Innovations in IPOs of High Growth Technology Companies

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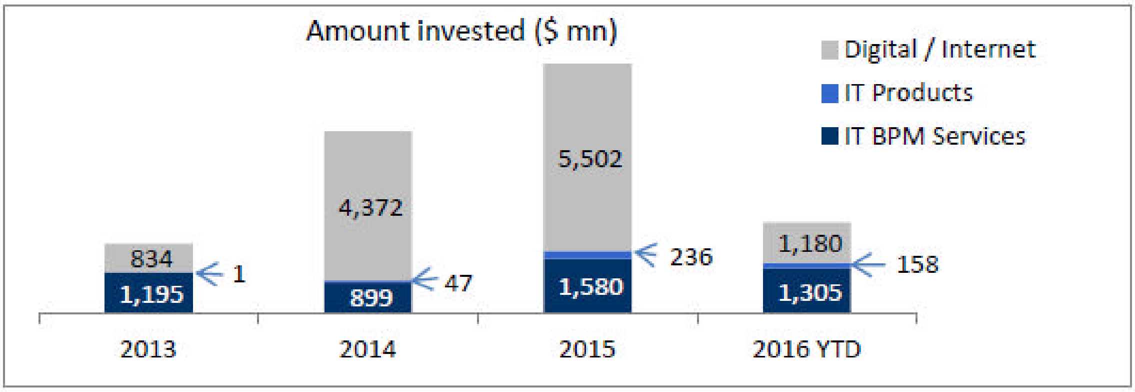
There is a need for a progressive framework to develop a vibrant capital markets funding ecosystem which addresses the long standing demand from new-age technology issuers and investors looking for growth-oriented investment opportunities in India.

A. Explosive growth of technology startups in India

Startup landscape has experienced unprecedented growth in recent years in India. According to NASSCOM, the number of startups in India, estimated at 4,200, is third highest in the world lagging only the United States (>47,000) and the United Kingdom (~4,500). The pace of startup activity in India has accelerated with about 800 new startups getting funded in 2015. A vibrant private funding ecosystem, consisting of venture capital and private equity funds (>150) and angel investors (>400), has supported the growth of these startups.

Technology sector in India has attracted over US$17 billion of private funding since 2013 as shown in the chart below.



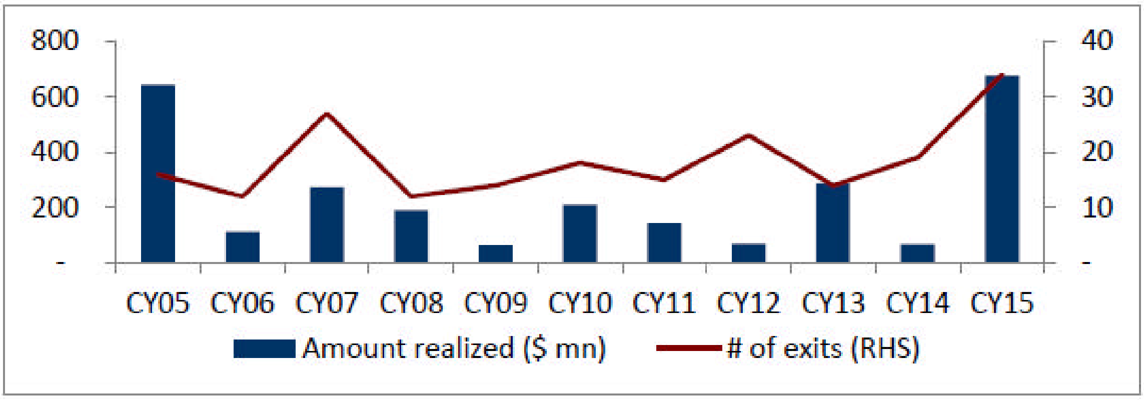
Source: Venture Intelligence

B. Need for enabling capital markets funding alternative

Although, there has been increased private investment activity in technology startups in India, it has not yet produced commensurate exits either through capital markets or M&A transactions.

The chart below provides the historical trend of IPO and strategic M&A exits for Venture Capital (VC) investors in technology sector in India.

