# Building on Experience

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“If an investor merely recognizes the way mob sentiment works, he is far ahead of most others. Ordinary people turn over billions of dollars’ worth of their hard-earned money … believing that strangers will give them back even more. Whatever would make them think so?”

William Bonner (*Mobs, Messiahs and Markets*, 2007)

Someone will call
Something will fall
And smash on the floor
Without reading the text
Know what comes next
Seen it before
And it's painful

Things must change
We must rearrange them
Or we'll have to estrange them
All that I'm saying
A game's not worth playing
Over and over again

Depeche Mode (*The Sun & The Rainfall*, A Broken Frame, 1981)

## The Listings Boom: The Euphoric Wave That Will Dump Most Investors

Between November 2005 and the end of November 2007, about 100 companies will have listed on the Johannesburg Stock Exchange's (JSE) main board or the alternative exchange, AltX. Whilst there is much excitement surrounding the wave of listings and individual prospects, in the fullness of time, most of these companies will fail to deliver. Here is why.

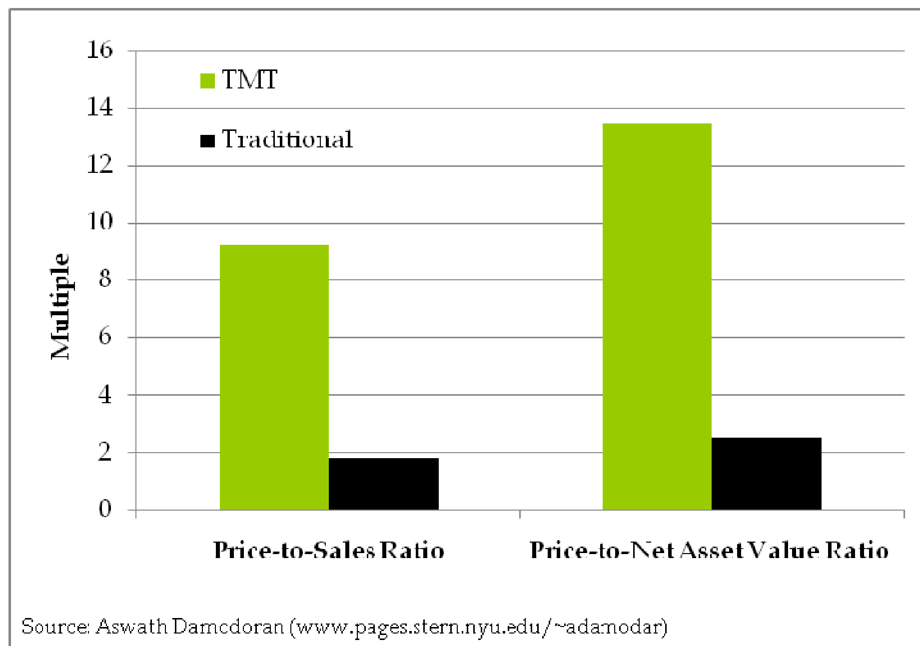
In the two years from mid-1998 to mid-2000, 120 companies were brought to the JSE, with more than one-third of the new listings related to technology, media and telecommunications (TMT), which was the flavour of the day. Nine years on, just 27 of the 120 companies remain listed in a form that resembles the original entity. Further, of the 42 TMT stocks that were listed during the period, just nine have survived. If we take ourselves back to the heat of the moment, though, it would have been hard to convince participants in the theme-driven listings boom that things would turn out that bad. Yet, it is often the case that people abandon good sense as they get caught up in the ideas of the day, and this reminds me of my childhood.

## The Early Years: Why Children Learn and Investors Don't

My early years were filled with a wonderful variety of games. But it was always the most thrilling games – like figuring out how far we could wheelie on a Raleigh Chopper Mk I bicycle – that would cause my mother to come out of the house yelling something like: "this game is going to end up in tears". Of course, the games always were too adrenalin filled for us to heed my mother's warning. Yet, she was invariably right: someone got hurt, and tears followed.

