An Arm and a leg

After dropping for five consecutive sessions, Arm's share price finally dipped below its IPO price on September 21 as investors appear to be souring on it.

Arm’s share price dipped to as low as $49.85, below the IPO price of $51, before finally finishing Thursday’s session 2.3% up at $52.16.

After an 18-month long IPO drought, UK-based Arm was hyped up to be the shepherd of the IPO recovery. Yet, the surprising underperformance is a signal that recovery may be slower than the market had hoped.

In fact, the investors look rather bearish. Ortex, a data analytics company, found that 14 million Arm shares, 8% of the free-float, were on loan as of Thursday. This is up from 5% the day before, suggesting the market has an increasingly skeptical outlook on Arm.

"The short interest at the moment is one of the highest (recently) we have seen a week after an IPO," said Ortex co-founder Peter Hillerberg, speaking about recent short activity for Arm. "It seems to indicate a negative view from some market participants."

The fizzling-out of a Wall Street debut full of spark, at least this early on, is rather unusual.

As the market leader in CPU design, with a history spanning more than 30 years and over 250 billion Arm-based chips shipped to date, the bedrock upon which Arm is built should be very appealing to investors in the tech-led recovery of the equity markets. Its CPUs are about as ubiquitous as it gets in smartphones, having chip designs inside approximately 99% of all smartphones on the market. Moreover, 50% of all chips with processors are based on its technology. Arm’s designs also have a significant presence in household appliances and other consumer electronics like TVs and laptops. It is increasing its presence in cars and data centers. Furthermore, the future of AI will rely on chips and sophisticated design of the circuitry inside their CPUs, which Arm appears to be well-positioned to profit from.

With a large and robust balance sheet, Arm is also a well-established company. The net cash flows for FY23 are valued at around $750 million. Its solid business model, which relies on consistent royalties on its designs, has been a key element it has leveraged over several decades to produce consistent revenues at a relatively low cost. As an additional reason for optimism, Arm announced to investors that one of its primary goals is to increase its royalty revenues, as it seeks to further strengthen the foundation of its balance sheet.

In many respects, Arm appears to have a great present situation and a very promising future with potentially all the indications of a future blue-chip stock on the NASDAQ.

Why, then, has Arm’s IPO done so poorly so far?

One of the reasons appears to be that investors have had their doubts regarding the valuation, which totals at over $50 Billion.

Responsible for the IPO valuation, Goldman Sachs acted as lead advisor, along with J.P Morgan, Mizuho, and Barclays, to Arm. As such, these top-tier advisory houses were charged with making everybody happy.

Yet, they had their work cut out for them. IPOs are a tough business. Advisors are tasked with appropriately gauging interest in shares, and have to cater to clients' demands while pricing shares so investors see upside. If priced too high, investors might hold off. If priced too low, clients won't raise as much as expected. This delicate balancing act can be tipped over if investors can't see past concerns they might have, which makes it very difficult to reach a valuation that keeps everyone satisfied.

In this case, it appears to be a part of the problem. Arm's exposure to China has raised concerns from investors. As of recently, 25% of Arm's revenue came from China. This puts Arm in the firing line of the current geopolitical battle between the United States and China over supply chain security in the chip sector.

Additionally, investors see Arm as a secondary player in the AI space, unlike other players like Nvidia, and will continue to be a secondary player in the coming AI wave.

Cathie Wood, CEO of Ark Invest, is one of the high-profile skeptics of Arm's IPO. The price is one of her principal concerns, seeing Arm shares as overvalued. In an interview with CNBC's "Squawk Box Europe", Cathie Wood explained her reticence in joining the IPO. "As far as Arm, I think there might be a little bit too much emphasis on AI when it comes to Arm and maybe not enough focus on the competitive dynamics out there, so we did not participate in that IPO, and we also compare it to the stocks in our portfolios. Arm came out, we think, from a valuation point of view on the high side, and we see within our portfolios much lower-priced names with much more exposure to AI."

Another skeptic, David Trainer, CEO of research firm New Constructs, wrote in a note on Tuesday: "We believe investors should avoid this IPO, as we see very limited upside ahead. SoftBank is wasting no time by offering Arm Holdings to the public markets, and at a valuation that is completely disconnected from the company's fundamentals."

In spite of all the critics, Arm shouldn't take it too personally. There is a larger trend of recent IPOs failing to live up to expectations. The 10 biggest IPOs in the US over the past four years were down, as of Thursday, 47% on average from their closing price on their first day of trading according to a Reuters analysis of data from LSEG.

Additionally, 260+ IPOs have debuted with stock market values over $1 billion, most of which are in the tech, healthcare, or consumer discretionary sectors. They are down on average 29% from their offering prices and down 49% from their initial trading highs, the only notable exception being GlobalFoundries, which has done 18% better than the S&P 500 since its 2021 listing.

The results so far seem to indicate that Arm has failed to buck a trend that has plagued the IPO market in recent times. Is it still too early to tell, or will this trend continue?

Unless things turn around, IPOs still seem to have a long recovery ahead.