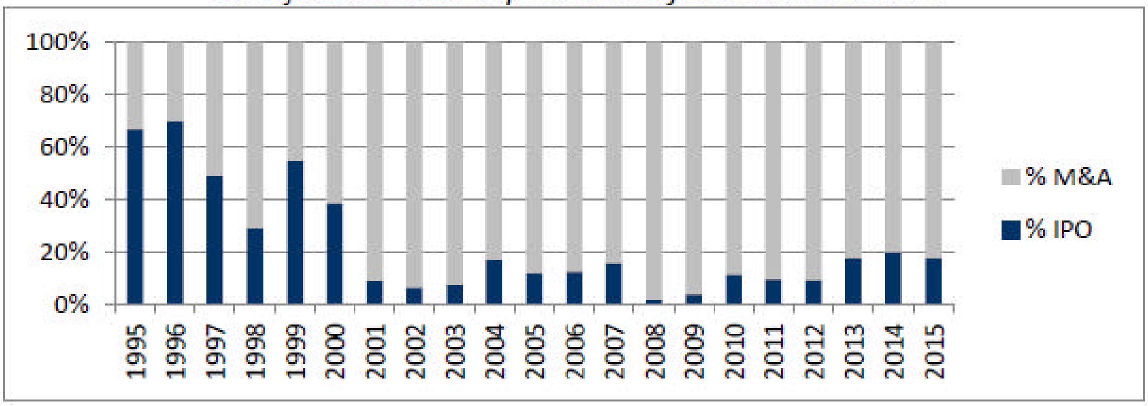
Indian technology sector VC exits, via M&A and IPO, by year



Source: Venture Intelligence

Based on an analysis of historical data, the value of M&A exits for technology product companies in India is only 0.4 times the amount of equity investment in the sector, which is extremely low as compared to U.S. (5.8x) and Israel (5.5x). As shown below, there is a robust market for M&A and capital markets transactions for VC backed companies in the U.S. For instance, when the public markets became lukewarm to technology companies after 2015, there had been a spurt in M&A activity led by strategic players who are taking advantage of the relative decline in valuation levels.

Exits for US venture capital backed firms via M&A vs. IPO



Source: NVCA Yearbook 2016

In order to sustain and reinforce the private funding momentum in the technology sector, there is a need for matching advancement and innovations in Equity Capital Markets in India. Internationally, early stage investors have traditionally looked at capital markets to monetize the investment in their portfolio companies.

Moreover, capital markets provide the most logical path for high growth companies to:

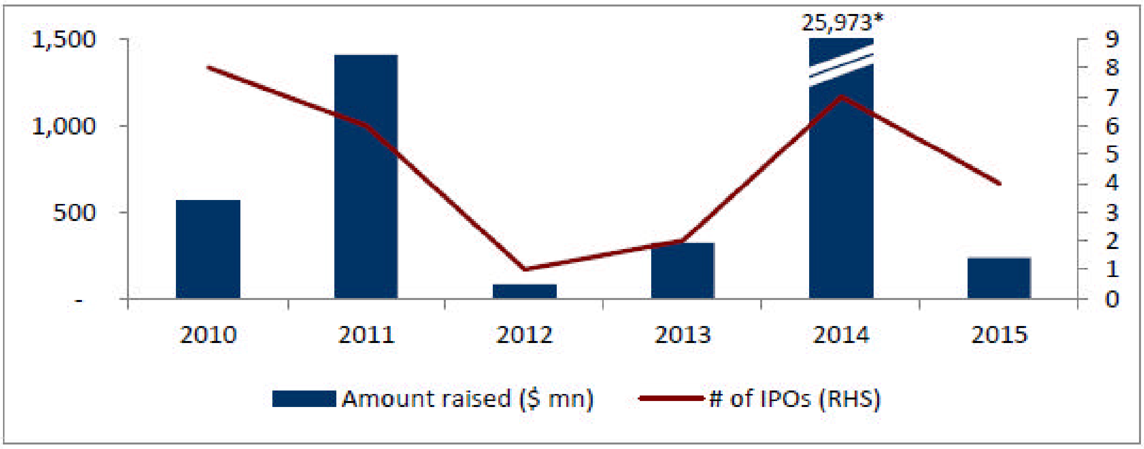
There is an equal interest from public market investors who are looking to make attractive returns by subscribing to the Initial Public Offerings (IPOs) of such high growth companies.

C. Overseas stock exchanges have an established track record of listing high growth companies

Globally, mainstream stock exchanges such as NASDAQ, NYSE and LSE and alternative stock exchanges including AIM, TSX and ChiNext have attracted public market listing of technology companies with varying levels of success. Since 2011, there have been over 430 technology IPOs on such overseas stock exchanges, which have raised around US$130 billion.

