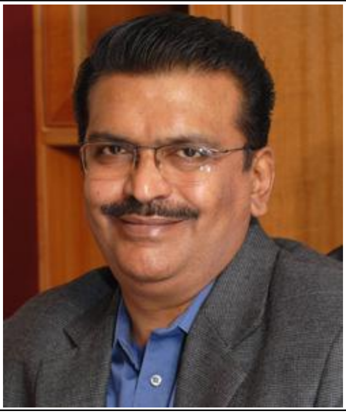
IPOs: Challenges in Distribution



C.Parthasarathy
Chairman
Karvy Investor Services Ltd.

Introduction

Equity participation is one of the cornerstones of financial inclusion in India. We may enjoy one of the highest savings rates in the world, but our exposure to equity and equity-related instruments has been dismal, to say the least. A significant chunk of our investments are channeled into fixed-income instruments, and this tends to play havoc with our long-term goals and requirements, as debt instruments barely manage to beat inflation and are inferior long-term wealth accumulators compared to equities.

So far, the performance of the domestic equity markets has been largely dependent on the extent of FII inflows. This, in turn, has been more a function of monetary policies implemented by central banks in the developed world. To facilitate greater balance of power on the bourses, there is an urgent need today to widen the ownership of equities among retail investors in metros, cities and rural townships across India. Moreover, we must have our own selfish reasons to ensure greater retail participation—with the next two decades expected to belong to India, retail investors should be given the opportunity to partake in the India growth story.

Role of distributors in greater financial inclusion

While there is an urgent need to ensure greater retail participation in the secondary market, the distributors' role is vital in the primary market. Given its wide reach and experience, the distributor is well-placed to facilitate retail investor participation in IPOs. However, given the challenges being played out in IPO distribution today, there are not many takers for this key function.

- ✓ In India, IPOs are largely driven by the book-building process, covering only 60-70 centers through a handful of brokers. Such a market structure has largely led to a general lack of traction, retail participation and equity cult in India. In fact, IPOs constitute a small percentage of the one crore estimated depository accounts in India.
- ✓ To ensure greater financial inclusion through the IPO process, there is a need for a strong distribution platform. In that regard, today, IPO distribution is not just about the delivery of application forms. It is important to focus on value-added research and advisory, besides offering a host of other services to retail investors. In that regard, it is crucial to communicate about the issue, but the quality is found wanting in the Indian markets.
- ✓ To provide the desired value-added support, one has to invest extensively in people, training & development, and the required 'support' infrastructure. Similarly, when markets are in an extended bearish phase, IPO distribution becomes more of a 'push' factor (versus 'pull' in a bull market). In such a scenario, distributors have to put in that extra effort to make a strong pitch. In that regard, communication plays a key role, and this can only be optimized by implementation of state-of-the-art technology.

  However, the diminishing fee structure in IPO distribution fails to justify such a move. This becomes particularly crucial for a relatively small, standalone distributor, who may not have the wherewithal to invest in key resources, given the expected rewards. Thus, standalone IPO distributors find themselves in a chicken-and-egg scenario. Likewise, many individual advisors and sub-brokers do not participate in IPO promotion because of the low fees.
- ✓ The deepening of the financial marketplace has led to newer mechanisms and points-of-distribution today, further queering the pitch for standalone IPO distributors. Banks, for instance, are playing an increasing role in the distribution process, and their reach and access has proved to be a significant advantage. Likewise, the Net-savvy in the urban areas prefer the convenience of their online broker—they can invest in an IPO with a mere click of a mouse, from the comfort of their home or office.
- ✓ Aggressive pricing is another reason why distributors find it difficult to push IPOs. The management of the issuing company—in consultation with the investment bankers—has been aggressively pricing the IPOs. Of course, in a bull market, the issue would still get heavily subscribed despite the aggressive pricing, but when the markets turn southward, the valuations come into sharp focus, driving down the price of the listed stock and causing a lot of heartburn for retail investors. Today, with many of these stocks quoting below or around the offer price, retail investors are discouraged from investing in fresh IPOs.

  Moreover, in an aggressively priced issue, the smart investors (*read* institutional) make a neat profit by exiting on the listing day, leaving the retail investors in the lurch. In fact, the recent Facebook IPO in the US is a perfect example of the hype and expectations built into what looked like an extremely aggressive pricing by the merchant bankers. Today, the stock is languishing at far lower levels from the offer price. The Indian stock markets are rife with similar IPO stories, and many retail investors have lost a packet! And the difficult market scenario today is doing little to regain investors' confidence in IPOs.

