The Indian IPO Market

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From a nearly extinct position 5 years back, the Indian IPO market has risen like the proverbial Phoenix from the ashes. And with issuances expected to touch USD 20 bn in the next 12 months, this has truly been a great leap of faith.

Therefore as we stand at the altar of some of the largest IPOs in the history of the Indian capital markets, it may be a good time to look at the road ahead.

One key characteristic that we have witnessed in this period has been the quality of issuances. Unlike in the past, there has been a virtual absence of fly by night operators, which is truly a pat on the back for the regulators and the regulatory system. The mandatory offering to Qualified Institutional investors for issues not meeting certain eligibility requirements has also ensured that the quality bar has been raised higher.

Another feature that one has seen in the issuances has been that the threshold size for successful offerings is constantly rising. A Rs 1 bn issuance which was a reasonably large sized offering a decade ago is now considered a small to mid sized offering. The issues that fall in the sweet spot now typically range from about Rs 5 bn to Rs 20 bn. This is primarily because these offerings (based on a minimum public float of 10%) end up with market caps in excess of USD 1 bn which is seen as a base by many large FIIs and some of the larger domestic mutual funds.

A third aspect of the offerings has been that the over-subscription levels after crossing a certain threshold number especially in the QIB category tend to balloon leading to post listing volatility. One reason for this is that beyond a certain over-subscription number, which is considered successful for an issue, large treasury applications that look at alternative money market returns, end up investing in the issue to make quick returns on the listing pop. And since the basis of allocation is proportionate, when multiple investors of the above kind invest, they cause an upward spiraling effect on the subscription levels. Also since these funds look at short- term returns, the volatility of the stock on listing tends to increase.

A fourth feature witnessed in the current scenario is that most issues tend to get subscribed generally on the last day since there is no premium for putting in applications earlier. This hampers to a certain extent the price discovery process for the retail investors since most bidding by institutions happens at the fag end of the issue.

There is however, a way of overcoming the aforementioned shortcomings, within the existing framework. Very clearly, the focus has to be on rewarding quality investors as well as investors with a longer term focus, whilst at the same time ensuring that the system of allocation remains fair.

We believe companies should have a right to close the QIB book at any time after a minimum period (say 1 day) of the issue remaining open and before the statutory closure of the issue. This would ensure that the quality institutional investors displaying greater faith in the company, bid early and end up getting a more meaningful allocation (on a proportionate basis amongst the bids received).Further institutions that look at only subscription levels for bidding would tend to get left out. The onus therefore would be on investors to bid early. This would greatly benefit the retail investors who would have a sense of price discovery before the closure of the issue. This system would work as a via media between the proportionate allocation system and the discretionary allocation system.

A fifth area relates to the pricing of issues. We have come a long way from the days of the CCI pricing for issues. Pricing of issues is closer to market valuations and investors are increasingly getting attuned to this reality. However pricing of issues still remains an art and is often the difference between the success and failure of an issue; measured in terms of post listing price. Companies that have priced issues leaving some gains on the table for investors have had better listing prices and have also found it easier to raise a second round of funding because of increased investor acceptance.

In the last financial year the total amount raised by way of public equity offerings was about Rs 25000 crores. This number is expected to triple for the current year.

So what does this mean for the economy, the liquidity and the markets?

From a macro economic perspective since the flow of money is being directed into productive investments, this portends well for economic growth in the years to come. A significant portion of the funds raised are proposed to be utilized by the power and infrastructure sectors. Public sector enterprises engaged in the power and power finance business, such as Power Finance Corporation, Rural Electrification Corporation, Power Grid Corporation, NHPC etc have either raised or plan to raise large sums of money from the equity markets. Banks and realty companies' are the other set that have large offerings on the anvil.

The market capitalization of the Indian markets very recently touched the magic figure of USD 1 trillion. As a percentage of the total market cap, the capital raising is expected to be 2 to 2.5%. However in absolute terms the liquidity that would get absorbed would be quite high especially in relation to the past.

The moot question is whether this would have a depressing effect on the secondary market. It is our belief that with liquidity being benign in the global markets and a strong appetite for Indian stocks, the current round of large raisings would be easily absorbed. This is more so in light of the fact that there is a growing feeling that secondary valuations have run ahead of growth. In this sense the primary offerings can be seen as providing an engine for future growth.

In the last few years we have seen fairly marquee names being added to the list of traded stocks. This trend will continue going forward, adding to the growing list of quality names being made available to investors. We have seen and are likely to see this trend across various sectors of the economy.

As a class of investment, despite the secular bull-run witnessed in the last 3 years, mid cap companies have by and large under-performed the markets especially in the last 18 months. We are gradually seeing a momentum build up in this segment. We believe that apart from a few large leaders, the real India story would lie in the mid cap companies. In almost every industry there are quality companies that are growing at envious rates and looking to raise capital for this growth. If we look at some of the industry leaders 10 years back, they were started as mid sized companies. The sheer pace of growth in the last 10 years has seen them emerge as giants in their domain and now looking at growing globally through international capital offerings or through global acquisitions.

We remain optimistic that today's mid cap companies would end up similarly in the next decade. In this context, the primary issuances of these companies through IPOs would continue to have a bright future and the road ahead seems bright.

It may not be out of context to mention that procedurally while we remain on par or better with the rest of the world as far as electronic trading in the secondary market goes, there remains a deep need to automate the process of IPO distribution. Far too much money is spent on paper application forms and there is just too much wastage in the system. This process needs to be made electronic at the earliest.

The last few months have seen the Indian rupee appreciate considerably against the US dollar. On the back of large issues being planned and consequently large FDI inflows, there is an expectation that the currency would continue to remain strong. It may not be too far when the rupee would become convertible and the Indian markets would then truly open up to the world. In this scenario, the possibility of international companies raising money from the Indian markets would not be too far fetched.

In summary, we live in exciting times and the road ahead for the Indian IPOs is truly interesting. The future is expected to throw significant opportunities whilst being challenging. As participants of this process, we look forward to this with optimism and enthusiasm.