Evolution of the Indian Primary Markets

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Equity raised through public issues in FY1990 : Rs. 25 bn
Equity raised through public issues in FY2001 : Rs.25 bn
Change over the past 12 years : Zero

After more than a decade, the amount raised through the Indian primary markets have witnessed almost zero growth. Have our markets developed during this period?

While the debate on the benefits of the reform process initiated a decade ago still continues, there is no disputing the fact that the economic environment of India has undergone a radical change. The Indian capital markets have been at the forefront of this process and a snapshot of the activity during the last 10 years provides interesting insights into the evolution of our capital markets. Though the statistics given in the beginning indicate almost no growth in the mobilisation of funds, the Indian primary markets have witnessed tremendous upheaval and have today metamorphosed into systematic, transparent and efficient markets.

During the last 12 years, the average equity funds raised per annum were Rs47bn, with a peak amount of Rs133bn during 1994-95, which amply demonstrate the ability of markets to mobilse significant funds. However, FY1997 onwards, funds raised through debt have outnumbered equity (see Chart I).

The Securities and Exchange Board of India (SEBI) has played a proactive role during this period and introduced a series of measures that have significantly transformed the primary markets landscape. While the basic process of fund mobilisation remains same, we are clearly witnessing two well-defined trends - institutionalisation and integration.

The institutionalisation of the markets has been all-pervasive, driven by significant participation by institutional investors and the evolving mechanisms that now require institutional intermediaries.

Increasing role of institutional investors

SEBI initially introduced stringent entry requirements for corporates, in terms of net worth and profitability track record and also stipulated a minimum dilution of 25% of the post-issue capital of a company. Such conditions restricted many companies from accessing the primary markets, though demand for the paper existed. SEBI has now liberalised the regulatory regime for companies not meeting these requirements and allowed them to tap the markets, provided the IPO is through a book-built issue and at least 60% of the allotment is to Qualified Institutional Buyers (QIBs) i.e. institutional investors like mutual funds, Foreign Institutional Investors (FIIs), financial institutions, banks, venture capital funds, state industrial development corporations and multilateral development institutions. These investors have participated actively in many IPOs and their role is likely to increase in the future.

Introduction of book-building

The introduction of book-building process by SEBI was a landmark event and subsequently many companies have successfully used this route to access the market. Introduction of book-building has had two major benefits: (a) market participants now have an efficient mechanism used internationally to raise funds; and (b) investors are more integrated into the process and now play an interactive role in the pricing and the success of the IPO. Though the current mechanism allows only up to 90% of the IPO to be executed through the book-built route with the balance 10% through a fixed price issue, introduction of 100% book-building is expected very soon. The book-building method involves the use of the stock exchange trading system for the bidding process; and the collection centres have shifted from banks to brokers with a wide distribution network.

Dematerialisation

In addition, stocks issued through an IPO have to be in dematerialised form, requiring depositories to be part of the IPO process, thus resulting in further institutionalisation of other intermediairies. Many of the large IPOs today are through the book-building process and involve significant underwriting requirements from the merchant bankers. This activity has, thus, been restricted to less than a dozen large, well-capitalised merchant bankers capable of undertaking/ arranging significant commitments.

SEBI has also introduced guidelines for IPOs through the stock exchange mechanism. Though this method is yet to be tested in the markets, the trend is towards greater institutionalisation of the primary markets.

Reforms in the secondary market

The changes in the primary market environment are part of the ongoing reforms across the capital markets. The secondary markets have experienced tremendous upheavals and the wide sweeping changes witnessed over the recent past have transformed the market structure. Indian markets today have a striking resemblance to markets in developed countries. The following developments have lent an international character to the Indian capital markets:

- Compulsory dematerialisation of stocks for trading;
- Imposition of rolling settlements in all leading stocks and ban on carry-forward deferral products;
- Introduction of trading in derivatives i.e. index futures and index and stock-based options;
- Introduction of code relating to corporate governance;
- Increase in limits on investments by FIIs from 24% to 30% of total equity of a company, with an option to raise it to 49% upon approval by shareholders;
- Permission to mutual funds to invest in American Depository Receipts (ADRs)/ Global Depository Receipts (GDRs) up to 10% of net assets managed, subject to a maximum of $50mn per mutual fund; and
- Two-way fungibility in ADRs/ GDRs.

Not only this, pick up any recent IPO prospectus and what you see is an offer document comparable with documents available in most of the developed markets worldwide. The offer document today is a far cry from the prospectus prepared five years ago, which contained a handful of pages and scant information. The stringent disclosure norms stipulated by SEBI have transformed the prospectus of yesteryears into a very comprehensive, transparent and detailed document that serves as useful reference to investors.

Access to international markets

Just as foreign investors have participated in Indian primary markets, so also Indian companies have successfully tapped international markets. The GDR markets in Europe have long been favourites among companies but, since 1998, the trend has been shifting towards the ADR market in the United States (US). While the GDR market has the advantage of acceptance of Indian accounting norms, the ADR market requires reporting of financial statements based on US GAAP (Generally Accepted Accounting Principles) or International Accounting Standards (IAS). Given the current level of disclosures required in the offer document, adopting IAS is a small step forward for most companies seeking a US listing. In addition, such a listing provides significant visibility and is an effective tool for equity financing in Mergers and Acquisitions and ESOPs in the US subsidiaries. While Infosys opened the floodgates with its maiden US IPO in 1999, many technology companies have subsequently raised funds, with listings on the New York Stock Exchange (NYSE) or the Nasdaq. The opportunities haven't been restricted to the technology sector, which has been followed by the financial services sector with successful listings by ICICI Limited - the first Asian (non-Japan) Financial Institution to get listed on the NYSE - and ICICI Bank Limited.

This trend of integration has had far-reaching impact on the fund raising plans of many corporates. At a time when the retail investor sentiments have been low, a few corporates have been able to raise equity through the ADR market. In first seven months of 2001, there have been only two IPOs while, during same period, there have been three ADR issuances, raising more than Rs20bn ($426mn). Though Indian markets are smaller in comparison, the domestic markets have kept pace with international developments, enabling quality issuers to raise sizeable funds at comparable valuations. For example, the IPO of Hughes Tele.com was the first of its kind from a private-sector telecom service provider and successfully raised Rs7.5bn for an infrastructure project that entailed significant capital expenditure and a long gestation period. Such deals clearly demonstrate the ability of our markets to support companies to raise funds even in difficult market conditions. Needless to say, Indian markets have come a long way and are truly integrated to the international arena.