Institutionalisation of Primary Markets

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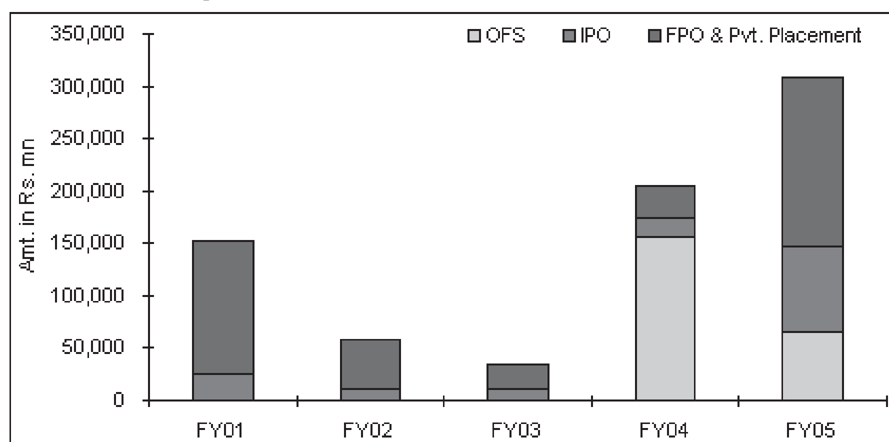
That some should be rich, shows that others may become rich, and, hence, is just encouragement to industry and enterprise. President Abraham Lincoln

It is said that the stock market is a barometer of current corporate health and economic trends. If that be so, the primary market must surely qualify as an apt indicator of the longer term growth and competitive outlook for India. Clearly, the quantum of fund raising by India Inc, the vote of confidence by investors (reflected in price discovery through book build, extent of oversubscription) and the post-listing performance are key factors to watch. Be that as it may, it is important to note that unlike in the capital market, in the real world there is an inevitable time gap between raising funds, implementing projects and generating returns. To that extent, a diverse, deep pool of long-term money is a *sine qua non* for sustaining a vibrant primary market. And, in the present phase of the evolution of our capital market it suggests that greater institutionalization is probably the only answer, at least till such time the allocation of household savings towards equities attains a critical mass.

In this article, we have analysed emerging trends in our primary issuance market, carried out a comparison vis-à-vis global benchmarks and attempted to prognosticate a roadmap towards creating a vibrant yet balanced primary market process and set-up that dovetails with the burgeoning demand of India's economy for funding technology, entrepreneurship and infrastructure.

Since India's tryst with reforms and integration with global trade and financial markets began in 1993, the primary issuance pie has undergone significant shifts both in terms of quantum and sectoral composition. In a way this has largely been in sync with the way the economy and India Inc's strategic thrust have shaped up. For instance, during FY93-97 saw the infusion of US$15bn of equity into India Inc (on an annualized that represented 8.3% of the then market capitalization of the BSE) in the first flush of exuberance post the easing of license raj. Subsequently, there was a lull in issuance (barring the TMT boom in FY00) as this capital was put to use and simultaneously corporates restructured to rejuvenate their competitiveness vis-à-vis global benchmarks. More recently, FY04 witnessed a fillip for the government disinvestment programme resulting in the 'offer for sale' market coming of age. Effectively, in the past two years, offers for sale account for over one-half of the total primary market pie. On the flip side, an encouraging trend is the pick up in amounts raised by way of follow-on public offerings including rights issues. Clearly, with corporates into the 2nd capex wave in the post-reform era, the uptick must accelerate substantially as FPO mobilisation of Rs 121bn over FY02-05 is well short of the Rs 208bn peak during FY94-97.

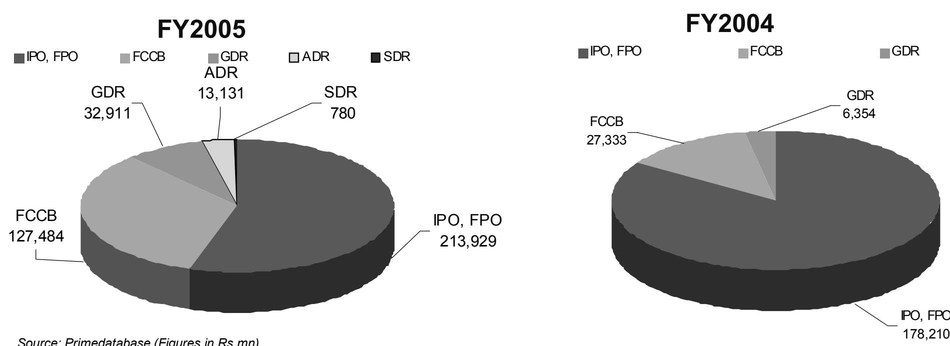
Chart 1: Primary market mobilization trends



Source: Prime Database
Note: Pvt. Placement data for FY05 is for April 04-Feb 05

Two other aspects merit highlighting - the emergence of private placements as an effective alternate and the venture capital wave finally lapping Indian shores. It is also heartening that funds from these avenues are now flowing to a diversified set of sectors - beyond the conventional IT-biotech-media domain – including core infrastructure, retailing, auto ancillaries, textiles. A quick analysis shows the inclusion of Rs.139bn of funds raised through private placements in FY02-05, completely bridges the FPO gap mentioned earlier.

