
Give all Private Equity Floats a Miss



Rod Drury is the founder of New Zealand's rapidly growing accounting software business **Xero**. Drury is unhappy about the prospectus disclosures from his Australian competitor MYOB, which plans a listing on the ASX in the next few weeks:

In NZ it is acknowledged Xero has won. If that is the case, investors will want to know if it is going to happen in Australia too. It is hard to know without breaking out the numbers

Drury is probably looking for free publicity. He's pretty good at that. But he's also a bit naive. Us investors don't need any of the finer detail to assess this float. All we need to know is that it is private equity doing the selling.

We're about to jump into some maths but all you need is common sense to reach the conclusion we will reach with numbers. At any point in time, it is either a good time to buy a business or a good time to sell it. Private equity want to sell only when it's a good time to sell. Therefore, the fact that they are selling tells you all you need to know.

Stop now if you don't like numbers. But there's a very useful piece of probability theory that helps us analyse these sorts of situations with numbers. It's called Bayes theorem and is all about re-interpreting a situation once you receive an important piece of information.

Let's start with some prior assumptions. That is, before we receive any information we think

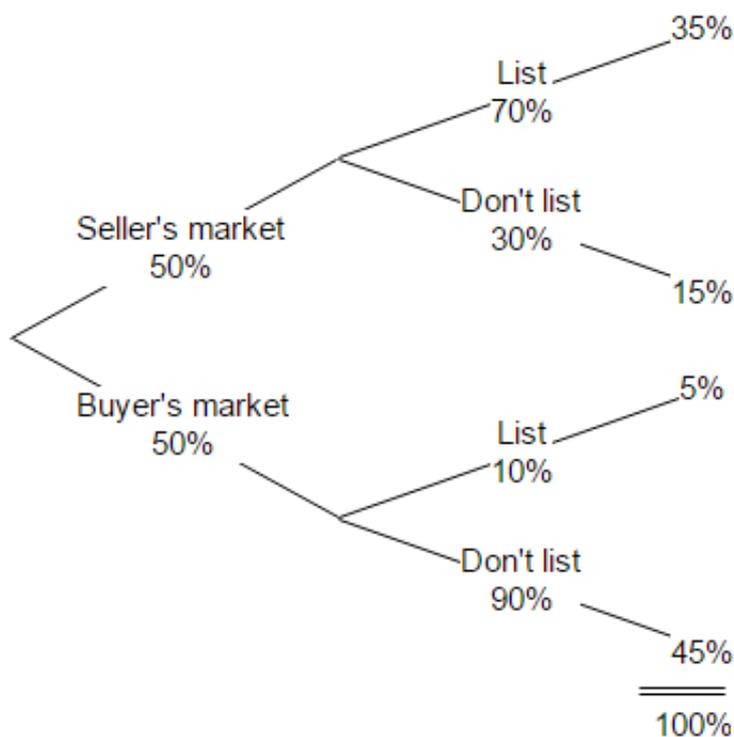
the lay of the land looks like this:

a) at any point in time there's a 50% chance that a business can be sold at a good price to the buyer, and a 50% chance that a business can be sold at a good price to the seller.

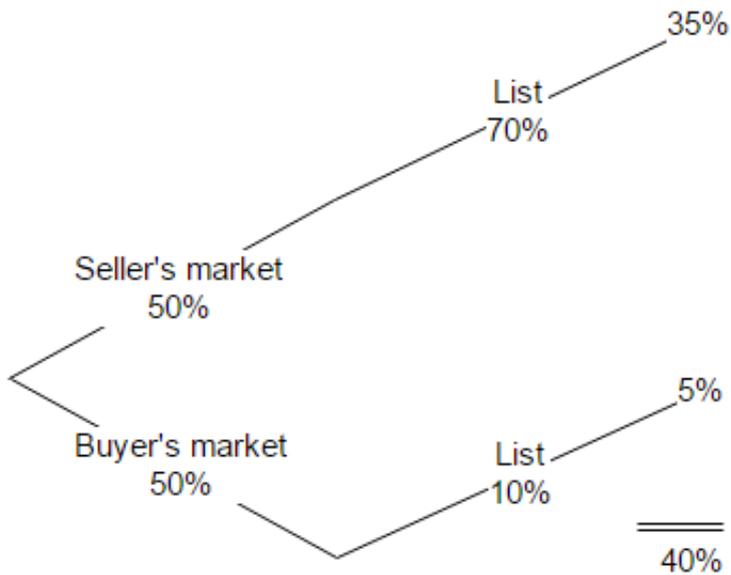
b) In a good market for sellers, private equity will sell their business 70% of the time and keep it 30% of the time.

c) in a bad market for sellers (a good market for buyers), private equity will only sell their business 10% of the time. The other 90% of the time they will hang on to it and wait for a better market.

Of course, we have just made up some assumptions. But we'd guess they are roughly consistent with reality. You can see the probabilities laid out in the probability tree below:



Now, here is the twist. We have been given an important piece of information. We already know that private equity has decided to list the business. That leaves us with only two branches on the probability tree. They are either selling into a good market because it is a good time to sell, or they are being forced to sell into a bad market when it is a good time to buy.



To calculate whether the float is likely to be good for sellers or good for buyers, we simply need to express each scenario as a percentage of the remaining options. So, given we know that private equity have decided to sell, the probability that it's good for the buyer equals $5\% / (5\% + 35\%)$, or 12.5%.

In other words you don't stand a chance. Give all private equity floats a miss.