Relevance of Mid Sized Investment Banks

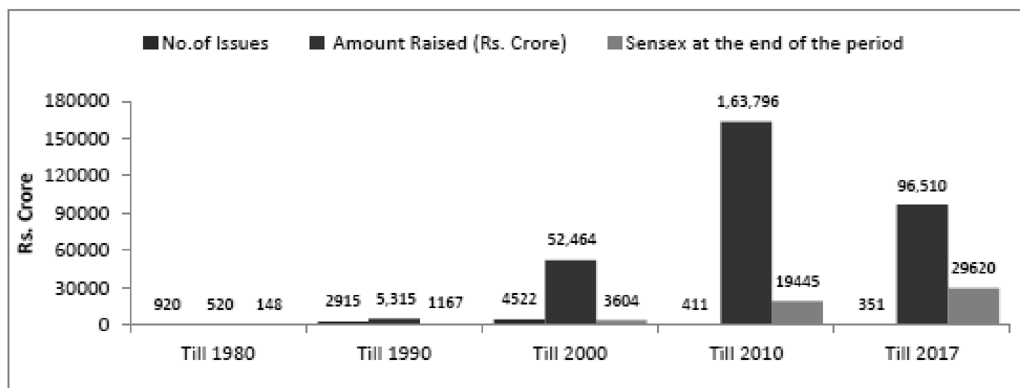
G.S.Ganesh
Founder
Inga Capital Pvt.Ltd.

As an active participant of capital markets over last 3 decades, I have seen the transformation of stock markets from being a pure satta-bazaar to a sophisticated capital mobilization platform. Contrary to early days, equity/debt markets have become an extremely important element in the macro economy of the country. The transformation is reflected in the level of participants moving up, over the last 3 decades and the quantum of funds being raised with a related ease. Another point which justifies or re-enforces our belief is the disinvestment program set by successful governments in planning from long term fund requirement which goes to fund social cause. Similar to transformation of equity markets, the investment banking industry has also transformed over the years. What used to be controlled by public sector banks is now a combination of large investment banks of private sector banks coupled with several notable independent investment banking outfits. The talent which is encompassed in this business has also moved from being banking professionals to management/chartered accountants holding experience in handling complex investment banking assignments. Investment banking business is a complicated tool which requires specialized kits for it's, this segment which charts the pathway for corporates to raise money from public markets to fund their growth. Alongside, India has seen a serious emergence of private equity funds who compliment the capital formation exercise for the corporate needs. In the succeeding sections, I have attempted to list the transformations of capital markets over the last 3 decades and the events which have laid the foundation for this tremendous growth.

1980s

In early 70's, stock market was at best, transactions between traders with almost nil participation from Indian public. This community was at best a joint family of brokers who used to transact for 3 hours and all the settlements were completed manually. Notwithstanding the manual settlement, a decent volume used to be transacted with appreciable efficiency. IPOs were almost nonexistent and the capital needs or the long term funding was met by financial institutions/banks in the form of term loans. The late 70's and 1977 to be precise saw the first change in the history of capital markets. Late Shri Dhirubhai Ambani launched his famous Reliance IPO which was received reasonably well and opened a new chapter for the Indian investors. The subsequent good performance of this stock brought a new element of equity for corporates in crystallizing the long term fund requirements by the corporates.