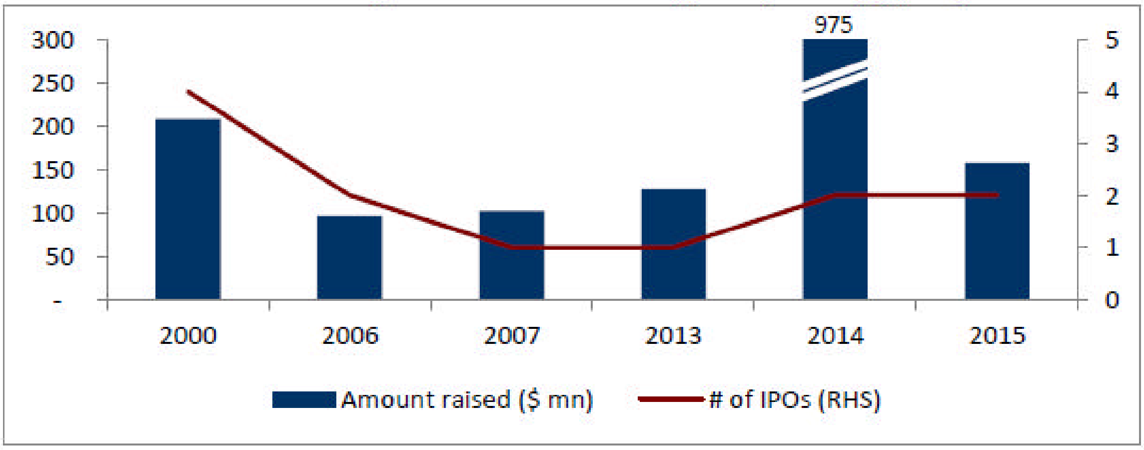
There is an established trend of Chinese and Israeli technology companies listing on U.S. stock exchanges, which are perceived to be more receptive to novel business models and budding sectors. Overseas companies have taken advantage of robust U.S. markets in 2011 and 2014 for IPO listings, as shown in the charts below.

US IPOs of China based technology companies (by year)



***$25bn out of this was just from Alibaba IPO**
Source: Bloomberg

US IPOs of Israel based technology companies (by year)



Source: Bloomberg

Most of the foreign issuers have cited several positive aspects of developed markets exchanges for overseas listing:

i. Lack of market depth in home markets to absorb larger issue sizes and provide post-listing liquidity. For instance, Alibaba, the largest IPO ever (US$25 billion), listed on the NASDAQ and Agricultural Bank of China's US$ 22 billion IPO was listed closer home on Hong Kong Exchange. Both these issues would have found it challenging to list in their domestic markets
ii. Active participation of sophisticated investors in developed markets who can properly value emerging sectors and new-age companies. For example, more than 250 Israeli companies, which have typically focused on high technology, biotech and defense sectors, have listed on NASDAQ since 1980
iii. Monetization of foreign investors' stake in USD/Euro etc.
iv. Restrictive regulatory framework and tedious listing process in home markets, and
v. Favorable branding impact by listing on overseas bourses.

In the past, Indian technology companies like MakeMyTrip have preferred a primary listing on such overseas bourses instead of domestic exchanges. Several high-growth private Indian companies such as Flipkart, Inmobi, Snapdeal, and MuSigma, are believed to have explored overseas listing.

D. Listing on Indian stock exchanges

Although, a few Indian technology companies such as Quick Heal, Justdial, and Info Edge have successfully listed domestically, a primary equity issuance on the mainstream Indian stock exchanges like NSE and BSE has some real and perceived challenges.

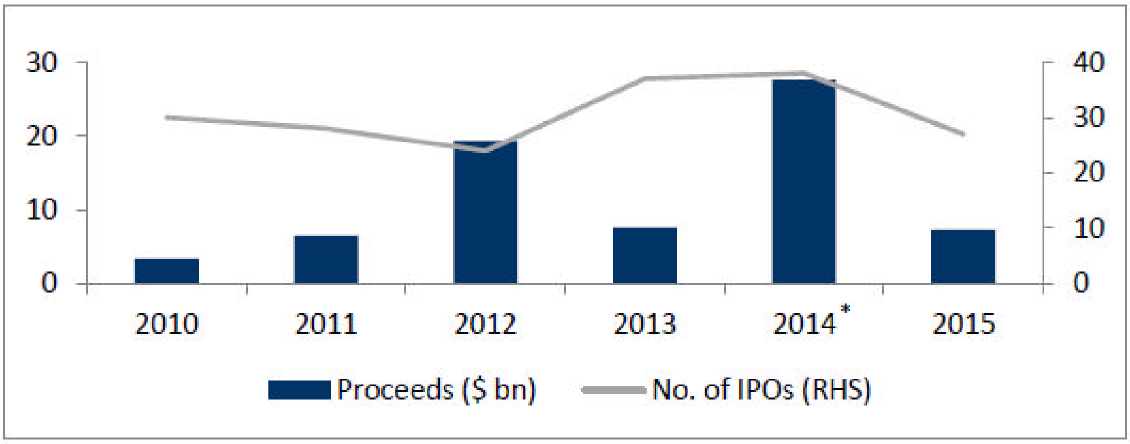
(a) *Eligibility:* In the initial growth phase, the emphasis of the startups is on non-linear growth and profitability is generally not the primary focus. Many of the startups are loss making and may have volatile business models. There are well laid out financial criteria of listing on the main board of the Indian exchanges, which do not fit well with the typical business and financial profile of the startups.

