IPO Valuation

Executive Summary

IPO Valuation is an art that is obscured by spreadsheets showing hundreds of statistics. In due course, price – perhaps the most important number – finally gets our full attention. This is the final installment in a three-part series covering (i) the Pros and Cons of an IPO, (ii) the IPO Process and (iii) IPO Valuation.

The IPO market is hot again. Today's flavor – mortgage and related businesses. Following Rocket/Quicken's IPO, many are now considering it. Knowing this, investment bankers are moving quickly through the industry, seeking new and willing candidates.

Companies go through the whole IPO process without knowing the price. Understanding what investors and investment bankers evaluate to determine the price is the best way to set expectations. As Caliber Home Loans, Guaranteed Rate, Guild Mortgage, loanDepot and even AmeriHome Mortgage move through the queue and price their offerings, some may get an unwelcome surprise.

Endurance believes that many of the mortgage banks seeking to follow Rocket/Quicken's lead would be disappointed by their price. An IPO is more often priced attractively for: (i) a bank than for a mortgage company; (ii) more often for a large cap than a small cap; (iii) more often for a tightly controlled company than a flexible one. Endurance Advisory Partners has worked with financial institutions to develop the internal discipline necessary to become a public company. Below are thoughts regarding IPO valuation.

Considerations for determining the offering price

The first step to determining the offering price is to identify key valuation drivers. At the most basic level, price is the product of the company's earnings and its PE multiple. The trick, of course, is to figure out how to estimate the PE. Key valuation drivers typically include both operating statistics and financial ratios.

Operating statistics include:

- Production volume
- Margins by product
- Data about the servicing book
- Prospective growth (organic vs acquisition)
- Risks and opportunities

Financial ratios include:

- Book equity (tangible and gross) and other balance sheet measures
- Net income, cash flow and other income statement measures
- Holding company capital structure (i.e. enterprise value versus market value)

The art of valuation is all about projections of future performance. A careful evaluation of the Company's historical operating statistics and financial statements should provide insight into its competitive position, its suppliers and customers, other industry participants and the impact of economic conditions This analysis not only improves the accuracy of projections but also assists the investment bank in its identification of the appropriate peer group.

Investment banks primarily use prices achieved by comparable companies when setting the price of an IPO.

The first type of prices used are "trading comparables" or current stock prices of similar companies times fully diluted shares outstanding (i.e. after adjusting for options). This is the market value of a company's common equity or its "market cap." Other adjustments are often made for the comps' capital structures. Adding in debt (often net of cash) yields a company's enterprise value.

The second pricing source are M&A comparables. M&A comps are the market cap and/or enterprise value of companies, divisions or assets of businesses that where recently sold in a publicly announced merger or acquisition. Calculations of M&A comps are similar to trading comps except that pricing is static as of the announcement date of the transaction – price does not vary day-by-day.

Valuation multiples (e.g. PE) for all comparable can be calculated. Once peers and peer transactions are identified, it is possible to compare a wide variety of operating statistics and calculate even more financial and operating ratios. The Price-Earnings ratio usually takes the lead. Not just price to earnings per share for the last twelve months, but also for the current year and next year. The second most common multiple is probably market-to-book which is really just price divided by book value per share.

Although an IPO will be priced based on current market conditions, it is common to look at valuation multiples as trends over time to gain an appreciation for stability or volatility as the case may be. Trend analysis is often most valuable when looking at broad indices over a business cycle since multiples for individual companies gyrate with company specific news that occurs from time to time.

It is critical to evaluate similarities or differences in the multiples calculated for each peer. Some high price companies trade at high multiples across the board. High margin companies tend to trade at low PE multiples (after all EPS is high) but high M/B multiples. Conversely, low margin companies may be high PE but low M/B. For every multiple, the analyst's job is to understand why it is as high (or low) as it is. All of this information is useful in determining how your company will be treated.

IPO pricing is typically at a discount to trading multiples. IPOs are often used to reward an investment bank's best customers; the reward comes in the form of an IPO discount. An IPO is usually priced at a 10-15% discount to the expected fully distributed valuation to incentivize investors to buy. As a result, IPOs typically trade up from the offering price, and this ensures positive market perception. When IPOs fall in the after-market it generates bad publicity for the Company. The size of the IPO discount depends sector specific and company risks, expected volatility, and expected liquidity (trading volume).

On the offer date, the IPO price is determined by the strength of the order book. Despite the apparent rigor of the financial projections and multiple calculations, the critical calculation is whether prospective investors

believe it, and belief shows up in actual buy orders. If the book isn't strong enough, the deal will need to be re-priced, priced at the low end of the indicated range or even pulled.

Timing an IPO requires strong and stable fundamentals as well as a strong general market. The Company needs strong fundamentals for next few projection periods in order to report good quarterly earnings for the first few quarters post-IPO. As noted in our second installment, the IPO process takes 4-6 months, so it's really a year or more of stability – a real challenge. No negative news; no earnings surprises; no exceptions. Furthermore, general market conditions must be good to support the deal. With these hurdles, it is fairly common for offerings to be postponed or scrapped entirely.

Considering the amount of "art" that goes into the IPO price, think about it as a price range. Sensitivity analysis can provide information about what price will be achieved at various valuation multiples and financial ratios. This analysis is necessary to fully understand all of the complexities that go into market discovery and IPO pricing.

Summary

Our team at Endurance Advisory Partners can help. Endurance serves as an independent advisor who will work alongside the Company to assist with IPO planning and valuation analysis:

- Assist with development of corporate strategy, risk management plan and key selling points for investors
- Provide analytical support to test and validate underwriter recommendations
- Work with the Company to model and right size IPO and prospective follow-on offerings to align a multi-year strategic plan and capital needs

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