# Investment Banking – The Emerging Challenges in Primary Markets

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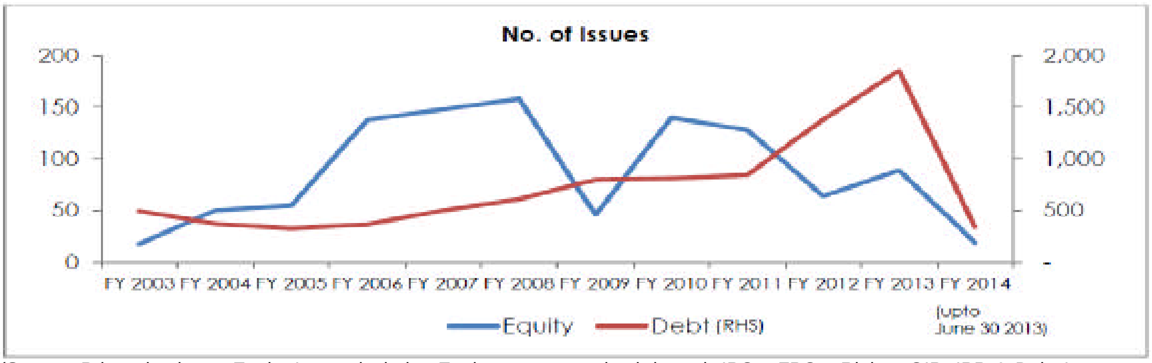
In any economy, the primary market plays an important role in the securities market by forming a link between the savings and investments. It is through this market that the borrower's viz., the Government as well as the Corporates raise funds by issuance of securities, which are subscribed by the investors.

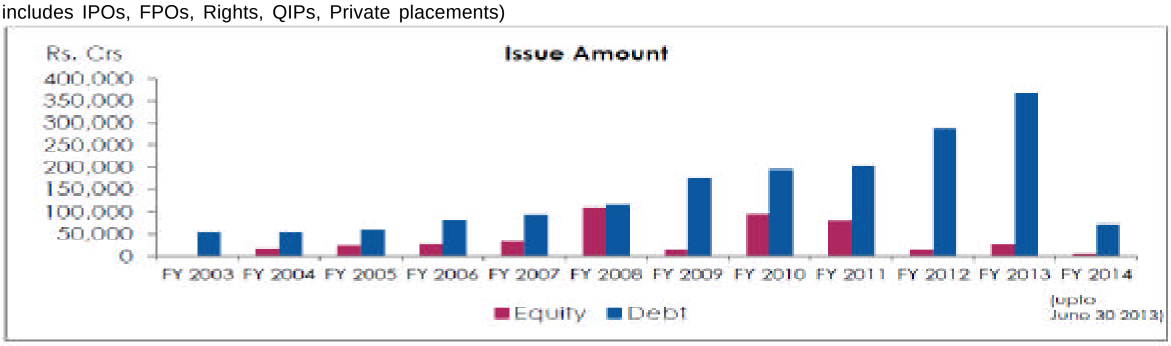
If we go back in history, it will be clearly evident in no time, as to how Primary Markets in India have transformed over the years, especially in last two decades & and also, how it has tapered off, in last few years. Let's talk about some of positive changes first.

Over last few decades, and more specifically after Securities and Exchange Board of India (the "SEBI") came into existence in 1992, Indian Primary Markets have witnessed structural improvement in quality and maturity. This can be seen in terms of quality and size of Companies accessing the Primary Markets today, which has become better. Today, it is nearly impossible for any fly by night promoters to tap public money for any projects or ventures, conceived in their backyard. Further, the entire process of fund raise has been tightened to bring out higher standards of disclosures, encouraging wider participation of institutional investors and making their intent more serious by asking them to bring in their full payments upfront, while ensuring minimum level of reservation for Retail investors, introduction of ASBA, encouraging a seamless mode of investing in IPOs through online platform and electronic refunds, transparent bidding process, anchor investor concept, weed out manipulations hitherto seen in allotments, considerably reducing the time-frame between launch of an Issue to its listing to name a few.

Having said that it would be very logical to assume that Primary Markets have become more conducive for a quality company with strong promoters to raise funds for their genuine business needs and that investors are increasingly gaining by participating in the equity of such quality Companies. However, the reality is worrisome as the Primary Markets are going belly up in recent years, which is evident from following facts.