India Main Board IPO Listings – Financial Criteria	
Minimum net worth	INR 30 million
Minimum net tangible assets	INR 10 million
Profitability track record	Average net profit of INR 50 million for the last 3 years

Most technology startups would find it difficult to meet the stringent financial criteria for listing on mainstream stock exchanges in India. Whereas, in overseas markets many loss-making companies have successfully secured attractive valuations.

In spite, of this widely held perception of the openness of the developed markets for growth stocks, recent data suggests that investor appetite is decreasing for companies which have weak financials and sustainability concerns. In 2015, the number of technology IPOs in the U.S. dropped by 29% as compared to 2014, resulting in a 74% fall in the proceeds. About 80% of the technology IPOs which debuted in 2014-15, are trading below their IPO price.

Proceeds raised from US technology IPOs in US$ billion (by year)

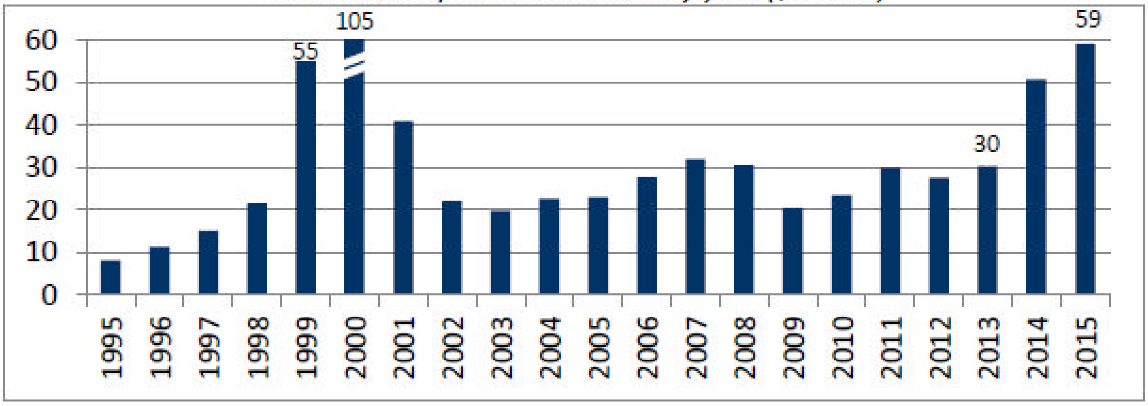


**A large portion of the 2014 proceeds was from a single IPO of Alibaba ($25bn)*
Source: Bloomberg

Clearly, the investors in developed markets have become more discerning and are focusing on issuers' path towards sustainable profitability. Wall Street is increasingly using traditional metrics like growth and earnings to price companies. Post-listing, investors have been demanding on Twitter, for example, because its user growth has decelerated. Similarly, Box, the cloud-storage company that went public has faced investor backlash because it remains unprofitable and the e-commerce company, Zulily, was likewise penalized when it cut its guidance for future sales.

The fallout of this disciplined response from public investors is forcing technology companies to remain private longer by raising multiple rounds of venture capital funding. The amount of VC funding in US in 2015 was $59 billion, representing an increase of 16% over 2014 and almost twice that in 2013.

