Investment Banking-The Emerging Challenges in Primary Market

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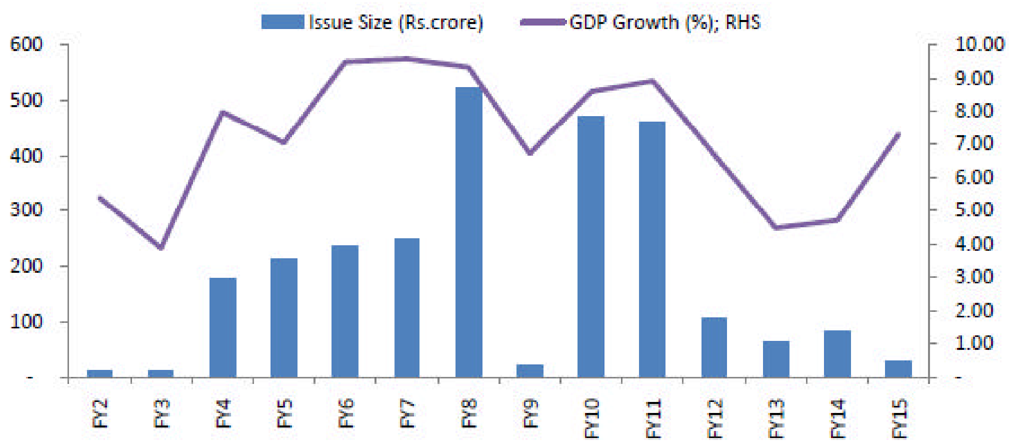
The key purpose of the primary market is to augment capital growth by providing an avenue for small investors to generate higher returns on their savings through investments, whilst making capital available to corporations to build their businesses. The financial markets have been a long–standing determinant in the overall economic growth of any country. It is a time tested phenomenon that mature capital markets are a reflection of a country's economic standing and consequently its social well being. In a world of ever increasing financial integration and cross border fund flows, corporations will access capital markets which present the best fund raising opportunities whilst fuelling their global ambitions.

The Indian capital markets has evolved dramatically over the past two decades witnessing oscillations of high and sluggish growth mirroring the economic growth during the similar period. Over the past 25 years, the three bull markets that we have seen in India have all lasted for less than 5 years; the Harshad Mehta led 1991-92 peak, the technology led 1999-2000 and the infrastructure led 2007-08 peak.



Over this period, the capital market regulator i.e. Securities and Exchange Board of India (SEBI) has enabled and developed the market infrastructure to provide a safe and secure environment for its participants. The various steps introduced by SEBI include improved disclosure norms, transparent bidding process, increased allocation to institutional investors (including anchor investors), online application and ASBA mechanism, minimum public shareholding criterion for listed companies, reducing the timeframe for listing thereby bringing in transparency and increasing market depth viz. wider participation and making the system more efficient. The above steps have led to the market capitalization of the companies listed on NSE to expand at a CAGR of ~22% (FY02-14) to reach at USD 1,213 Bn. Correspondingly, India's Market Cap/GDP ratio has increased from 25% in FY02 to 69% in FY12.

The primary market's traditional drivers include funding expansions, deleveraging, wide visibility, private equity exits and spin offs by diversified business groups. However, there are challenges associated with primary market activity, in particular in the life cycle of the company at which it is planning a fund raise.

Challenges of the primary market in current times:

a) Pricing of the initial public offering

Going public is one of the most significant transformations most closely held companies undergo and it can seem to be a daunting task, leading to an expectation of premium from issuers to bring the unknown investor on board. Pricing/valuation of the company for the public offering is the most important factor in success of an IPO. Pricing of an IPO is function of financial and non financial parameters including market comparables of the peer group companies, etc. The attractiveness of the pricing lies on several factors like past performance, business model, the economic moat of the business, products, scalability, utilization of issue proceeds etc. It is a major challenge for the Merchant Bankers to price the offering in a way that should be taken well by the Investors as well as the Issuer. With the higher allocation for Anchor Investors being permitted by SEBI, Issues are being priced at valuations to attract these investors which would have a strong signaling effect to NIIs and Retail investors who rely heavily on the QIB subscription statistics. The strong response for IPOs has also been due to the revival of the IPO financing product for HNIs and retail investors based on return expectations which are driven by IPO pricing.