(Source: Prime database; Equity Issues includes Equity converts, raised through IPOs, FPOs, Rights, QIP, IPP & Debt Issues includes IPOs, FPOs, Rights, QIPs, Private placements)

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Between FY2006 to FY2008, 444 Equity Issues raised ~Rs. 1720 bn from the capital markets, which sharply fell to 281 Equity Issues raising ~Rs. 1215 bn, between FY2011 to FY2013 showing a decline of ~36% and ~29% respectively. For the similar periods, the number of Debt Issuances more than doubled from 1480 to 4080, while the Issue amount increased by almost 200%, from ~Rs. 2922 bn to ~Rs. 8618 bn, which perhaps explains the challenging state of Equity Primary Markets and the increasing leverage levels of India Inc.

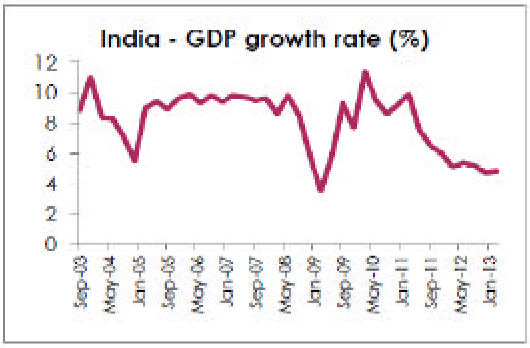
Two contrasting scenarios have emerged. While a few years back, the primary market for Equities was booming like never before, with multiple Issuers lining up every day to hit the markets, merchant bankers and other market intermediaries working overtime to help such Issuers and retail investors in even more hurry to participate in the booming Primary Markets.

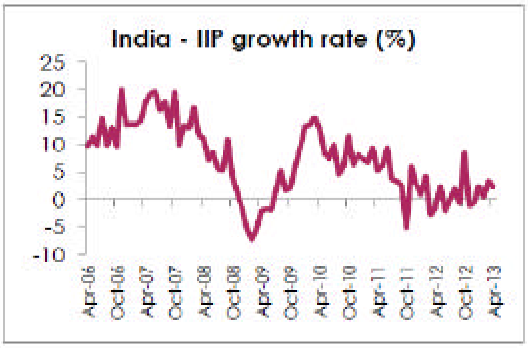
That situation was short-lived and today there is significant reluctance on the part of both Issuers as wells as Investors to come to Capital Markets. For Issuers, this can be inferred by sharp decline in fresh filings of offer documents, many Issuers withdrawing their offer documents, and large number of cases, where SEBI validity has lapsed due inability of Issuers to hit the markets in time due to present state of Capital Markets. As for Investors, clearly they have become more selective about the type of Companies they invest in and are now not easily swayed by Issuers' promises. Infact, it will be not be wrong to state that Investors have stopped taking Issuers on face value and the trust deficit between them has become wider.

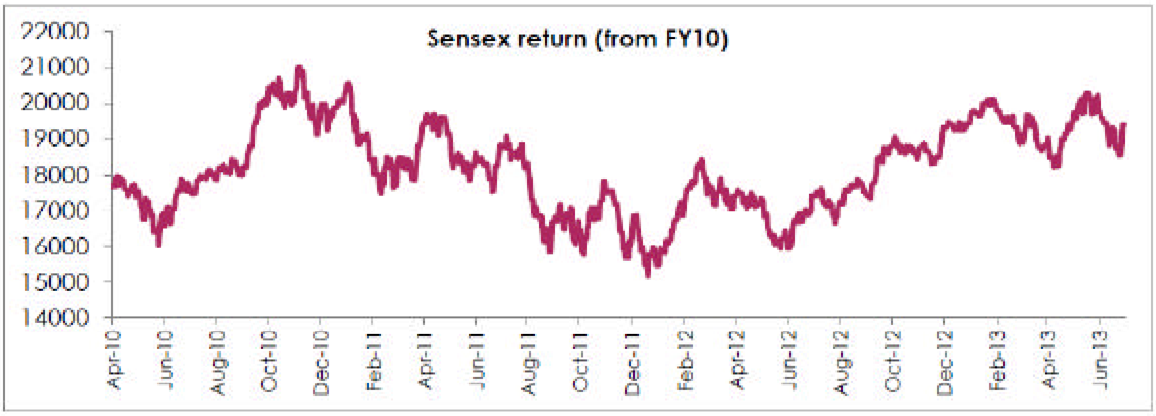
This phenomenon of dwindling Equity Issuances, can be attributed to several factors like external environment, structural issues, increasing gap between expectation levels of Issuers & Investors

**The Challenges**

**Uncertain Economic conditions:** The primary markets are undulating the world over. The incidents occurring in the primary markets are reflections of the scenario prevailing in the secondary markets. Post US sub-prime crisis in 2008, the economies around the world have never been able to recover completely. The global slowdown coupled with other internal factors like government policy impasse, slowing exports, un-ending problems with infrastructure has affected India also which has seen its slowest GDP growth rate recently. The slowing economy along-with host of other internal and external factors have kept Indian Equity markets more or less stagnant over last 3 years, although the volatility has shot up. This highly volatile nature of secondary markets has put off many Issuers from taking a call on fund raising especially via IPOs. Considering the various macro-economic factors, impending elections, the volatility in markets will be order of the day showing an increasing trend going forward, which makes planning a fund raising real tough job for Issuers, as well as Merchant Bankers