On the much debated issue of 'export of the capital market', it is pertinent that share of overseas offerings (read ADR/GDR) has actually declined in percentage terms from the peak of 66% in FY2002 to 18% in FY05. Be that as it may, the recent bull run coupled with a favourable foreign exchange and interest rate perception has resulted in the FCCB (foreign currency convertible bond) instrument coming into vogue. FCCBs saw a near five fold jump in issuances with more than 30 companies tapping into these markets. Along with FCCBs, the overseas capital market captured a 45% market of total funds raised through capital markets. Further, 'overseas listing' avenues have expanded beyond Luxembourg, London, NYSE and Nasdaq with Singapore Stock Exchange, Hong Kong, Dubai etc emerging as the new destinations.



Source: Primedatabase (Figures in Rs mn)

Another question raised of late is whether the primary issuance pipeline in India is bloated, out of sync with the economic undercurrents and could potentially derail market sentiment. One cannot but disagree on this score, both in terms of assessment relative to the global IPO market and in relation to the cusp at which India's economy is poised. Clearly, there is no evidence of any irrational exuberance. A comparison of India's share of the global IPO issuance market suggests that we have just nudged up to 0.9% (from 0.4%, four years ago) despite the nearly five-fold surge in actual amount raised. Even within Asia-Pacific, we continue to be minnows with just a 4.6% share. In fact this data brings a serious issue to the fore – is India Inc adequately funded in terms of equity to actualise its growth ambition both in India and across the globe.

Taking the argument a step further, the immediate task on hand is, therefore, to facilitate access for India Inc to the right quality and quantum of equity resources. And, given that Indian households, despite high savings rates, almost shun the capital market (as a % of Gross Domestic Savings the flows have dipped from 4.5% in FY97 to 2.3% in FY03) and equity AUM of domestic mutual fund industry is yet to surpass the March 2001 level, the dependence on institutional investors (both domestic & foreign) cannot be over emphasized. An important statistic – as of March '05 aggregate FII holdings in the Indian capital markets at US$57.3bn are almost double that of the domestic institutions' (FIs+MFs) and together they account for just over a fifth of India's m-cap.

Is this too high a concentration? A quick analysis of the aggregate shareholding pattern of listed companies in India, Korea, China, USA and Brazil reveals that the ownership of institutions in India is the lowest versus well over 50% in other markets. Given the favourable tide of FII flows and the QIB reservation of upto 50% in IPOs, the overall institutional ownership is rising but only gradually. Evidently, the scope for deepening institutional participation through say PSU disinvestment, listing of large privately held corporations and simultaneously gravitating household savings towards equities is immense.

To recap, the retail response to regulatory changes that raised the allocation share in IPOs (to a minimum of 35% from 25% earlier) has been overwhelming. The resurrection which began with the Maruti IPO in 2003 has been reflected in huge oversubscriptions through FY05 and several offerings garnering well over a million retail applications. Over time, preferably sooner than later, one expects the magnet of returns from these issues to pull several retail investors into the secondary market, albeit through mutual funds initially. To that extent the primary market has a key role to discharge in expanding, diversifying and stabilizing the universe of secondary market players as well.

The dominance of book building mechanism has led to marginalization of the traditional broker and emergence of large broking firms who have invested into infrastructure, technology, manpower and effective risk management systems capable of handling such issuances. These developments have enabled deepening and broadening the retail reach and the markets have witnessed mobilization from more than a million investors in large issuances like NTPC and TCS.

Looking ahead, present undercurrents portend the next decade in India's capital markets to witness unprecedented activity and attainment of new milestones. The proactively evolving role of banks (presently underinvested in equities compared to permissible limits) and pension funds vis-à-vis equity markets and the emergence of a 'new middle class investor' (who has already surprised with a refreshing attitude to retail debt by consigning the adage Indians live poor but die rich to history) would be the fountainhead for sustaining a potential US$15bn plus annual primary issuance pipeline. That in turn would be the bulwark for more broadbased fund raising capabilities (to suit entrepreneurial, mezzanine or long-gestation infrastructure needs), debut of desirable innovation (LBOs, buyouts, big ticket cross-border M&A) and in the longer term for India to emerge as a global listing centre (a wish echoed in the recent budget to develop Mumbai into a regional financial hub).

While we prognosticate all this, challenges do remain. Particularly, in terms of the financial network reach, technology infrastructure, corporate governance and disclosure framework and qualified personnel to provide best in class service and ensure an efficient financial market. Be that as it may, the improvements of the past few years reassure one that more desirable change will be delivered, in a preferred way. On the ground, initiatives by SEBI, AMBI, AMFI, NSE/BSE etc are already being crystallized for implementation in this direction. And, to conclude with another truism, in the final analysis all that is institutional in the market is retail as households are the ultimate beneficiaries of all wealth creation.