However, whilst children learn from mistakes, it seems that investors often are doomed to repeat theirs. The well-worn example on this front is the TMT boom of the late 1990s. The episode saw investors collectively accept the argument that new technologies would produce many years of abnormal growth in revenue and earnings. The valuations on TMT stocks went stratospheric as a result, with some analysts dreaming up new ways of pricing businesses to support the argument that "this time it is different". Evidence of investor enthusiasm is given by the performance of the Inter@ctive Week Internet Index, a price index of 50 companies classified as deriving their business from the Internet, which increased ten-fold from its launch in 1996 to June 2000. But, it was not only small, young firms that got caught up in the excitement. Technology heavyweights also got swept along.

Consider Cisco, a business that had been listed since 1990, which traded as high as 120 times earnings at the peak of the ratings cycle. To put that figure into context, the market average was 30 times earnings, which in itself was considered extremely expensive. Other measures were as indicative of inflated valuations: at the peak of the cycle, TMT stocks were priced at nine-times annual revenue and 13-times net asset value, which compared to traditional, smoke-stack stocks that were priced at less than two-times annual revenue and three-times net asset value (see the figure below).




But the growing excitement around TMT stocks – and the increasingly stretched valuations - produced some obvious results. As the party had grown wilder, a spate of new listings was brought to market. To wit, while there were no listed firms categorised as Internet companies in the United States in 1996, there were 304 in that category by 2000. But wild parties do not go on forever, and eventually prices capitulated as failed prospects collided with investors' growing recognition that no amount of dreaming makes the impossible possible.

As a result, between the TMT-price peak of March 2000 and the end of that year, the technology-laden NASDAQ Index fell 50 percent and then fell another 50 percent over the next 18 months. At this point my mother would have yelled something like: "You see, I warned you, and you just don't listen."

**Here We Go Again**

It seems that, in characteristic style, investors in South African equities have found a new rainbow to chase: building and construction stocks. The factors behind the argument for buying companies in these sectors are compelling. To start with, four years ago, it was announced that South Africa would host the 2010 FIFA World Cup.

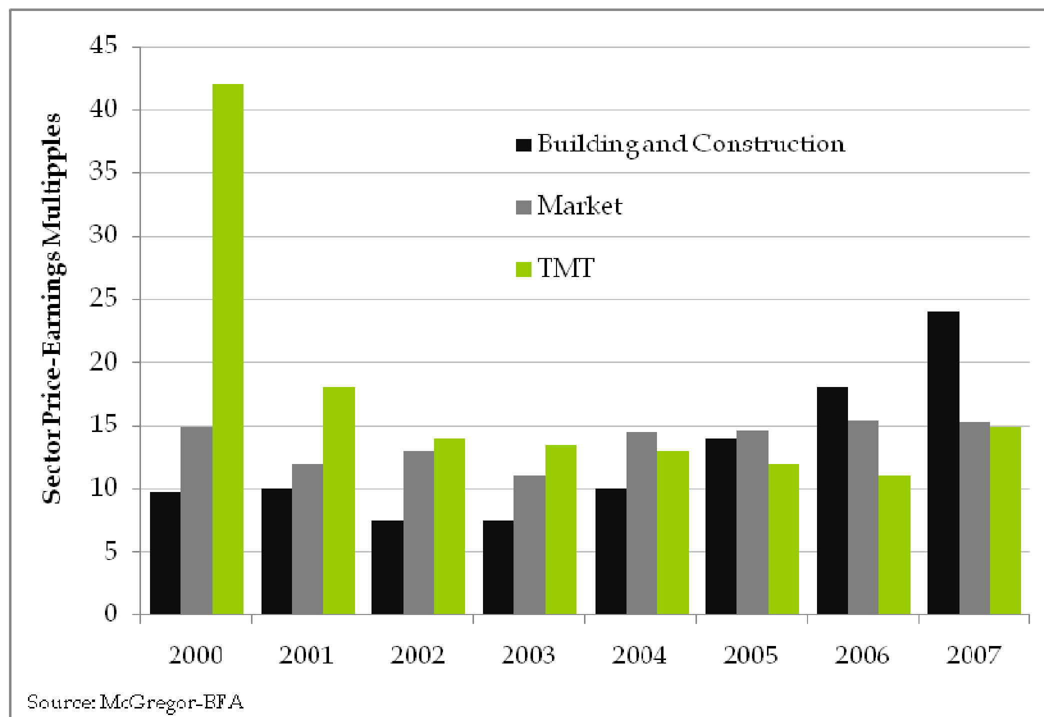
Associated with this announcement, the South African government noted that hosting the event would require a large injection of capital to promote physical infrastructure, which would include spending on football stadiums, airports and roads.