- ✓ The IPO retail participation is hampered because merchant bankers to the issue neither emphasize nor do they have the faith on the retail portion. Indeed, a widespread participation from retail investors is key to optimizing liquidity in the stock. In that regard, issuing companies have to be encouraged to raise the maximum threshold for the retail portion of the issue. From a distributors' perspective, such a move will enable him to reorient and reinvent himself if he finds the cost-benefit analysis rewarding.

Clearly, therefore, distribution as a standalone business for IPOs is not finding too many takers, given the market structure, lack of resources, diminishing fees and newer (and more competitive) avenues of IPO distribution. In a nutshell, there is an urgent need today to look beyond the simple distribution process. IPO distributors must look at providing advisory-based services, increasingly considered to be an integral part of the distribution function, in today's dynamic financial marketplace.

Investing in the right people and technology can help to optimize the distribution function, backed by a robust research team. However, the diminishing fees can hardly justify the huge investment made in these value-added services. Going forward, therefore, distributors should look at offering not only IPOs but also other financial products.

Challenges to IPO distribution: Difficult market conditions

It has been nearly five years since the sub-prime crisis reared its ugly head in the US. As the crisis unfolded in the latter half of 2008, the banking system seized up and financial institutions collapsed, unleashing mayhem across asset markets worldwide. The resultant liquidity crunch led to a sharp global economic slowdown, with developed markets entering into a recession. Needless to say, the financial services sector was one of the biggest casualties of the Great Recession of 2008. So much so that, today, four years later, this space is yet to show a marked recovery.In fact, revenues of many key businesses in financial services is still down 40-50%, from its peak levels in 2006-07.

Sure, there were strong indications of a revival in 2009-10, when emerging markets recovered sharply and the US showed signs of gradual improvement, following coordinated efforts by central banks and policymakers to boost their respective economies. In fact, emerging economies appeared to be well on their way to their previously recorded peak growth rates. Moreover, despite inflationary fears, emerging markets were recovering smartly as FIIs pumped in a record Rs1,30,000 crore into the Indian bourses in 2010 alone! Even the mammoth Coal India IPO—in the last quarter of 2010—proved to be a staggering success!!

The events following the sub-prime issue, however, had a deep impact on the 17-member Euro-zone, starting with the Greek sovereign debt crisis in 2010. As the contagion spread to other member nations, the heightened risk caused significant volatility across financial markets worldwide in 2011 and 2012 year-to-date, and the high-beta Indian bourses were not spared either. Today, with Europe in a recession and emerging markets like India and China slowing down sharply, the global economy is clearly putting on the brakes. What's more, the Euro crisis threatens to dilute the membership of the region, and this could unleash mayhem.

Undoubtedly, the hardships facing the secondary market in India have clearly spilled over to the primary market as well. The foreign institutional investors (FIIs), which dominate the IPO scene, are shying away not only because of increased risk aversion globally but also due to a general erosion of business confidence in India, particularly from a policy perspective. The continued adversity in the domestic and global environment and the lack of FII interest have, to say the least, also driven out retail investors and HNIs (high net-worth individuals) from the equity markets. Needless to say, given the losses in equities over the last two years), distributors today have their task cut out when it comes to pushing IPOs to retail and HNI investors.

Challenges to IPO distribution: Miscellaneous factors

We list a few more factors that have proved to be challenges to IPO distribution. That said, these are more operational in nature, and most of it can be minimized by investing in the relevant resources:

- ✓ There is significant stress involved on the last day, when 80% of the IPO applications come in, leading to possibility of human error in the bidding process. In fact, it becomes difficult to verify the important PAN, DP and bank account particulars.
- ✓ Applications need to be compulsorily banked on the following day of issue closure. On closing day, however, the issue remains open for bidding until 10 PM, and, therefore, branches may be unable to courier these applications by the following day.
- ✓ If there is a huge IPO, it calls for outsourcing which could further raise the incidence of human errors.
- ✓ There are not many collection points in Tier II and Tier III cities, making it difficult for investors in these cities to invest in IPOs. Also, sometimes, applications fail to reach the branches on time.
- ✓ Although ASBA has been introduced, it has not taken off as expected because not many banks offer or encourage this facility. Moreover, as it is mandatory for HNIs to subscribe to IPOs through the ASBA route, many approach their bankers directly.

Conclusion

Clearly, there should be increased focus to raise the retail participation in the IPO market. A higher retail portion, broad-based market structure, greater co-operation with merchant bankers, rational pricing, special incentives for brokers and investors to mobilize through the online / e-IPO route, introduction of a 'no-frills' account for small investors with a simplified KYC, and regular financial literacy programs to improve the equity cult in India will go a long way to encourage distributors to reinvent themselves in the business.