# Investment Banking-The Emerging Challenges in Primary Market

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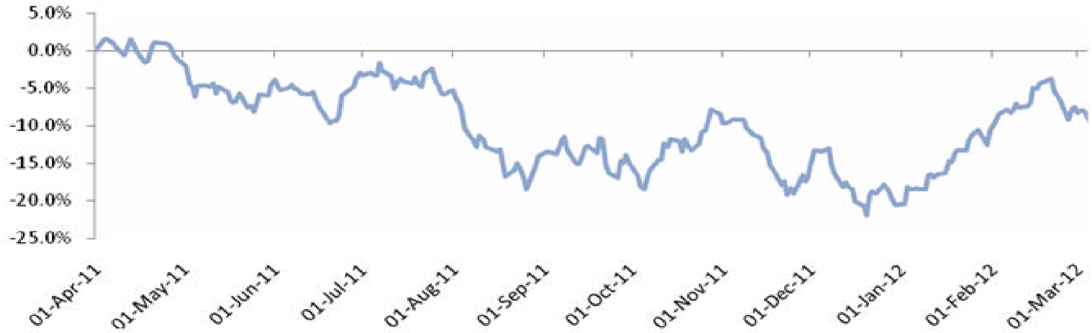
Oscar Wilde once quipped "An idea that is not dangerous is unworthy of being called an idea at all". Perhaps that was more of an aphorism than the author intended. There has been a great deal of trust deficit between issuers and investors of late. Arrangers, who often ideated before entering the markets, seem to be incapable of bridging the gap between expectations of the two sides. And that brings us to the moot point that maybe plain vanilla offerings are now not enough to entice increasingly fastidious investors.

The world at large is suffering a period of economic and geo-political volatility. Our ties cemented during the previous influx of capital flows have ensured that it is not possible to isolate oneself from in the contagion across the financial services industry.

*The state of the Indian Economy*

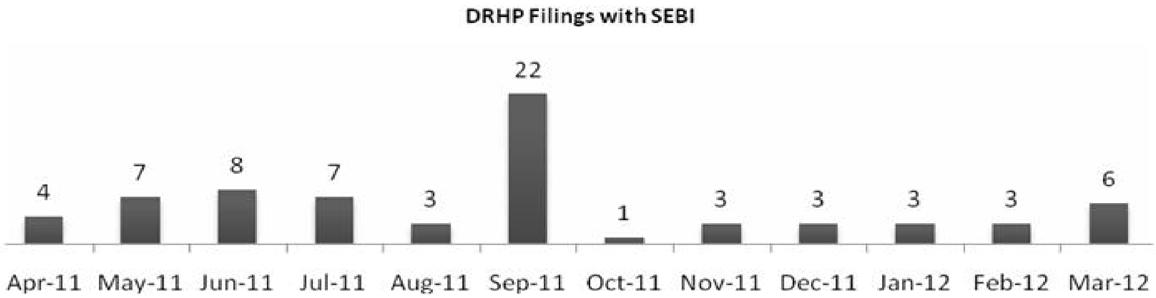
We have been blessed with rising incomes coupled with increase in savings and investment rates in the domestic economy for a significant period of time, barring a few blips. This has led to a higher investment demand in the economy. Although positioned more favourably than its counterparts, the Indian primary market is fraught challenges in terms of identifying risk management issues and speed of regulatory reform.

**Nifty Return over the last 12 months**



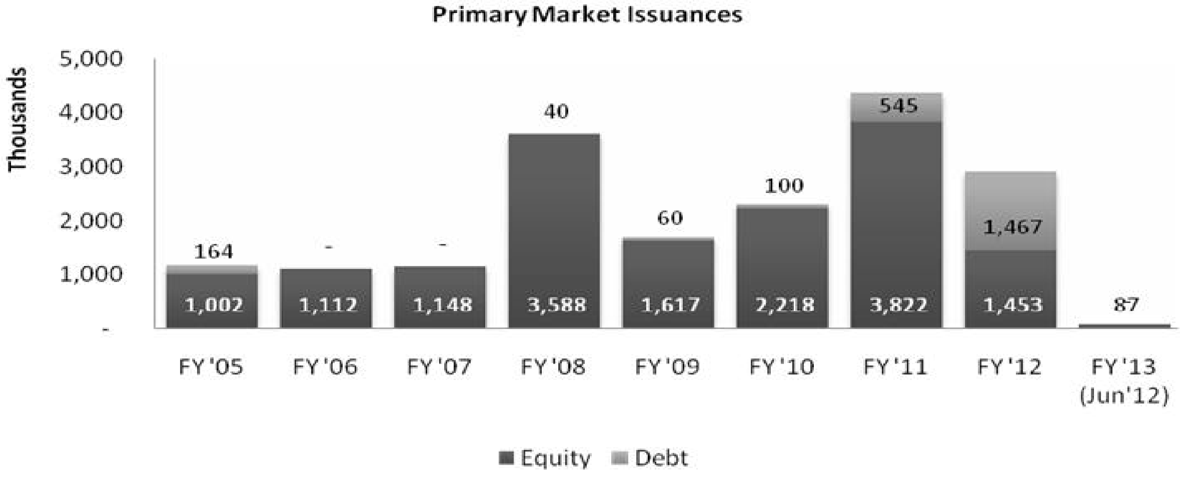

*Source: NSE*

The dynamism, or the lack of it, has taken stakeholders by surprise with the uncertainties and complexities becoming a persisting challenge. The most mercurial approach, involves postulating change over the medium term and thence persisting with existing strategies and minimising investment until a level of certainty returns. The danger is that it may subjugate business opportunities, and therefore render the strategy entirely counterproductive. As is evident from the illustration below, companies are now reluctant to even file their documents with the regulator and seem to prefer to "wait it out".