Then, soon after that, investors were met with the further news that the South African government planned to undertake a series of multi-billion Rand projects (summing to over R400 billion in capital spending over five years) to improve other types of physical infrastructure that had been neglected for decades. This included spending on power generation, the rail-freight network, fuel pipelines, hospitals, schools and provincial roads. When coupled with an already buoyant economy, falling interest rates and a domestic housing boom, the upshot was obvious: in 2005 the South African economy stood on the verge of a sustained boom in building and construction.

Since then, the results produced by building and construction companies provide ready evidence that activity and profitability in these sectors has surged. In the case of listed stocks, for instance, between 2005 and 2007 profits have increased by more than two-and-a-half times. Further, growth in profits is expected to continue at an above-average rate for the foreseeable future. As a consequence, building and construction stocks, unloved in the early years of this decade, have enjoyed a substantial rerating. For instance, the market capitalisation of Murray and Roberts, the largest stock in the sector, has increased from R4.6 billion in 2005 to R31.4 billion today. Whilst some part of this is explained by growth in profits (which doubled from R477 million in 2005 to R968 million in 2007), the more significant force behind the increase in enterprise value has been valuation multiples: the price-earnings ratio of less than 10 times trailing earnings in 2005 has increased to more than 30 times trailing earnings today.

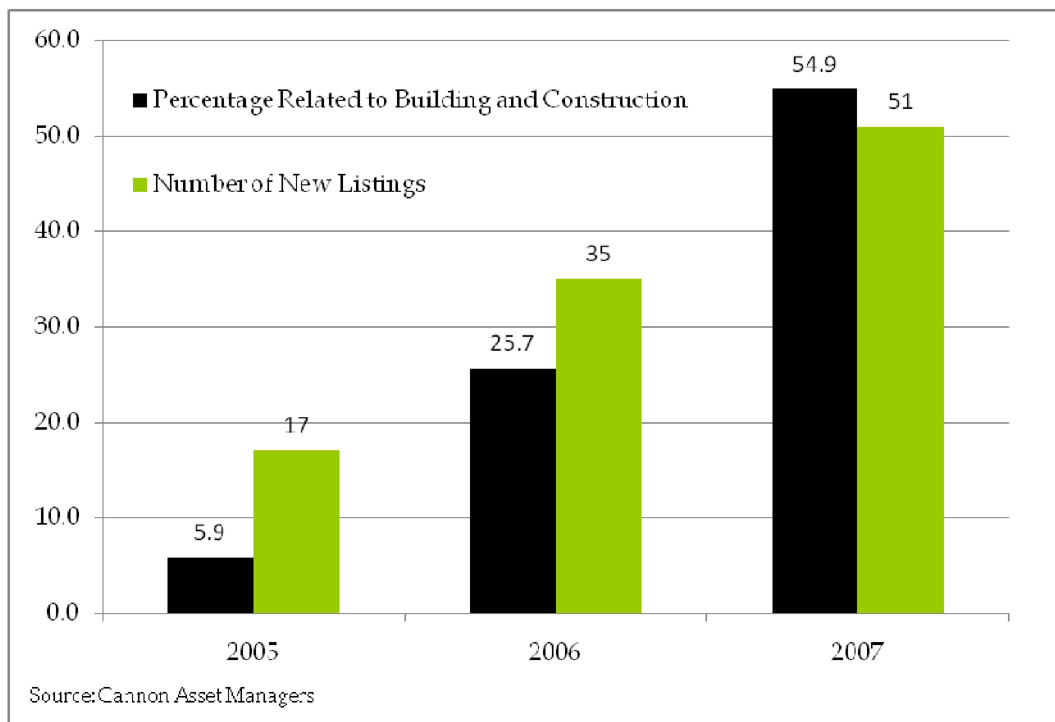
Significantly, as the figure below shows, the increase in valuation multiples is not company specific, but rather sector wide. However, a real sense of the degree of investor enthusiasm is given by comparing the current sector rating to historical figures. To start, whereas the building and construction sector typically has traded on a price-earnings multiple of less than 10 times, today the sector trades at almost two-and-a-half times that historical average. Second, whilst building and construction stocks traditionally trade at a discount to the market, since 2006 the sector has traded at