US venture capital investments by year ($ billion)



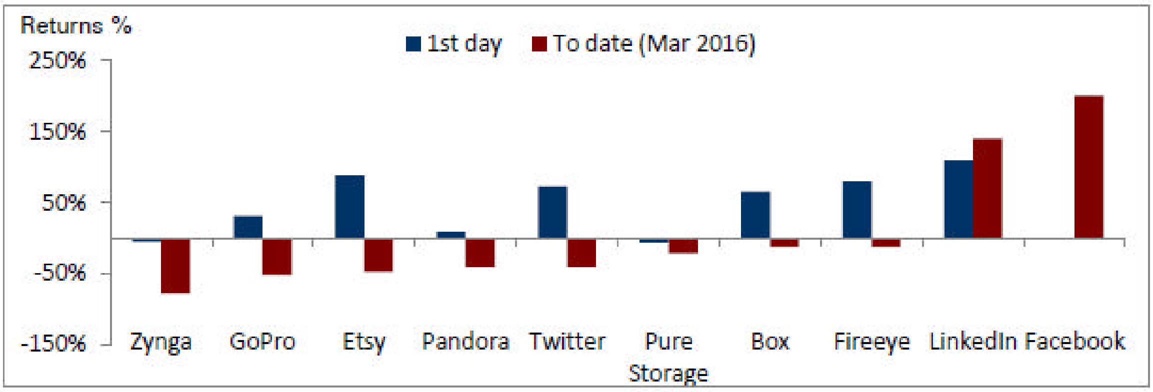
Source: NVCA Yearbook 2016

Even the VC and PE firms have been marking down their earlier lofty valuations of the unicorns to reflect their lower appetite for early stage risk. Public market investors seem to have enhanced focus on company fundamentals, cash flows and path to profitability. For example, IPOs of Box, Square and Hortonworks were priced below their most recent private funding rounds.

Recent IPOs of technology companies such as Twitter, GoPro, Etsy, Linkedin and Box have attracted significant attention in recent time leading to the primary issues getting significantly oversubscribed and stock prices going up on the first day of trading. However, in the long run, on average they have tended to underperform or provide lower returns.

The weighted average first day returns of all US IPOs in 2015 was 20%, whereas the return to date is only 6%. Nearly 61% of the 185 US IPOs in 2015 are currently trading below their IPO price. The data in the following chart for some US technology IPOs in recent years clearly shows that the first day and long term returns are not related to each other.

IPO returns on listing day (1st day) and returns to date for select companies



Source: Bloomberg

Shift in investors' focus away from initial excitement driven by getting exposure to a new, emerging category, to emphasis on profitability and stability of business model is the main factor contributing to the relative under-performance of the technology companies' returns in the longer term as compared to the immediate jump in the share price post listing.

(b) *Limited understanding of emerging sectors:* Many new startups operate in unconventional sectors including cloud computing, data analytics, Internet of Things (IoT), digital payments, online commerce, medical devices, energy efficiency and mobility among others. There is a perception that these new sectors are not properly researched and fully understood yet by investors in India. Thus, startups presume that it would be challenging to get proper appreciation of their business models, thereby, impacting the valuation of their potential IPOs. Lack of domestic peers has been often cited as a limiting factor for listing of new age technology companies on Indian capital markets.

However, recent IPO market experience for newer businesses in India points to increasing maturity, with investors willing to bet on first-of-kind companies' listing.

For instance, Team Lease and Just Dial did not have any listed peers in India for their IPOs but their issues were substantially oversubscribed. The investors were able to evaluate the differentiated business models, dynamics of the new sectors and growth potential. As a result, they were able to ascribe a higher valuation multiple. Team Lease got a premium IPO valuation of 40x trailing P/E multiple as compared to 33x for global peers.

(c) *Conventional investors:* Indian stock markets are dominated by traditional sectors with technology sector contributing only 14% of the market capitalization as compared to 40% in the U.S.

It is perceived that most of the institutional investors in India look for profits and earnings multiples and would not be interested in emerging sectors in which technology startups operate.

Interestingly, recent trends have been encouraging with increasing participation of foreign institutional investors in the Indian capital markets.

For instance, MakeMyTrip's current and IPO institutional investors such as FMR, Oppenheimer, Temasek, Standard Pacific, T Rowe Price, Tiger Global, Soros and Janus are actively investing in the Indian capital markets. Similarly, top foreign institutional investors have significant positions in listed Indian technology stocks like Info Edge and Justdial. FIIs dominate the QIB holdings in these stocks. Thus, access to high-quality global investors does not appear to be a limiting factor for credible companies in the emerging sectors with proven business models and high-growth potential.

