most difficult to control, but we aren't seeing a total collapse comparable with last spring. The IPO market will always show an amplification of the price movements in the overall stock market, but the current slump seems to be largely due to factors unique to IPOs.

The most significant factor being an oversupply of IPOs themselves. Originally, the peak season for IPOs in Japan was in December during the dash to the end of the year, while there was usually around ten companies conducting IPOs each year in June. Last year, due to market turmoil, IPOs were virtually at a standstill until the first half of the month, and there were only six companies listed. In contrast, against a backdrop of online and mid-sized securities companies strengthening their processes, this year IPOs exceeded investors' capacity to consume them.

As I have always asserted in this column, the concentrated period for launching IPOs is a real nuisance for institutional investors. In the case of companies that plan to go public with an IPO at the end of the fourth quarter, because surveys of demand for institutional investors are conducted a month to 6 weeks prior to the IPO, the schedule conflicts completely with the release of financial statements of already public companies. Especially this time, it was very difficult to adjust the schedule because the demand survey was concentrated in mid to late May period, when the coverage of companies with fiscal year end in March is also concentrated.

In terms of the characteristics of the IPOs, firstly they are mostly small companies. There was only one large IPO with a market capitalization of close to 100 billion yen, and the majority were less than 10 billion yen. The main reason behind the increase in supply is likely due to the strengthening of the structure of online and medium-sized securities companies.

Although this does not necessarily mean that there is an oversupply in terms of sums of money, considering the funds of the limited number of investors interested in IPOs will be spread, the number of companies is of course important. There was a large number of niche companies in a wide variety of industries. In the past few years, cloud computing IT companies have been the main players in the IPO market, but it seems that the range of industries has been expanding again more recently. Of these companies, there were many stocks with strong characteristics, and I believe that in the current context, investors are now being asked to be more selective.

What was most striking was the fact that two companies that place M&A at the core of their business strategy were listed in one month. While there are existing listed companies that have done so in the already mature food and restaurant industries, this time we saw two new companies listed in new fields, including an auto parts subcontractor and a small regional civil engineering and construction company, that have repeatedly gone through the process of M&A and management improvement. It remains to be seen how far these two companies will be able to continue this cycle in a stable manner, but they are attracting much attention as effective business activities that could help sustain the mature Japanese economy.

Mail-order cosmetics and health food product companies are also attracting attention. The widespread use of the Internet has made it easier to appeal to consumers and connect them to actual purchasing behavior. This is thought to be the reason why these industries are seeing fast-growing companies emerge in succession. However, there have also been companies penalised for creating hype, and as the potential for sales activities has expanded, it has become increasingly critical to pay attention to what each company is doing in actuality.

Although it is tricky to lump them together, there is an increase in the number of companies that provide a standardized sales support menu to small and medium-sized companies across the country. There are many small and medium-sized companies that want to introduce new methods to their companies, especially in terms of using the Internet, and this demand is what makes these businesses possible. The Internet is also playing a major role in helping these companies to expand their business nationwide.

Several subcontractor development and temp agencies in the game industry are also listed. Although the industry is considered mature, this is an industry with a large number of growing customers that many people want to join, as such this is a field where growth opportunities exist even for latecomers.

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The four abovementioned fields all offer many opportunities for individual companies to grow in the stagnant Japanese economy. However, there is a great deal of risk in terms of the sustainability of the growth of individual companies, and investors are required to have a discerning eye to select the right stocks. If your strategy is to use the current slump in stock prices as an opportunity to invest in undervalued stocks for the long term, you may be better off with a run-of-the-mill manufacturer.

The IPO market has fluctuated up and down more violently than the stock market as a whole. Although the current downturn is slightly different from the past, I have not changed my view that it is a good starting point for long-term investment in reliable companies.

Source: Based on an article by Tatsuro NIGAURI, published in The Nikkei Online Edition on 17 August 2021.

About Tatsuro NIGAURI, CMA

Mr Tatsuro Nigauri is a Japanese small-cap equities manager with three decades of experience managing money based in Tokyo. He joined the firm in October 2002 and has managed the Japan Equity Small Cap Absolute Value strategy since its inception in 2004 and the UCITS funds since their launch in 2017.
He started his career as a research analyst at the Daiwa Institute of Research in 1991. Mr Nigauri is an award-winning manager and has received many accolades, including the Lipper Fund Awards Japan (2012, 2013 and 2016), the R&I (Rating and Investment Information) Fund Awards (consecutive years from 2012-2019) and the J Money Fund Awards (2016 and 2017). He obtained a BA degree in economics from the University of Tokyo in Japan, and is a Certified Member Analyst of the Security Analysts Association of Japan.

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NOTES:
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