Indian IPO Market – The Road Ahead

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The demand for Initial Public Offers (IPOs) is all set to scale new peaks in coming years if the deals in FY'2006-07 is an indication to go by. India Inc mobilized the highest ever aggregate amount of approx. Rs 25,000 crores through equity offerings including IPOs and Follow On Offerings (FPOs) as compared to an aggregate amount of approx. Rs 23,670 crores in FY'2005-06. With this the average deal size too has increased from Rs 232 crores in FY 2005-06 to Rs 294 crores in FY 2006-07 and the year did not have any issues of less than Rs 10 crores

If I were to assess on the parameters such as market depth, market understanding of emerging business, price discovery ability for non-standard business models, innovation relating to financing instruments and governance, it would not be wrong to say that we have indeed come a long way. The Indian IPO market has shown tremendous depth which in turn has made possible large equity issuances like Reliance Petroleum, Power Finance Corporation, Idea Cellular, DLF and now ICICI Bank. These are nothing but signs of the maturation of the IPO market and the Indian capital market in general.

Here it would not be out of place to examine some of the factors that have played a critical role in shaping the IPO market and will continue to shape this very significant capital market segment going ahead.

Role of SEBI

Primary market has immensely benefited from the increased regulation brought in by SEBI. Over the years, SEBI has worked towards systematic reforms – all of which have made the markets safer, transparent and modern. Stringent disclosure and eligibility norms have been issued. Further, various operational procedures for the issuers have been simplified to facilitate smooth mobilization of resources. SEBI is committed to protect the investors' interests and to increase the transparency and efficiency of the primary market.

Some of the important measures initiated by SEBI over the years include tightening of issue norms, introduction of QIP market, improved disclosure requirements cooling off period for companies / promoters against whom action is pending by a regulator etc.

`The tightened norms have also kept fly-by-night operators from taking investors for a ride. Firstly it has become very tough for willful defaulters to raise capital. Secondly, issuers have to tie up means of finance prior to the issue to ensure financial closure of the project for which public money is raised. Thirdly, SEBI has introduced the concept of 'net tangible asset' to ascertain a "minimum tangible existence of the company seeking to access the capital market."

`The book building route has been made compulsory for companies, which do not have eligibility track record. Further, 60 per cent of the offer made by them should be allotted to Qualified Institutional Buyers (QIBs) comprising financial institutions, banks, mutual funds, FIIs and VCs registered with SEBI. Inability to meet this condition would mean failure of the issue. The book- building route has also been made compulsory for IPO's with issue size exceeding 5 times the pre-issue net worth. In these cases also, success of the issue requires allocation of 60 percent of the offer to QIBs.

The market watchdog has also amended the guidelines on qualified institutional placements (QIPs). Only companies with a one-year trading history will be allowed to raise funds through QIPs. However, companies with a trading history of less than six months can go in for a preferential issue as long as they meet certain conditions.

Role of Investment banks

Investment bankers have a major responsibility in the IPO process. They have to ensure proper due diligence in an IPO. A lot of things go into this. As transparency is very important, disclosures have to be adequate and current. The credentials of the investment banker are also looked at when FIIs / QIBs consider investment in an IPO. Each company issuing securities has to enter into a Memorandum of Understanding with the merchant banker, which specifies their mutual rights, liabilities and obligations. The merchant banker has to exercise due diligence and satisfy itself about all the aspects of offering including veracity and adequacy of disclosures in the offer document. All the other formalities like allotment, refund and dispatch of certificates are also taken care by the merchant banker. The lead manager should also ensure that the issuer company has entered into agreements with all the depositories for dematerialization of securities. Investment Banker is a specialized intermediary who understands the requirements of the regulators, issuer of securities and various classes of investors including retail and institutional.

Importance of QIBs

In many cases institutional investors invest in a company before its IPO. While such investment is subject to lockin, it also aids in efficient price discovery process. The retail investors often rely on such QIBs to determine the IPO price. The entry of QIBs including FIIs definitely helps in generating confidence amongst investors in the company.

Most major global investors focused on emerging markets and India, have participated in the recent IPO's. The global institutional investors' response to these IPO's has been extremely encouraging.

Levels of transparency and corporate governance standards by the issuer companies have vastly improved. Coupled with stringent SEBI disclosure norms, the last five years have seen global institutional investors playing a major role towards achieving this. This has also resulted in huge benefits to the shareholders.

Under the current SEBI norms, FIIs are allowed to take part in domestic IPO's under the QIB category. Companies coming out with initial public offer desire FII participation in order to achieve the benefits as discussed above. Similarly FIIs too are eager to invest in quality IPO's.