MakeMyTrip				Info Edge				Justdial			
IPO Investors	Type	Current Investors	Type	IPO Investors	Type	Current Investors	Type	IPO Investors	Type	Current Investors	Type
Treeline	Hedge Fund	T.Rowe Price	Long Only	ICICI Bank	Medium Term	HDFC MF	Long Only	Temasek	Long Only	FMR	Long Only
Soros	Hedge Fund	Wasatch	Long Only	Acacia	Long Only	Matthews Interna-tional	Long Only	Macquarie Bank	Medium Term	Alliance Bernstein	Long Only
Kelusa	Hedge Fund	Wells Capital	Long Only	JF Asset	Long Only	Reliance MF	Long Only	Columbia Management	Long Only	FIL	Long Only
Oppenheimer	Index	Tiger Global	Long Only	Government of Singapore	Long Only	FIL	Long Only	FIL Investment Mgmt.	Long Only	Baillie Gifford	Long Only
Geosphere	Hedge Fund	Janus Capital	Long Only	ICICI Pru MF	Long Only	Capital International	Long Only	IDFC MF	Long Only	Tree Line	Hedge Fund
Temasek	Long Only	MSIM	Long Only	T Rowe Price	Long Only	Axis MF	Medium Term	Eastspring	Long Only	Blackrock	Long Only
Indea Capital	Hedge Fund	Ward Ferry	Hedge Fund	Kotak MF	Long Only	FMR	Long Only	Waddell & Reed	Long Only	Columbia Investment Mgmt.	Long Only
Discovery	Hedge Fund	Artisan	Long Only	MSIM	Long Only	ICICI Pru MF	Long Only	HSBC Global Asset	Long Only	BNP Paribas Asia	Long Only
Robeco	Long Only	FMR	Long Only	Birla MF	Long Only	T.Rowe Price	Long Only	GSAM	Long Only	Reliance MF	Long Only
Standard Pacific	Hedge Fund	Acacia Partners	Long Only	SBI MF	Long Only	SBI MF	Long Only	Birla MF	Long Only	DSP Blackrock	Long Only

Source: FactSet

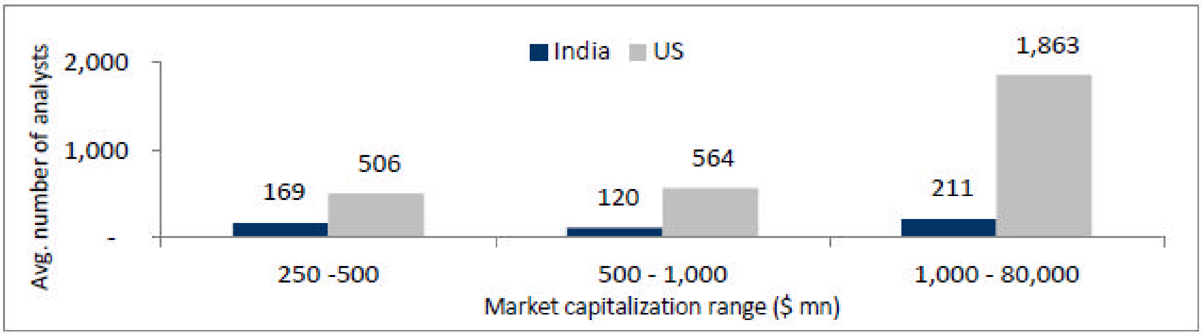
(d) Post-issue liquidity and research coverage

Traditionally, there has been a lack of liquidity post-listing for smaller and mid-size companies in India. High levels of promoter holding and limited free float are main considerations.

Venture capital and private equity funds might find it challenging to exit their positions post IPO listing. Limited research coverage might lead to inadequate investor visibility, thereby negatively impacting valuation.

Comparison of Indian and U.S. stocks points to some interesting data on post-listing visibility and research coverage dynamics:

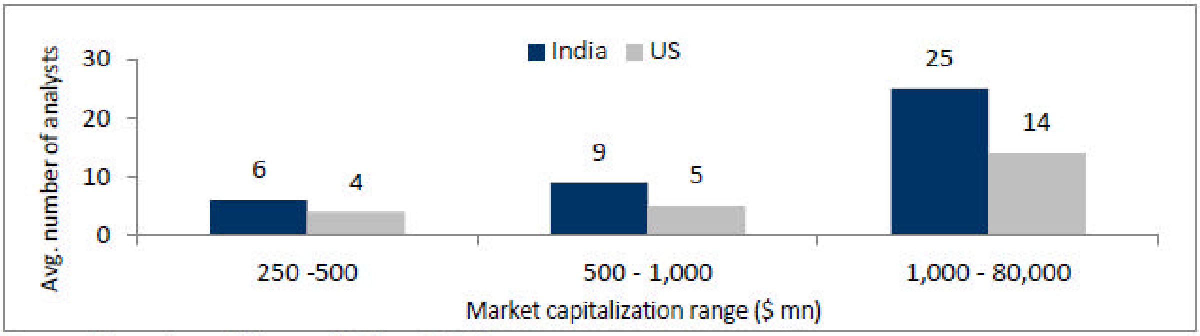
- Research coverage is higher in India as compared to the U.S. for comparable market capitalisation range, despite lower free float
- The market capitalisation range for top 500 listed companies in India is in the range of US$250 million to US$ 80 billion. In the U.S. markets, there are 2,900+ companies in the same market capitalisation range



