Investment News

Monthly Bulletin from the Insurance & Investment Team

May 2018

Last Month in Brief

In April 2018 it was reported that the UK's economy grew by 0.1% in the first quarter of 2018. This was the slowest quarter of growth since 2012. The Office for National Statistics announced that the lack of growth in the first quarter of 2018 was driven by a contraction in the construction sector, which shrank by 3.3%. Following the announcement sterling dropped 0.7% to $1.3817 against the dollar, its lowest level since March 9th.

The yield on the 10-year US Treasury note reached 2.99% on April 23rd, its highest level since January 2014, almost reaching 3% for the first time since 2014. Similarly, the 30-year yield was also higher at 3.143%, which has been attributed to signs of growing inflation and what is expected to be an impending interest rate rise in the US. Economists have suggested that rising yields may impact global stock markets and raise concerns about rising borrowing costs.

In April, Investment Association UK Equity Income were the top-performing fund sector closely followed by Investment Association UK All Companies on the back of the FTSE 100 climbing just under 6.84%, making it one of the best-performing global indices. Market analysts stated this result was due to takeover talks which occurred in April, in particular the agreed major merger between Asda and Sainsbury.

Chart 1: Equity Indices
FTSE and EMU increased and North America declined.

Chart 2: Sterling Credit Spreads
Credit spreads on weaker rated bonds rose over the month

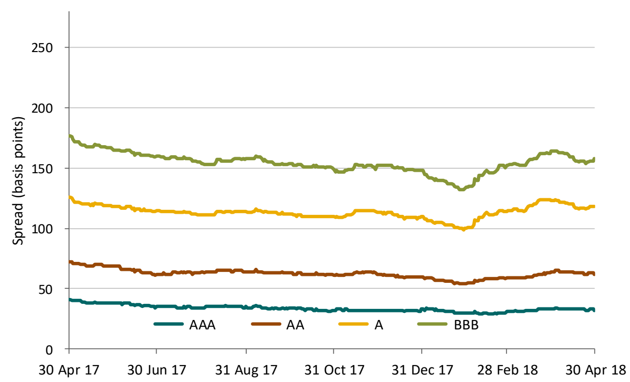


Chart 3: Gilt Yields
Short term nominal yields were stable over the month, other yields fell.

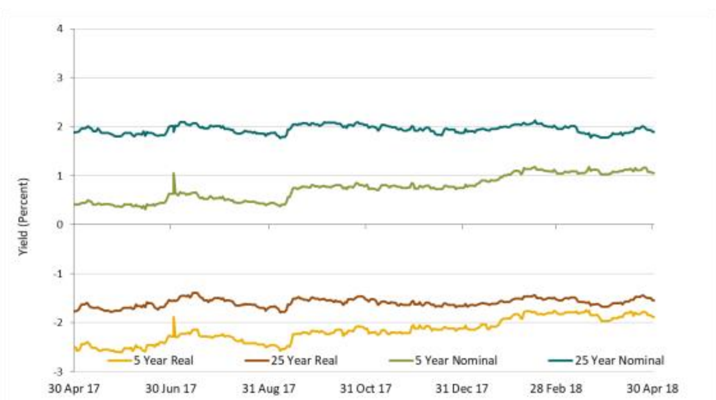
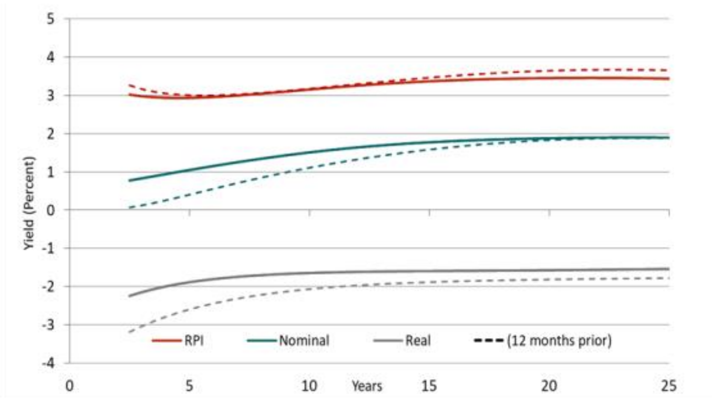


Chart 4: Gilt Spot Curves
The yield curves were stable over the month



Source: Bloomberg, Business Insider, MSCI, Merrill Lynch Bank of America and Bank of England.

