Indian Primary Markets : Challenges in Distribution

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The most familiar lament of the retail investor in India has been that like a proverbial cop in a Bollywood movie – he arrives when the party is over. Or at least this has been the trend. But events in the recent past point the other way.

Currently, retail investors seem to arrive at an appropriate time in the markets – through the IPO route. Though IPOs have a built-in risk as an equity instrument, within the equities universe the IPOs are arguably less risky. Also, the prices of an IPO issue are dynamic and linked to market realities – and hence investments in IPOs can be done without any detailed knowledge or study of the markets, as in the case of the secondary market. Therefore IPOs play a very important role in ensnaring the first time investors – and thereby help to expand the equities market as a whole.

IPOs are good for the broking business too. Newer public issues get distributors into the public eye and several of these IPO subscribers turn into regular customers – a win-win situation from the brokers' perspectives.

The time has come for the market players to take their roles seriously in an industry that is in a consolidation mode. Appropriate pricing of IPOs, organised distribution processes, a large merchant banking community and wider reach – seem to have come together for the first time in the Indian primary market.

A slew of IPOs bode well for the primary market as a whole – as markets evolve only with expanding retail participation. Though retail investors usually follow the trends set by the qualified institutional brokers.

It is our view that FY06 will also see a healthy flow of IPOs through the year. However, the regulator will have to play an important role and ensure that every fresh equity issuance passes through the mandatory checks and filters so that only quality gets approved. It will be equally important for a merchant banker and the broker community to educate the investors on the positives and the negatives of an IPO.

Two landmark primary market issuances in 2004, in terms of quality of the companies issuing fresh equity and the quantum of retail responses were the National Thermal Power Corporation and TCS. The TCS IPO received a staggering 12.5 lakh responses while NTPC attracted 14.3 lakh applications.

The trend of an expanding primary market in FY05 was clearly visible through 2004 as mop up of public issues rose 5x since 2001 to Rs.35, 859 crore. Additionally, the growing sophistication and dept of the market was also seen as a slew of very large issues hit the market and the average IPO size rose from Rs.31 crore in 2001 to Rs.870 crore in 2004.

Also, considerable issuances took place through private placements. Meanwhile, the public debt market continued to languish at low levels in 2004 with the bulk of primary issuances of debt securities taking place through private placements.

Table 4.2 : Primary market

(Rs. crore)

	Calendar year			
	2001	**2002**	**2003**	**2004**
Debt	4,916	3,451	3,790	2,383
Equity	726	2,373	2,892	33,475
Of which, IPOs	525	1,981	1,940	22,611
Number of IPOs	17	6	13	26
Mean IPO size	31	330	149	870
Total	5,643	5,825	6,682	35,859
Number	48	28	42	65

Source: SEBI.

The mutual fund industry (including IPOs) has slowed down in the recent years, with assets under management stagnant at Rs.1,50,537 crore in 2004. While IPOs of mutual funds attracted enthusiastic subscription, the total assets of the industry were stagnant. Stagnant total assets in the industry, along with enthusiastic subscription to mutual fund IPOs, indicate that money is being churned between schemes.

Means of distribution:

The players in the distribution space of the primary markets are active with initial public offerings through equity, fresh issuances of mutual funds, RBI bonds, tax saving bonds and fixed deposits.

Distributors sell these primary market instruments through

1) Physical distribution of IPOs through its branches, franchisees and channel partners
2) Online through the web

Fixed price versus book building

A major development in the Indian primary market in the last few years has been the introduction of "screen based book building", where securities are auctioned through an anonymous screen based system, and the price at which securities are sold is discovered on the screen. This eliminates the delays, risks and implementation difficulties associated with traditional procedures. It is reported that resource mobilisation through book building rose steadily from 25% of public equity offerings in 2001 to 53% in 2002, 64% in 2003 and 99% in 2004. In this process, the primary market has matched the secondary market in terms of using technology to achieve an impersonal system of price discovery with widespread retail participation across the country.

Challenges in distribution

The investor base in the primary market is divided into three: 1) the retail investor (below Rs.1lakh), 2) the high net worth investor (HNIs who can invest above Rs.1lakh) and 3) the qualified institutional brokers (QIBs).