*Source: SEBI*

With the current economic scenario, supplement in great deal by Greek winds, the risk appetite of investors has become abysmal. The very appetite that fuelled all primary market booms.




*Source: SEBI*

The anaemic global conditions have had a crippling effect on equity issuances, as is evident from the illustration above. About 35 IPOs were called off in the past 18 months depriving those companies of nearly INR350 billion of equity. While there has been a flight to safety, as is demonstrated by the increase in debt issuances, the lack of risk appetite has become endemic. Companies are finding it increasingly difficult to fund their expansion projects with cheaper, long term (read: equity). This, in turn, has resulted in a slowdown in capacity addition, further fuelling the problem.

*The Challenges*

The primary market aids capital formation. The secondary market supplements it by giving the securities liquidity. But our culture has been ingrained with a constant fixation on the market levels. The deeper malaise lies in the fact that a country with one of the highest savings rate does not channelize it to equities as a means of investment. The lure of the returns made on the secondary market are diverting the attention of the investor from investing in companies that are extremely good long term investments.

While there is a plethora of variables that make the primary market a challenging, investor mix, pricing and regulatory environment cover a majority of the challenges:

**a. Getting the 'right' investors**

For a healthy primary market, a vibrant secondary market is essential. Of latea herd mentality has crept into the minds of the investors. For any investment in equity to prosper there are two major factors. One is the price, and the second more important factor is the right mix of investors. Waiting for the stock to list and dumping it on the first day seems to be the approach of a lot of investors these days. Capital appreciation of 5-10% on one day is sufficient for them to sell a stock that they had invested in just 12 days prior to their sale.

This has often resulted in good stocks getting pummelled within a few days of listing and then remaining well below their issue price due to lack of investor interest. While the anchor investor concept in IPOs has ensured some flexibility in choosing investors that are likely to stay with the Company for a longer period, there are some inherent drawbacks. Anchor investors are less likely in smaller issues due to the minimum ticket size, and it's the smaller issues that need such support to ensure longevity of capital appreciation.

Most market participants are of the view that IPOs and Equity in general is increasingly becoming a short term "get-rich-quick" avenue, and when the expected returns are not available, the price falls dramatically, further extending the payback period to the investors left holding the baby. Unlike most developed nations, the IPO market still does not represent an opportunity for long-term investing gains, and this is something that needs to be addressed head on.

**b. Getting the 'right' price**

Pricing, in an IPO, is a tough job. Think of it like the launch of a new product, but unlike the FMCG sector where a price cut would bring customers back, the pricing in the IPO has to be near perfect from the word go. This generally means lowering the expectations of the Issuers to bring it in line with the market expectations. Seems simple enough, but therein lies a problem. Good response in an issue generally indicates that the pricing of the issue has been good. However past issues indicate that this is not always the case, issues that have been oversubscribed multiple times in the last year alone are already trading below their issue price. Not surprising considering the overall fall in the markets, but the quantum of fall in a lot of cases is more than the average market decline.

This is a worrying trend not only for intermediaries who help with the pricing, but more importantly for companies, who will have to learn to live with moderating their expectations. The recent spate of withdrawn IPOs should be looked at as a case where the right price was not achieved rather than dismal market conditions. The happenings in the primary market are actually a reflection of the secondary markets.

**c. Regulatory reform**

We need to reinforce our long standing commitment to adopt and refine regulatory and supervisory standards on a par with international best practices and ensure that their timely implementation. This would not only bring in best practices and strengthen the structure from external shocks; it would also systemically improve productivity and quality of output

This is very essential for foreign funds to continue to flow into the country. Foreign Investment in key sectors such as infrastructure, retail, pharmaceuticalsetc. have been known to pivot on the country's ability to absorb and efficiently deploy the resources without bearing too much of systemic costs.

Economic growth, improvement in the financial sector in the long term and diversification of investment avenues are some benefits that seem to weigh heavier than the concerns associated with Foreign Investment to whom India has slipped in the list of desirable destinations. Further, the reforms needed in this direction would require consolidation in the banking sector since banks would now be exposed to greater risk, and consolidation would help create stronger banks that are both in tune with the direction of reforms as well as strong enough to weather potential problems that may arise.

The reforms should, as it has in the past, leave no stone unturned to encourage FDI, which, by its very nature, is less vulnerable to sudden withdrawals and also tends to promote economic growth, it should be guarded of short-term capital flows and their sources, that have in the past displayed the potential to destabilise financial markets.