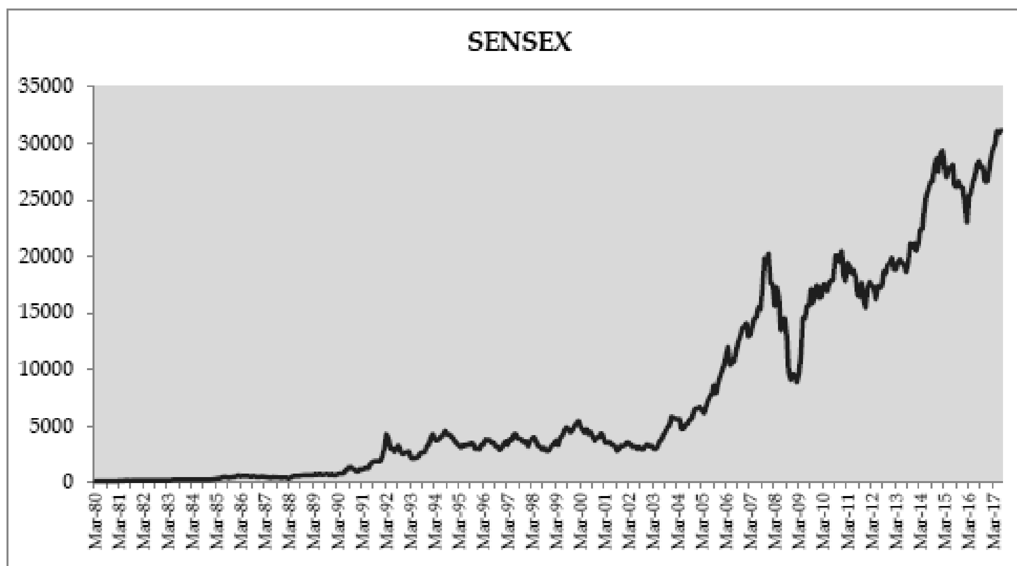
Alongside Dilution of control by MNC's under FERA Act resulted in 123 MNC's offering shares worth Rs150 Cr, creating 1.8 Mn shareholders in 4 years: The intrinsic worth of these shares were higher than their offer price. Hence, for the first the FERA dilution created an equity cult in India. It was the spate of FERA issues that gave a real zest to the Indian stock markets. For the first time, investors got an opportunity to invest in MNC stocks such as Colgate and Hindustan Lever Limited. Multinational companies, with operations in India, were forced to reduce their foreign shareholding to below a certain percentage, which led to a compulsory sale of shares or issuance of fresh stock. Indian investors, who applied for these shares, encountered a real lottery as the share prices were decided by CCI. There was no free pricing and their formula was very conservative. The subsequent 10 years saw an outbreak in the equity issues being launched and significant activity happening in the primary capital markets.



The above graphs reveal that from near non existing platform, Indian equity markets raised approx Rs 5315 Cr from the primary markets. What was more satisfying was the multi fold increase in the number of folios reflecting the strong support given by Indian retail investors. In this phase while the PSU bank Investment Banking were flourishing private sector names like DSP, Kotak, JM and Enam controlled a sizable chunk of transactions. Supporting them was a cluster of several small time brokers who were involved in marketing the offerings to retail investors. Thus over this 10 year period the Indian market saw emergence of retail investors and a strong equity cult among the middle class population. The fact that a portion of household saving moved into equity is a testimony to the rise of equity cult.

1990s

While 80's opened a new chapter in the Indian capital markets, late 80's and early 90's saw the government initiate steps to support the growth of equity markets in India. Financial budget by then FM Shri V P Singh propelled this growth to a new level. Though mid 90's saw the first major financial scam, the strength in the markets absorbed the shock without a major collapse. Few steps initiated by the government such as establishment of Securities Exchange Board of India ("SEBI") in 1992 and National Stock Exchange ("NSE") infused new energy into the vibrant equity market. SEBI instituted several reforms which among others included free pricing of equity, shift from floor trading to electronic trading and setting up of National Securities Depository Limited ("NSDL) to enable dematerialization of securities from the physical mode. Steps initiated by SEBI along with NSE and BSE ensured that Indian capital markets, both primary and secondary attain global standards thereby attracting large foreign institutional investors to participate in Indian markets. Undoubtedly, this expansion of participants led to a significant rise of the Sensex as well as funds raised through primary capital markets.