Indian Depository Receipts

Even as the domestic IPO markets are set to sizzle, SEBI has recently paved the way for global companies to sell its shares to Indian investors. Interestingly, government had given an in-principle approval for Indian Depository Receipts (IDRs) on February 23, 2004. IDRs would allow foreign companies to issue shares in India which will be similar to Indian companies raising funds from the international markets through Global depository Receipts (GDRs) and American Depository Receipts (ADRs).

The clause 49 listing agreement would be applicable to the issuing company. This means, if a company has an executive chairman, at least 50% of its board members should be independent directors. And if it has a non-executive chairman, the board should have at least 33% independent directors.

Investing in overseas equities

The Reserve Bank of India (RBI) in its annual review of the credit policy on April 24, 2007 has allowed any individual citizen of India to invest up to $ one lakh in foreign equities during the financial year, April 1, 2007 to March 31, 2008. Similarly mutual funds registered in India are allowed to invest in equities listed on recognized stock exchanges.

Indian investors are getting the opportunity to invest in foreign equities. So as an Indian investor, one can expand the portfolio by investing in equities abroad. Diversification of investments across different countries / currencies would help reduce portfolio risk. Developed countries have different economic cycles as against developing countries. Thus, their equity markets could follow different timings in peaks and troughs. Same principles hold true for other asset classes also. Blending investments with different market cycles and rebalancing the portfolio at regular intervals is a proven technique for risk reduction and performance improvement. Therefore the Indian investor and Indian stock markets which represent a small portion of the global equity markets will certainly benefit.

Private Equity – a prelude to IPOs

The strong emergence of active private equity players has enabled capitalization of even unlisted companies. Similarly, increased participation of global investors has precipitated understanding of new industries such as organized retail, radio, power trading, wind energy and multiplexes. Industries such as construction and ship building which had been passive until a few years ago have been suitably re-priced by Indian capital when they went through an inflexion point.

Infusion of capital by private equity players in unlisted companies is often a prelude to an IPO and is beneficial in more ways than one. PE brings in an entirely new entrepreneurial culture of transparency and management style, imbibing global corporate governance standards which are required fundamental attributes.

A growing company requires funding at different stages of growth. At the initial stage of growth an IPO is not the right option as valuations may not be requisite. In addition given the stringent listing norms, the company may not be in a position to handle them. As a result the company may tend to lose focus on the big picture in a bid to comply quarterly norms. So a viable option is to bring in a PE investor in the company who can not only infuse capital but also mentor the company till the next stage of growth post which it can go for an IPO.

Once a PE investor invests in a company, the valuations for that company go up in the financial markets. The markets trust the PE investor's name and. is more comfortable investing in the company where an investor is involved. A PE investor invests only after a thorough due diligence on the past performance and the management of the company. A PE investor's expertise will help in bringing about fundamental changes in the company like professionalizing management, systems and processes, corporate governance, access to global technology. It also helps the company to sail through tough times and infuse financial discipline.

IPO grading

SEBI has now made the grading of IPOs mandatory. Companies knocking the doors with draft prospectus will need to get their offering graded by a credit rating agency. The issuer shall be required to disclose all the grades obtained by it for its IPO in the prospectus, abridged prospectus, issue advertisements and all other places where the issuer is advertising for the IPO. Being the first country in the world to have a mandatory grading system needs to be applauded. The fear is that it should not slow down the flow of IPOs.

Busy IPO season

The IPO's market in FY' 2007-08 is all set to witness some of the big equity sale. A number of companies are slated to hit the market with large public issues. Indication as at the end of first quarter of FY' 2007-08 are that the total amount likely to be raised this fiscal would be in the range of Rs 60,000-75,000 core. By the time this gets published, one of the largest IPO's, the DLF issue would have been through, so would have been the FPO of ICICI Bank.

Investors are no doubt set for exciting times with a host of companies planning to raise capital such as Power Grid Corporation, Oil India, National Hydroelectric Power Corporation, Central Bank of India and Bart Earth Movers. Other big IPO's that may raise capital include State Bank of India (SBI), ICICI Holdings (insurance business), UTI Bank and Development Credit Bank (DCB). It is estimated that banks and real estate will account for some of the largest issues.

Conclusion

A trend that has been clearly established is the size and the better quality of IPOs. Stringent entry norms and better vetting by stock exchanges, SEBI and QIBs have hugely improved the quality of issues. Moreover we will see existing companies with profitability trackrecord and in most cases well known promoters entering the capital market.