The biggest challenges in the distribution business today are posed by timelines. The entire process of IPOs – from issue opening to allotment (where-in subscription forms from all the three types of investors are collected and processed) is to be completed within a 15-day span.

Therefore, market dynamics and timelines create a lot of pressure on the distribution chain when an IPO opens for public subscription. The distribution channels tend to concentrate on the mere distribution and logistics rather than attempt at reaching a wider market or educating the investor.

Do alliances hold the key to successful distribution:

The bigger players in the distribution business are facing fierce competition while the smaller players are trying hard to stay on as technology, competition and corporatisation are re-writing the rules of the game. Also, the severe time constraints have made it necessary that a broker has several channels to conduct business and widen reach.Branding too has become very important as firms try to cut through the clutter with the help of a differential.

Smaller players were finding it difficult to cope with the expenses of research, investor seminars, and aggressive advertising - commonplace necessities in today's broking business. In this scenario, many on-the-brink brokers have traded independence to enter into an alliance with established brokers.

As aggressive branding by bigger and corporatised broking house is a distinctly visible and intensifying trend. Their associations with big brands aid the small time distributors of equity in terms of credibility while clients get quality guidance, research and service from big players.

Big brokers, on their part, are getting aligned to several smaller brokers to form alliances and channels of distribution. This distribution model based on alliances is immensely feasible due to the cutthroat competition and secondly due to the easy availability of brokers and sub-brokers aligned to the regional stock exchanges as franchisees.

These factors have altered the modalities of the distribution business in India. The big and branded brokers are best placed in terms of distribution to aggressively target high net worth individual who are offered personalised advisory and consultation services. These facilities are provided online or through branches offering personalised solutions.

The next stage in the distribution business will see brokerages transforming themselves into one-stop financial intermediaries.

Technology:

In the current scenario, the role of technology in distributing primary market instruments is very limited. Though distribution processes per se haven't been affected by technology – it has become a focussed business today as brokers choose their customers with the help of readily available data.

In the distribution business, technology has helped create geographical touch points for investors. For example, a retail investor from a small town is able to go to a broker's office and log in his subscription number. This has increased the reach of brokers across India

Also, electronic trading has made it possible for retail investors to subscribe to IPOs on-line. Companies today aggressively market their primary market offerings through the web and brand power makes up for the impersonal nature of online trading.

The broking business (especially distribution) tends to invest into data storage and data mining technologies – as it helps them tap the high network individuals on the basis of their investment patterns, credit history and preferences.

If SEBI has its way technology is all set to play a bigger role in distributing primary market instruments with the e-IPO, as explained below.

Efforts of the regulator:

The Securities and Exchange Board of India had set up a market infrastructure leveraging expert task force (SMILE) under the chairmanship of Dr. PJ Nayak to look into widening the reach of the distribution network in the primary market, especially mutual funds. SMILE was set up as SEBI also felt the need to upgrade the current infrastructure of the stock exchanges. SMILE has submitted its report "Infrastructure and Process Flows for Enhancing Distribution Reach in the Mutual Fund Industry" to SEBI and has recommended e-IPO as the way forward.

The way forward

SMILE has proposed electronic means to subscribe to an IPO. In the e-IPO way, an investor will subscribe to a fresh issue by filling in a form available on the regulator's or a broker's website. The application form along with the application money will be submitted online. He can also withdraw or modify the bids online. After the issue closes, the investor will receive allotment of securities or refund for unsuccessful bids on paying in or payout day.

The broker's role in e-IPO is described as follows. He has to open a primary account with the clearing Bank of the exchange and accept all forms provided by investors, along with the entire application money. He has to enter the order on behalf of the investor and provide a transaction receipt slip with an application number to the investor. The broker will receive fees for these services from the issuer.

In practise, these recommendations will go a long way to ease pressure off the existing distribution system. The e-IPO route will ensure reduced timelines that will result in a reduced market risk. This will widen the investor base with higher retail participation and help the primary market to expand.

In the coming years, we are likely to see the Indian markets increasingly aligning to the global economy. The size and the depth of the primary market is all set to expand – along with more number of IPOs, larger mop ups by IPOs, and huge target customer base. This is going to increase the responsibilities of the intermediaries in the market in terms of business operations and inculcating ethical business practises.

To conclude, we see humungous opportunities in distribution and dispensation of market knowledge in the form of advisory services.