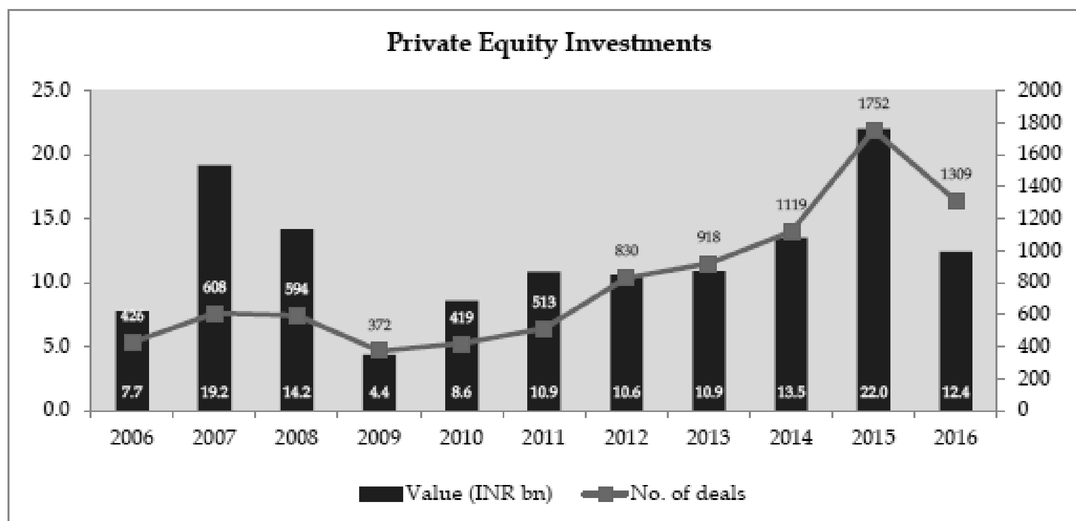


The above table reflects the multi fold jump in the capital mobilization by corporates and the corresponding movement in Sensex. 90's could be easily termed as of the most important phase in the growth of Indian capital market. The initial steps set by SEBI have augured well in the subsequent growth in the Indian capital markets. Alongside, we saw the emergence of private equity funds supporting the capital needs of corporate India. The co-existence of primary capital markets and private equity has laid a strong foundation to raise significant volume of funds required for the growth stories.

The new millennial

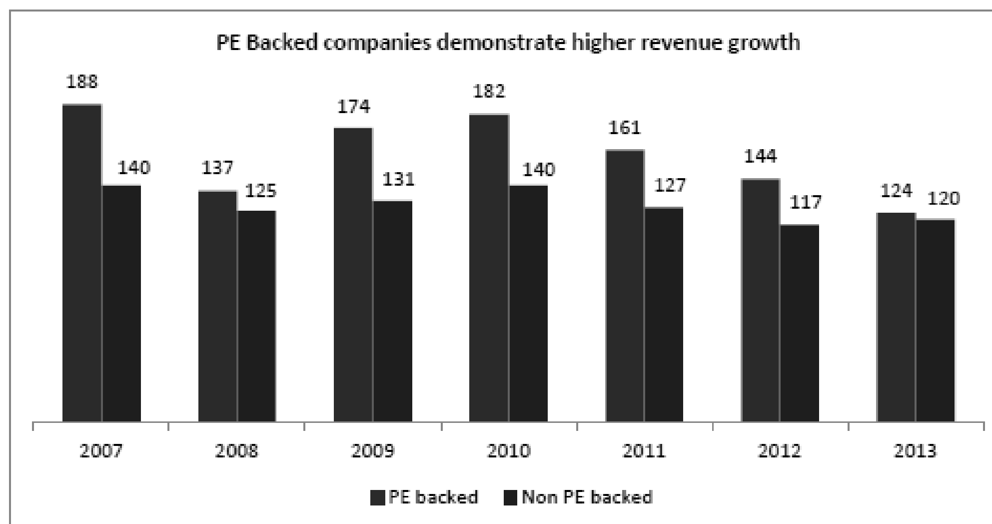
This phase saw several MNCs set up their Investment Banking units namely; Citi, Morgan Stanley, UBS, Credit Suisse. Indian market provided opportunity to the entire diaspora of investment banking by throwing a wide range of fund raising transactions viz GDRs, FCCBs, ECBs and domestic IPOs. This phase also witnessed the slow but a steady emergence of private equity investments.