Source: Bloomberg data as of 2 June 2016

- Thus, given the lower market valuation threshold for top listed companies in India, there is a higher likelihood of active institutional and research coverage. There is a basic economic size (US$1 billion) for meaningful research coverage in the U.S. markets
- Our analysis shows that the average / median number of research analysts tracking these stocks are higher in India as compared to the U.S.

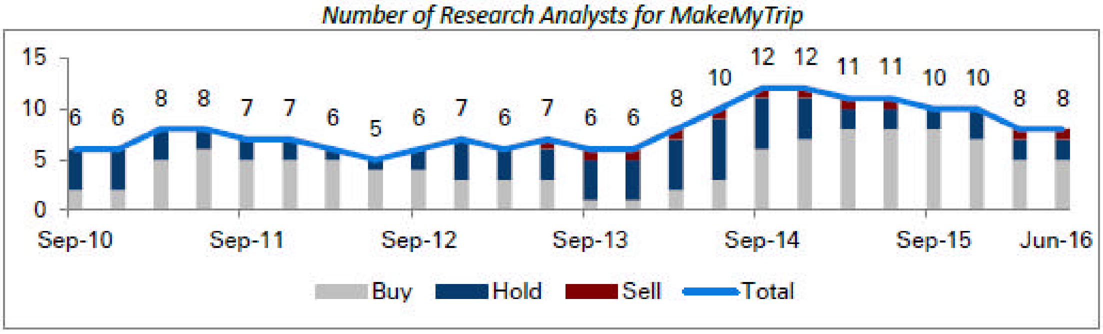
Average number of analysts for US and India listed stocks



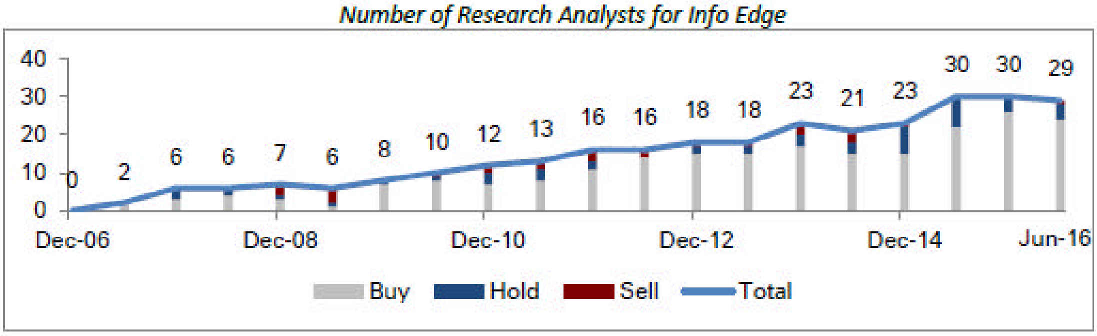
Source: Bloomberg data as of 2 June 2016

Comparison of research coverage of MakeMyTrip which is listed on NASDAQ and technology companies like Info Edge and Justdial corroborates this observation.

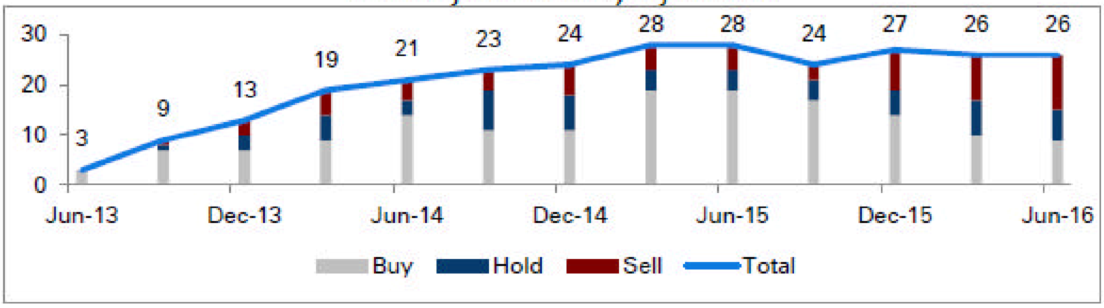
Number of Research Analysts for MakeMyTrip



Number of Research Analysts for Info Edge



Number of Research Analysts for Justdial



Source: Bloomberg

(e) *Usage of funds raised in an IPO*

The requirements for disclosure of use of funds raised in an IPO, is much more detailed and elaborate in India. Companies have to disclose year-wise utilization of funds with specific supporting details such as quotations, agreements, etc. Additionally, use of proceeds for General Corporate Purposes is limited to 25% of the IPO issue size.