a premium, with the current premium to the market in the order of 60 percent. As an aside, it is interesting to note that, as building and construction stocks have ascended from their neglected state of the first part of this decade, the ratings placed on TMT stocks have fallen, to the extent that today the sector trades at a discount to the market – a concept that was unthinkable seven years ago.




In short, while the surge in profitability and sound growth outlook for the building and construction activities explain some part of the recent rerating, a more detailed examination suggests that the rerating has a growing element of euphoria. On this front, one of the most compelling pieces of evidence is the spate of new listings in the sector, to some extent reminiscent of the TMT listings boom of the late 1990s. Consider that building and construction stocks make up less than five percent of the JSE's market capitalisation. Converting this ratio to a headcount, it means that only one in twenty companies that come to market should be expected to be related to the building and construction sector. This was the case in 2005: of the 17 new listings that year, one company was related to the building and construction sector. However, in 2006, a quarter of the 35 new listings were companies related to the building and construction sector. This year, more than 50 companies have come to market to date, of which more

than half are firms related to building and construction. In other words, the frequency of new listings related to building and construction is ten times higher than expected (see figure below).




## The Rhyme of History

Of course, in the heat of the moment, there is great excitement over the prospects for these new listings. Some of these companies will go on to achieve great things. Consider the cases of the various successes born out of the TMT listings boom: amongst others, Infowave Holdings, Compu Clearing Outsourcing, Paracon Holdings and Pinnacle Technology Holdings. However, if history is anything to go by, the majority of the new listings will not succeed.

The list of fallen TMT companies is extensive, but a reminder of the excitement is offered by recalling the likes of APS Technologies, Bynx, Computer Configuration Holdings, Cyberhost, Global Technology, Hix Technologies, Infiniti Technologies, Interconnective Solutions, Integrated Technology Holdings, ITI-Technology Holdings, Jem Technology Holdings, Maxtec, MMW Technology Holdings, Netactive, Oxbridge

Online, Prada Technologies, Top Information Technologies, The Internet Gaming Corporation, World Education Technologies, Y2KTEC and the ambitiously named Y3K Group. In each case, the price of the business collapse was paid, in full, by investors – many of whom would have swarmed in to take advantage of the "exceptional prospects" offered by the business in a world that had fallen in love with the idea that the technology boom would run for a very long time.

Coming back to today's love affair, whilst the prospects for building and construction and related business in South Africa are bright, the market has raced ahead of itself. To be sure, the market has agreed to place high multiples on companies involved in building and construction, and owners of these businesses have responded to investors' heightened appetites by bringing companies to the market. Yet, as in the past, the investors who will fare the best will be those who are able to identify the risk that this wave of excitement has brought about. To cite William Bonner (Mobs, Messiahs and Markets, 2007): "If an investor merely recognizes the way mob sentiment works, he is far ahead of most others. Ordinary people turn over billions of dollars' worth of their hard-earned money … believing that strangers will give them back even more. Whatever would make them think so?"

Or, as my mother would have said: "You're being silly. If you just stop to think, you'll be able to avoid getting hurt". But for most, stopping is not fun.

## End Note: Building Value

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