Private equity as an asset class has been through a remarkable journey in India over the past two decades. The seeds were sown in the 1990s itself, when a few private equity and venture capital funds served as alternative sources of financing to local businesses who were accustomed to traditional forms of using public equity markets or bank financing to underwrite their growth agenda. At macroeconomic and microeconomic levels India has developed with significant investments from the industry, and, over time, has increasingly been accepted by local entrepreneurs as a secure and strategic source of capital funding to facilitate transformational changes in their business.



Private equity has represented a broad-based source of equity capital, both in terms of sectors covered and individual companies. From 2006 to 2016 we have seen a considerable upside trend in the number of Private Equity deals that have taken place over the years. Even after seeing a year of financial crisis in 2008-2009 the private equity deals kept increasing post that year as well. Companies from early stage to mid-size corporations accounted for about 80 per cent of all private equity deals (46 per cent by value) in India.

Private equity's impact on the overall economy is the culmination of its effect on myriad companies that benefited from these investments. In general, private equity firms selected companies with high growth potential and worked with them to exercise and expand their corporate capabilities to exploit this potential. A look at revenue and profit growth data since 2007 shows portfolio companies consistently outperformed their peers without private equity funding.



Source: Indian Private Equity: Route to Resurgence; McKinsey and Company, June 2015

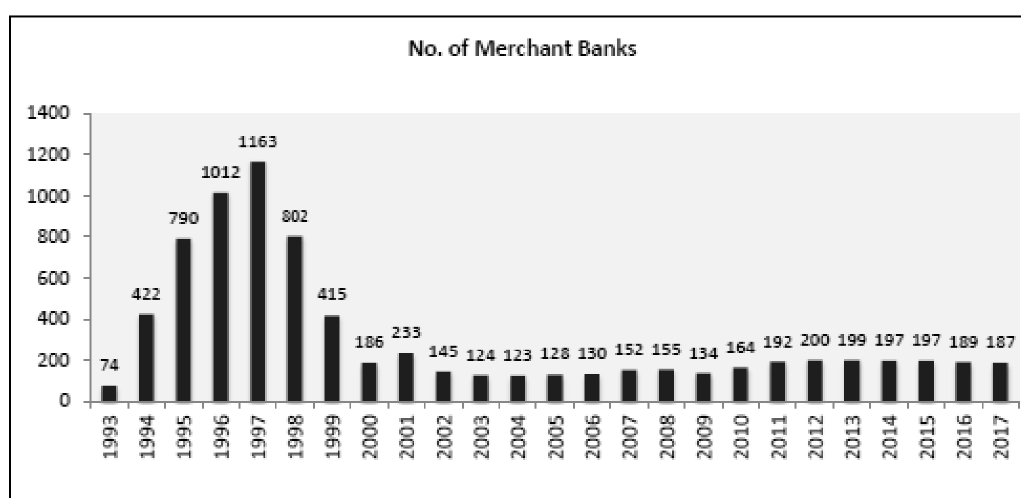
In most cases, private equity has been instrumental in building new capabilities for its portfolio companies, notably evidenced in technological innovation, export growth and cross-border mergers and acquisitions. Often private equity investors bring in their own expertise in international markets to these companies and in several instances eased access to foreign customers in an effort to drive export growth.

Cross-border M&A also accelerated in portfolio companies. These companies that have PE backing appear more likely to engage in cross-border M&A than their peers without the same. The trend was seen across most sectors, including automotive, pharmaceuticals, manufacturing, metals, and consumer goods in particular. In sectors such as IT & IT services, companies backed by private equity lagged their much larger and cash-rich peers. Private equity firms contribute their experience, proprietary knowledge and networks to help these companies find and obtain appropriate strategic partners. Analysis also shows that, in addition to accelerated earnings growth, companies with private equity funding appear to be more diligent in ensuring good corporate governance.

As private equity gains greater acceptance in India and its benefits are more broadly recognized, the industry is likely to continue to play a major role in building private sector capabilities and India's economic development.

