Creating a Real IPO Market

India's IPO markets are disproportionately small to India's PE market. Why?

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India's large technology IPO's of the next decade – Flipkart, Quikr, Ola, Snapdeal, etc - will probably bypass India's Capital Market and list overseas. This IPO venue equivalent of the Wimbledon effect – that tournament is held in Britain but hardly any Britisher wins – is painful and dangerous. IPO markets in India have clearly failed to keep pace with the development of India's private equity and venture capital market. Why? But more importantly, what can we do about this?

IPO markets are more important than policy makers think. India has a high savings rate but little of this flows into India's formal financial sector and even less into equities. A well-functioning IPO market is an exit gate for institutions that channel domestic savings into growth capital for companies that will translate into more investment, more enterprises and more jobs. Today our 63 million enterprises only translate to 1 million companies and only 14,500 of them have a paid up capital of more than 10 crores. The lack of size and productivity in enterprises is rooted in our poorly functioning land, labour and capital markets so it is clear that reforming IPO markets are important for nation building.

India was once a vibrant IPO market. Close to 4000 companies 'IPO'ed' in the 10 years between 1991 and 2001. The next decade saw this number reduce ten times even as market capitalisation of secondary markets increased ten times. This asynchronous decline is explained by the IPO markets failure to come to terms with three important changes over the last 10 years.

1. An entire generation of retail investors has left the market: This generation was brought up on assured returns driven by pricing controls. Things changed after pricing controls were abolished. Companies changed sooner than investors. IPOs reflected free pricing but investors took a long time to realise that the free lunch was over and not every IPO was a ticket to capital gains. Consequently an entire generation of investors burnt their hands and deserted the market subsequently.
2. Development of domestic institutional investors: The last 15 years have seen significant growth and development of the Indian mutual fund and insurance sectors. Both mutual funds and insurance companies have significant primary volumes and absorb significant amounts of domestic savings. 20 years ago LIC and UTI were the only 2 significant institutional investors. Today there is a plethora of domestic institutional investors with significant AUMs. One could argue that the theatre of primary capital formation has shifted from IPO markets to mutual funds and insurance companies. For today's investors the default channel for equity investment is either investing in a mutual fund scheme and/or an insurance scheme. But IPO markets continue to obsess over retail participation and protection of retail investors who are conspicuous by their absence. IPO norms have to be designed with institutional investors in mind and not just retail investors.
3. Development of the private equity sector: India's PE sector has come a long way. Even as late as 2004 the sector played a marginal role in capital raising for enterprises. Private equity investors in India now have the scale and sophistication to provide capital across the life cycle of enterprises. In conjunction with the development of the M&A market this implies companies can play out their life cycle without going public. This is a far cry from the time when going public was almost mandatory for companies beyond a certain scale. Private equity investors now own significant share of an issuing company's share capital, have presence on the board and exercise control and influence to an extent not fully understood by the IPO market which continues to exercise a pre-PE mindset.

What can we do about this? For IPO markets to grow and deliver meaningful amounts of capital to enterprises, the market must come to terms with the changed reality. Summarising their impact we can say Indian enterprises are no longer just promoter driven but almost as a rule set up by serial entrepreneurs who move from one enterprise to another. The companies are no longer owned entirely by promoters and FIs but significantly by private equity investors. The bulk of the capital provided in the IPO markets will come from institutional investors and not retail investors. And most listed companies will delist by the 20th anniversary of their listing.

This needs a radical rethink. Firstly, we need to bring the Indian disclosure philosophy up to par with US standards and practices. Indian IPO disclosure norms currently differ significantly from norms in the more developed capital markets from where PE firms source their primary capital. The focus should shift to materiality as opposed to brute force disclosure and eliminate all ghost control on pricing. Secondly, we need to eliminate

the concept of promoter and promoter group in companies. This is a regressive and outdated concept again out of line with global standards and private equity practices. Finally a number of plumbing changes are needed; enable discretion on book building and direct retail participation, bring IPO settlement standards closer to global norms to T+2, shorten lock in requirements so that PE investors are not compelled to look at IPOs as exit events rather than liquidity events, give complete flexibility on use of proceeds, and allow ease of delisting (currently taking a company public is like marriage without divorce)

Private and public markets are much more dependent on each other than policy makers believe. Private markets have grown recognizing the new appointment India has made for her missed Tryst with Destiny. This is an appointment she will keep. But reforming IPO markets are an overdue and important input into creating India's infrastructure of Opportunity.