High-growth companies might find such detailed disclosures and restrictions daunting. Many would not like to disclose details of use of funds for competitive reasons and the major use of proceeds could be to fund their operating cash burn.

(f) *Branding*

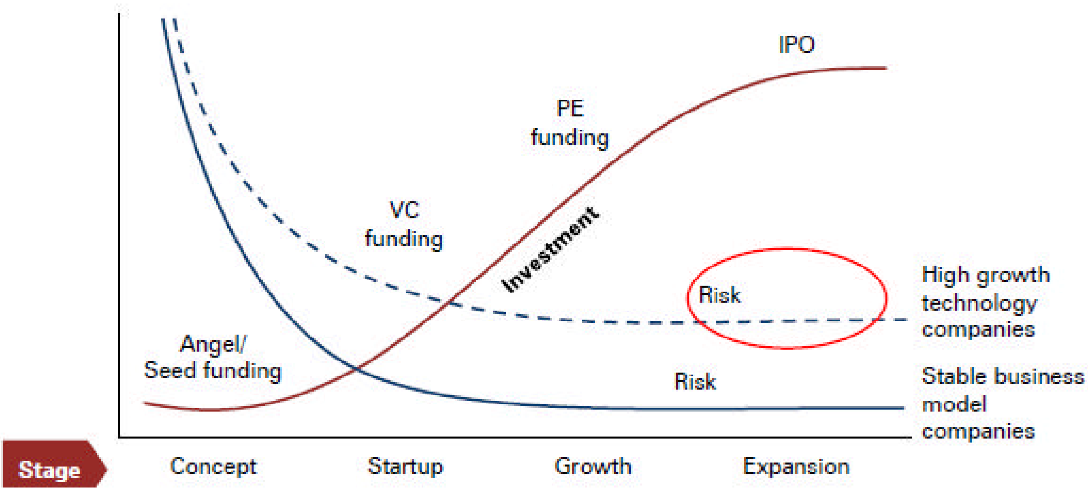
A successful IPO can be a great branding event for a company. Going public creates a lot of media coverage and enhances visibility and credibility for the company. The company can leverage this in a various ways to help the business. An IPO could also help in increasing the confidence of various stakeholders in the company including customers, vendors, investors, employees and job applicants. This can be even more advantageous for a business-to-consumer (B2C) company, which can leverage the IPO event for wide scale brand building. For a company which has majority of its customers in India, listing in India may be more beneficial for enhancing its visibility in the addressable market.

E. Conclusion

There are two kinds of companies – ones with established business models and stable cash flows and others with emerging business models, high growth with breakeven or negative profitability. The Indian public markets have been very receptive of the former. In recent times, even the latter set of companies has found success on the stock exchanges.

For continued success, there is a need for capital from investors willing to take high risk in public markets. The risk of investing in a company typically reduces as the company matures and is even lower by the time it hits the public markets. The risk for certain technology companies, with emerging business models, may be higher than that for conventional companies with stable business models. As long as investors are willing to invest in these comparatively higher risk IPOs, companies would be willing to list on Indian stock exchanges.

Various funding stages in a company life cycle



There seem to be multiple investors willing to invest in this category in India also. Institutional investors including top foreign institutional investors have significant positions in listed Indian technology stocks. An analysis of the portfolios of the top 50 public market institutional investors in the Indian technology / internet sector shows that these investors are open to investing in high growth technology companies with negative earnings or limited profitability, both in US as well as India. For instance, this includes investors like Fidelity, BlackRock, Vanguard, Morgan Stanley etc. Thus, access to high-quality global investors does not appear to be a limiting factor for credible Indian companies in the emerging sectors with proven business models and high-growth potential.

Overall, the appetite for investing in technology companies in the Indian public markets is increasing, which would also improve the confidence of companies to list in India. We could likely witness a rising number of technology IPOs in India in the coming years.