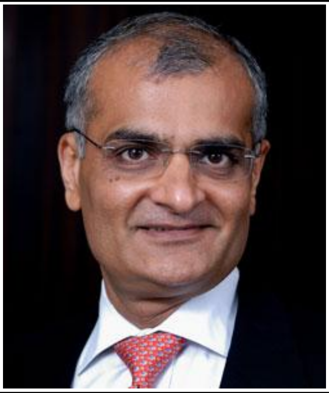
Reforms push needed



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The sign of a mature economy is when entrepreneurs find it relatively easy to raise capital for new ventures, expansions, acquisitions etc. This ensures that innovative ideas, disruptive technologies, make it quickly to the market; businesses can respond to market conditions by either expanding their operations or take the inorganic route to expand.

If we look at some of the biggest global companies, especially in the technology sector – Apple, Dell, Yahoo, Google or Facebook — most of these companies started out in some garage, trailer park or college dormitory. They were able to grow into global giants because at an early stage, they were able to access capital, which helped them to grow from a "proof of concept" into viable businesses.

It is in such a mature economy that the financial services industry plays its classical role; that of being a bridge between savers of capital – households and corporates — and users of capital – companies and government. The more efficient this bridge – the financial services industry is – the more effectively it will channelize savings into productive use resulting in capital formation.

In India, the economic reforms of 1991 also marked the birth of the modern financial services industry. Prior to 1990, the license permit raj ensured that new entrepreneurs couldn't enter most businesses nor could existing companies expand capacities unless they had a license. The quantum and pricing of new capital issues was controlled and selling such underpriced issues was a no-brainer.

By de-controlling the entire system, economic reforms allowed businesses to flourish. Existing companies could look to expand their operations, enter newer markets, and add capacities. Talented entrepreneurs with little or no access to money could dream of starting out on their own. All they required was an idea and execution capabilities.

What used to be the biggest roadblock – capital, was no longer so. Multiple avenues of funding are available and a whole legion of finance professionals which could help these companies/entrepreneurs tap these avenues.

Over two decades since the launch of the economic reforms programme and the business and economic scenario in India has unalterably changed. Companies today have access to a whole range from funding options beyond the traditional term loans or public equity offerings. These range from venture funds, private equity funds, hedge funds, mezzanine funds to commercial paper to deep discount bonds etc. And their efforts to raise funds no longer are restricted to India. Foreign Financial Institutions (FIIs) have been making a beeline into India and are happy to get in early on good opportunities. Companies/entrepreneurs also have the option of raising funds internationally through a variety of instruments and avenues.

But the last two or three years have been tough for companies wanting to raise risk capital. Volatility in the international markets and an economic slowdown at home has meant that the action on the capital raising front – both in the public as well as private markets have slowed down appreciably.

On the public market side, on significant trend has been the exit of the retail investor. Retail investors have burnt their hands in the capital markets and have been leaving in droves to invest in alternative avenues like Real Estate and Gold.

Even investors in the private markets have found the going tough. Slowdown in IPOs has meant that a lot of PE funds which had invested in growth companies are finding it difficult to exit their investments. New deals are also difficult to come by as too many funds are chasing too few deals. In such a scenario, valuations get pushed to unrealistic levels, making future exits that much more difficult.

The answer to both these problems lies in thinking beyond plain vanilla equity offerings. Undoubtedly, equity markets when functioning properly provide significant benefits across an economy. They are an important source of long-term financing for high-growth companies; they allocate capital efficiently; and they disperse risk and reduce vulnerability to bankruptcy. But in uncertain times such as these, the financial services industry needs to be more innovative and offer products that are more finely tuned to cope with the current volatility.

Household savers' primary concern is about liquidity and inflation adjusted returns. If we have to get the retail investors back to the public market, these concerns need to be addressed. We need hybrids (like the convertible debentures of the 80s), warrants, bonds etc. These will provide a large range of risk-return options to cater to various needs. We should have inflation linked bonds for retail investors. We should have GSecs sold to retail investors. Gold ETFs have shown a way to channelize savings from gold to the financial markets. We need to similarly liberalize rules for real estate funds so that savings going into real estate can be channelized into the markets.

Another alternative source of retail investment which is currently not very popular is pension funds. There are several issues about the rules governing pension funds. If these can be sorted out, pension funds would be the ideal vehicle for long term investments especially in sectors like infrastructure.

For the private equity investors we need to similarly offer hybrid products that meet their needs of returns. Already we see an increase in investment options that offer debt like returns with a potential upside in equity. This trend needs to strengthen. In that sense SEBI's guidelines on preferential shares couldn't have been better timed. Not that the rules and regulations governing preferential shares have been clarified, it is hoped that a significant proportion of public as well private market funds will flow into these quasi-debt/quasi-equity kind of instrument.

Another recent welcome move was the finalization of the Alternative Investment Fund (AIF) guidelines by the SEBI, which opened up another investment avenue for domestic HNI investors. That SEBI's move was popular is seen from the fact that in just a few months after the release of the guidelines, xxx AIF schemes have managed to raise over xxx.

What is important is that the government needs to think through these reforms from all angles, including tax. For example one compliant that investors have about the present structure governing AIFs is that it is not very tax-efficient. If these anomalies are removed, far more funds could be raised and deployed using this route.

It seems certain that the next 18 months or so are going to be trying times for the economy as the markets recede from liquidity fuelled boom, Rupee depreciates and Current Account Deficit balloons. If the government continues and in fact accelerates it reform push, especially in areas concerned with alternative investments, it could attract a significant amount of capital into the country.