(Source: Bloomberg)

**Regulatory Environment:** We need to put in place a conducive regulatory set up, which facilitates and promotes genuine corporates with sound business model to raise funds at faster pace, subject to compliance with minimum regulatory process. We have already seen conscious efforts by different regulators to align their regulations so as to avoid conflicts and contradictions. However considering the number of regulators and regulations we have in our country this has posed a challenge and more work needs to be done to bring them in sync to promote a healthy business environment. At the same time the speed, decisiveness and flexibility observed in the actions of our regulators has matched the global standards.

Our country ranks very low in ease of doing business. Reforms in the regulatory environment are very important step, which will also help in ensuring more Foreign Direct Investment coming to India.

Majority of Indian households do not participate in India's financial markets. Hence, the mobilization of household savings into productive investment in the capital market must also be part of the reforms in the regulatory environment.

**Over-pricing of IPOs:** The perfect pricing of an IPO has been a challenge in any market and a difficult job for Issuers and Merchant Bankers. While it is fair for a promoter to expect reasonable premium for letting a new investor become part of an existing business or asset created by them over the years, it needs to be understood that investors should and will benchmark such Primary market issuances to secondary markets valuations. Therefore, Issuers needs to align their expectation in line with general markets and investors' expectations.

Many IPOs launched in recent years have not only given negative returns on listing day, but also for many months thereafter. In some cases, current market price is significantly lower than IPO price, even after many years. This indicates that somehow IPOs are not priced in line with broader markets valuations and trend, resulting in capital losses for Investors especially retail investors, who are therefore, off-late driven to look out and invest in alternate destinations like real estate, gold, Bank fixed deposits. Regaining trust of such driven out retail investors remains the biggest challenge till today.

One way to protect retail investors can be that they are offered Convertible securities instead of Equity shares in an IPO, which should be convertible within a defined time-frame at the prevailing market price or issue price, whichever is lower or with some other criteria like average market price post listing etc., subject to applicable regulations

**Preference of short term returns over long term wealth creation:** In today's fast paced life and reducing average age of investors' community, an age of instant noodles and smartphones, an age that seeks "instant gratification" and "quick-fix" solutions, it would be erroneous to expect all investors to always think of the long term.

It would be their natural behavioural tendency to make a fast buck. This tendency drives oversubscription, selling immediately on listing and even day-trading.

Sometimes Issuers and intermediaries try to take advantage of this herd mentality and greed of investors by resorting to unscrupulous practices like over the board advertisement campaigns, rumours of significant grey market premiums etc,

The government and regulators should focus on finding ways to inculcate long term investment habit in investors by reasonable policy initiatives and make sure that such corrupt Issuers and intermediaries are caught off their practices before they hit the markets. Safety Net concept is certainly a good step towards it, but needs to be refined further to make it practicable for all concerned viz. Issuers, private equity investors in the Issuers, Merchant bankers etc.

**Providing capital to Mid-caps & SMEs:** Over the years, it is becoming increasingly difficult for small corporates to raise funds, especially through Equity. Infact realizing this situation, SEBI introduced the concept of SME exchange and SME IPO sometime back. But this has not gathered must steam. Since its introduction in FY12, a total of 28 SME IPO have been completed raising ~Rs. 237 crs.

SMEs in Indian context are very critical in the economy, since it has higher employment providing intensity, as compared with automated large scale set ups. With the kind of demographic profile we have, we need to promote and support SME sector in a big way to ensure jobs to our huge and burgeoning working population. We need to direct our savings to such Corporates. While all major banks have dedicated teams focusing on SME, we also need to ensure flowing of sufficient Equity capital to such SMEs. Policy actions should be directed towards ensuring simplification of regulatory compliances for such corporates, reducing paper-work etc. We also need to think of some innovative measures to ensure such corporates find favor with investors, like some fiscal benefits for SME dedicated investor funds, retail investors etc.

**At the End..** Its been a long journey for Indian primary markets, from the restricted regime under Capital controller of India to an era of free pricing under Securities Exchange Board of India. Our markets both primary and secondary have become wider and deeper. While the macro-economic and external factors are not in our control completely, we definitely need to continually improve our processes, systems, regulations to ensure a vibrant primary and secondary markets. Every participant has to contribute in the journey from regulators, by being strict but practicable, to Issuers, by being more reasonable in their pricing expectations and to investors, by bringing a mindset change to have somewhat longer term investment horizon.