b) Consistency and Certainty of Legal/ Tax regime

Volatile political conditions and fear of government intervention in markets brings uncertainity in markets case in point being retrospective taxation, transfer pricing and other tax related matters. These have been the major area for concerns for the Foreign Portfolio Investors investing in India. The Foreign investors are looking for clarity on the matters related to tax as this directly impact their investment and subsequent return. Any uncertainty of matters related to tax has a negative impact on the foreign investors return expectation and may in turn decrease the fund flow. The ever changing legal and regulatory environment is seen as the factor most likely to impact the fund flow in a particular market.

c) Regulatory steadfastedness to adapt changing market dynamics

An increasing number of the companies are looking to approach regulators for capital needs depending on their respective patterns of domestic growth, consumer demand and investment flows. In the lifecycle of the company, listing in a particular market has long term implications resulting from standards of compliance, disclosures, regulatory clearances etc. Since the financial crisis, the window of opportunity to raise funds has narrowed owing to the increasing equity market volatility and higher global financial market integration. In light of this, it is commendable for SEBI to have significantly decreased the turnaround time for processing offer documents whilst maintaining one of the highest disclosure standards. SEBI has also taken following steps to ensure ease of availability of capital to the growing needs of the companies:

1. Giving a fillip to e-commerce boom in India by providing a separate platform (*yet to be notified*) to meet the capital needs of the companies in the sector with requisite disclosure requirements.
2. Reducing time to market as well as exposure to market volatility through adoption of technology in the form of launching e-IPO
3. Ensuring genuine market participation through the mandatory use of ASBA
4. Encouraging higher institutional participation through higher reservation for Anchor Investors
5. Actively using the OFS mechanism to divest which has significantly reduced price volatility of the listed companies during the offer period compared to an FPO which exposes the stock to detrimental market forces. Whilst FPOs do have their positives, the OFS achieves similar objectives through a simpler process (from the disinvestment perspective).
6. With Companies Act, 2013 permitting upto 200 investors for private placements, the breadth of investor allocation to QIPs/Private Placements has increased.

d) Dependence on Foreign Portfolio Flows

Inspite of the higher savings rate in India, a small proportion of it is invested in capital market instruments leading to a large dependence on foreign capital flows. Post the US sub-prime crisis of 2008, the foreign portfolio investments in India got impacted largely due to the slowing economy and stalling of various government investments leading to a drop in CAGR to ~17% (FY09-FY14) vis. a vis. a CAGR of ~28% (FY02-FY08). However the foreign portfolio investment saw a significant jump of ~24% in the first 9mths FY15 vs. 9mthsFY14, after the stable government formation at the Centre. The primary market activity largely reflects the sentiment in the secondary market. The number of issuers approaching the market via IPO/ FPO/ OFS during similar period stands at 346 (FY02-FY08, raising Rs.142,247 crore) vis. a vis. 168 (FY09-FY14, raising amount of Rs.120,285 crore).

e) Liquidity and implied Volatility in secondary markets

For an issuer, liquidity is by far the most important characteristic when choosing a stock market, followed by a sizeable investor base and good analyst coverage, initial listing and ongoing legal requirements, and Infrastructure. It is important for the issue to have an active aftermarket to ensure subsequent exit and entry opportunities for investors. Investor response to a primary market issue is largely driven by the prevailing conditions in the secondary markets. Primary issuances are also important from the perspective of keeping markets from running at inflated valuations wherein too much money is chasing too few stocks. Primary issuances offer this crucial aspect of diversification from an overall market perspective as well as a portfolio perspective. The S&P BSE IPO index has delivered strong returns of more than 180% since the lows of 2013.

To summarize, in the medium term, with slow growth across major economies and Asia providing engine for the World Economic Growth, investors globally will have Asia on their investment radar leading them to look at investment opportunities across various industries/ sectors/ companies. On the backdrop of stable Central Government, reforms expectation, declining inflation, rate cut hopes, the leading financial institutions like World Bank, IMF consider "India" to be at the sweet spot with high GDP growth rates expectation going forward. Thus our country is at the inflection point of a long structural bull run and primary market activity in the coming years is expected to remain abuzz.