	Latest	Previous		Latest	Previous
CPI (annual change)	+2.3%	+2.5%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	93.1%	95.6%	**$/£ exchange rate**	1.38	1.41
Halifax house prices (monthly change)*	-3.1%	1.6%	**VIX (volatility) index**	15.93	19.97

** Halifax have recently changed their methodology for calculating the above figures so the figures may not be consistent with previous updates*

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

Government Actuary's Department, Finlaison House, 15-17 Furnival Street, London, EC4A 1AB **Telephone +44 (0)20 7211 2601**

Initial Public Offerings (IPOs)

In April, Swedish music streaming service Spotify floated its shares on the New York Stock Exchange, in a move which valued the company between £14.2bn to £17.8bn, making it the third biggest flotation for a technology company on record. In this article we look at initial public offerings (IPOs), the most common type of flotation. In particular we look at why companies choose to go public, the IPO process and how Spotify's flotation compares to other recent IPOs.

What is an IPO?

An IPO is when the stock of a private company is offered to the public for the first time. Before an IPO, a company typically has a small number of shareholders, usually consisting of the founders of the company and in some cases professional investors such as venture capitalists. IPOs are commonly used by companies who are looking to raise capital to expand, as well as to spread the risk of ownership among a larger number of shareholders.

There are two types of IPO: fixed price and book building. In a fixed price IPO, the share price is announced before the company goes public, and investors pay the full share price when applying to buy shares. Book building is when the company offers a price band for the shares. Investors specify how many shares they want to buy and the price they are willing to pay. The final share price is determined by an underwriter who analyses all of the investors' bids.

Following the financial crisis, the number of IPOs reduced, but since 2011 the number of IPOs has been steadily rising due to improved global economic conditions (see Figure 1).

Figure 1: Global IPO Activity 2008-2017

Why have an IPO?

The main advantage is that an IPO raises a large amount of capital for the company in comparison to other existing financing options such as borrowing and raising further finance from investors. Other benefits include:

- The company may benefit from lower rates on issued debt, as public companies are subject to strict rules and regulations, meaning they will likely be seen as a more secure investment.
- A public company will typically find it easier to raise further finance in the future from a secondary offering.
- The founders of the company may use the IPO as an exit strategy. Many venture capitalists have used IPOs to cash in on their investment of successful companies.
- There will be a diverse group of investors to raise further capital and share the risk of ownership.

However, going public means that the company has to comply with regulatory requirements, which incurs significant additional costs, in addition to the costs involved in the floatation itself. Furthermore, due to the dilution of ownership the newly formed public company may feel pressured to focus on short term results to ensure shareholders are happy, rather than considering the long term growth of the company.

How does an IPO happen?

The main steps in an IPO process can take anywhere between six months to over a year to complete. First, the company has to choose an investment bank to act as an advisor and underwrite the issue. Underwriting is when the investment bank agrees to purchase any shares not taken up by other investors.

Next, the company will need to ensure it satisfies all the conditions for the listing which may include preparation of a prospectus and a full due diligence exercise. The prospectus is sent to potential investors and will include relevant financial information, the reasons for the IPO and details of the offer. If the IPO is not at a fixed price, the final price will be decided once the orders have been received. The final prospectus will then be submitted and applications for listing will be submitted before trading commences.

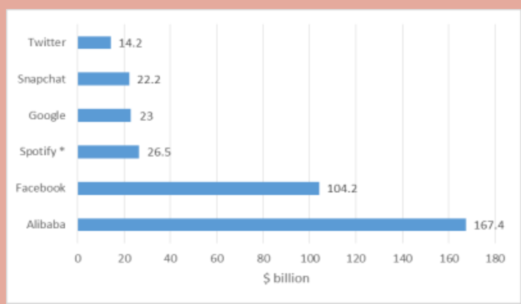
How does Spotify's IPO compare to other companies?

Recently IPOs have been popular with "unicorns"; start-up companies who have reached a valuation of more than $1bn before going public, such as Spotify. Spotify's IPO is unusual in that it is using a direct listing to float its shares. The process is not being underwritten by investment banks, and there are no new shares being issued. By using a direct listing, Spotify is offering its current investors an exit route, rather than raising new capital through creating new shares and diluting the current shareholding.

Other technology companies who have gone public recently include Alibaba, a Chinese online ecommerce company which went public in 2014 and raised $25 billion (see Figure 2). Social media company Facebook went public in 2012 at a value of $16 billion. Both Alibaba and Facebook went public via traditional IPOs which were underwritten by investment banks.

Figure 2: Valuation of technology companies after IPO

Data Source: Wall Street Journal (wsj.com);



* Data from https://uk.reuters.com/

The number of IPOs in 2017 increased by 44% compared to 2016. Experts forecast that this trend is going to continue, with other technology unicorns expected to go public in the future.

Contact Information

Colin Wilson
Deputy Government Actuary
T: 020 7211 2672
E: colin.wilson@gad.gov.uk

Aidan Smith
Chief Actuary
T: 020 7211 2632
E: aidan.smith@gad.gov.uk

Andrew Jinks
Deputy Chief Actuary
T: 020 7211 2655
E: andrew.jinks@gad.gov.uk