**Some thoughts on general measures**

*Encouraging the role of AIBI as a self-regulatory institution*

AIBI was establishedfor providing efficient services and establish standard practices in investment banking and financial services. It was granted the responsibility of exercising overall supervision.The next logical step would be to increase the role of the body so that it does not become disenfranchised in the larger scheme of things. One probable role would be to convert it into a self-regulatory institution, thereby creating increasing the accountability and creating a platform that can ensure that best practices from across the globe are inculcated in its culture.

*SME Exchange*

The Indian Small and Medium Enterprise (SME) market is worth ~$5 billion. A large percentage of the Indian industrial units belong to the sector of small and medium enterprises, and they are expected to contribute 40 percent to the overall industrial output of the country. These enterprises are in constant need of funds, and while debt satiates a part of that appetite, the equity component is not available as an option to a lot of these players as most investors worry about an exit route. Furthermore, there is a general lack of awareness among SMEs about equity capital, stock market and funding options other than banks. The SME Exchange is a platform for companies wanting to get listed and having a post issue paid up capital of less than INR 10 crore. Companies having a post issue paid up capital between INR 10 crore and INR 25 crore have a choice of listing on the SME Exchange or on the main board. The disclosure requirements are similar to a company wanting to list on the main board ensuring adequate transparency needed to take critical investment decisions.I firmly believe that this is the ideal platform and has the potential to bridge the yawning gap between demand and supply of equity funds to the SME space.

*Role of PSU Disinvestment*

Disinvestment is considered desirable for a plethora of reasons, but they primarily belong to two schools of thoughts. The first propagates the inflow of money into the government's coffers augmenting the government's non-debt receipts and, thereby, reducing the fiscal deficit.

The second school of thought is latent efficiency of tapping the equity markets to fund fiscal deficits. In the year substantial offloading of equity takes place, the funds available to the private sector equity would be greatly reduced. On the flip side, heavy government borrowing does exactly the same. On the one hand, disinvestment in PSEs results in institutions and the public at large holding shares, whereas in case of a debt issuance, it would end up with bonds, which would entail a further round of fund raising at the time of redemption.

But perhaps the best argument for an increased role of PSU disinvestment lies in the fact that some of the best sectors, Coal, Oil & Gas and other niche sectors where the Government operates, was hitherto unavailable to the investor as an equity investment option. With the listing of diverse PSUs, latent benefits of efficiencies notwithstanding, the investor has a large menu of sectors to build his portfolio from.

And thence, while there is no easy manner or remedy to meet the emerging challenges facing the primary market, our erudition from the past should act as a beacon for the path we choose to tread.

## SUM UP

During the stressed economic situation in the international market and due to various reasons in the domestic market mentioned in the earlier paras, the capital market raising has become very difficult more particularly in the primary sector. When the industry requires the risk capital to sustain the economic slowdown, the availability of buyont capital market has suffered them maximum earlier due to higher expectations of the sponsorers and now due to the sentiments. The performance of the corporate in some of the industries such as steel, hospitality, textile and infrastructure is already under stress and facing uncertainty of cash flow. The developments in the infrastructure sector such as power, telecom involving regulatory, environmental and due to limited availability of the natural resources has put many of these projects into difficulty and therefore no. of them are looking for equity. The private equity market to a large extent is facing problem of exit because of capital market situation as also rupee dollar parity and lack of fresh inflow of new funds for secondary sale. In such a situation the challenge before us is to evolve new products and instruments to revive the confidence in the capital market and enable the corporate to correct their leveraging. Inducing public savings and international investors for domestic equity investments would require certain fiscal measures as also newer products available with larger cross section of entities such as banks, NBFCs etc. for attracting investments in capital market. Lead to rejuvenate this equity culture will have to be taken under the public initiative so that capital market again revives and some of the public issues are also taken up.

Some issues which need further closer examination would be capital market exposures of banks, products for investment in the capital market available with various entities and further fiscal benefits. Once there is a sentiment change and confidence built up based on few healthy offers from the corporate including leading public sector companies then the possibility of market revival will increase considerably. Indirectly banks are already supporting the corporate in the CDR mechanism and are therefore extending in a way cash flow support. If some hybrid instruments could be evolved which also do not hit the banks provisions requirements and mark to market position, then it may be a useful solution in the current scenario. For strategic international equity capital to be attracted the corporate governance issues and clarity in the internal cash flow and the regulatory stability in the respective sector is very essential. Towards this Govt is already taking no. of steps including relaxing various limits for FIIs. Further, there is need for creating policy frame work for encouraging no. of players in capital market in different sectors such as infrastructure, large corporate SME etc. as the same yardstick on expectation of returns makes it difficult for overall growth of capital market and emergence of long term players. Therefore, for this purpose we require to encourage domestic funding agencies jointly with venture capital entities to evolve their suitable business model based on such policy. Once few such funds are created for SME, infrastructure etc. then we are sure further capital would be attracted, which will go long way to revive the capital market.