IB Rollercoaster

The Investment banking industry has transitioned over the years; with the ANZ Grindlays bank setting up the 1st Merchant Bank in India in 1967, to handle new capital issues. This was soon followed by Citibank in 1970 and eventually several foreign banks together held a monopoly in the country. The Banking committee report of 1972 identified this lacuna and indicated the necessity of merchant banking service in view of the wide industrial base of the Indian economy. The Commission was in favour of separate institutions to render merchant banking services. Consequent to the recommendations that Indian banks should start merchant banking services as part of their multiple services they could offer their clients, State Bank of India started the Merchant Banking Division in 1972. In the initial years the SBI's objective was to render corporate advice and assistance to small and medium entrepreneurs. The commercial banks that followed SBI were Central Bank of India, Bank of India and Syndicate Bank in 1977; Bank of Baroda, Standard Chartered Bank and Mercantile Bank in 1978; and United Bank of India, United Commercial Bank, Punjab National Bank, Canara Bank and Indian Overseas Bank in late seventies and early '80s. Among the development banks, ICICI started merchant banking activities in 1973, followed by IFCI (1986) and IDBI (1991). JM finance was set up by Nimesh Kampani as an exclusive merchant bank in 1973.



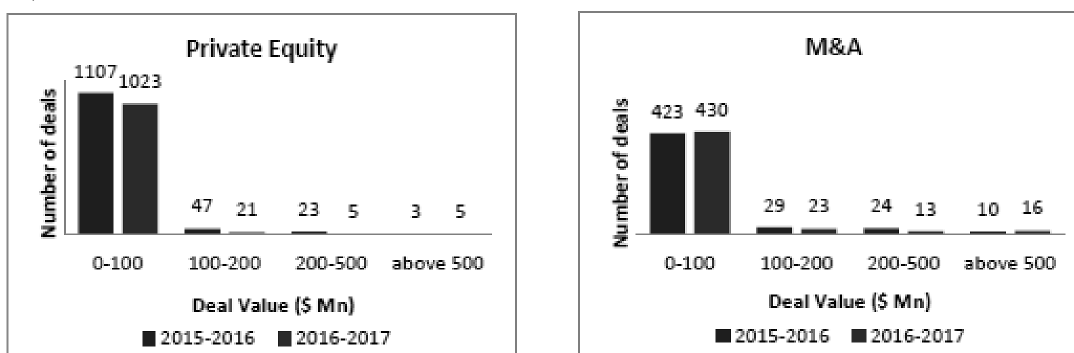
The graph above shows surge in the number of Merchant banks upto 1997. This is attributed to the abolition of CCI office and introduction of 'Free-Pricing' of issues. After 1997, the trend has reversed and number of MBs registered declined from considerably, primarily due to increased competition, sluggish conditions in capital markets, reduced number of issues, increased reliance on private placement route by corporate houses.

Today there are about 15 multinational I-banks, 15-20 large home grown I-banks, about 500 I-banks that have a team of around five to five-hundred members and approximately 1000 I-banks with one or two partners running the entire show. This last stratum is now known as the boutique investment banks; which have shown a sudden upsurge in the recent past. Boutique I-banks typically handle sub-$15 Mn (Rs 100 Cr) deals, aiding fund-raising, debt, and private equity (PE) and venture capital investments. The industry dynamics have pushed even big I-banks to tread into deals of this range, below their usual $100 Mn benchmark. However, the key lies in creating a niche for itself.

The fundamental reason behind the growth of a plethora of boutique investment banks is the swarm of small and mid-sized deals in India in the past years. Nearly, 1023 M&A deals sub $ 100 Mn category were concluded last year, while the number of $100-200 Mn range deals were 21. Only 5 deals took place in the range of $200-500 Mn and above $500 Mn each in India in FY17. In FY16, there were only 3 deals in the above $500 Mn category. In the sub $100 Mn category, about 1107 deals have materialized in 2016.

The growing numbers of smaller deals have created a demand for the boutique investment banks in India. With more cross border transactions happening, boutique I-bankers are finding an opportunity to form alliances with global partners as well. The collapse of the big players in the Ibanking industry in the aftermath of the 2008 crisis is a blessing for these boutiques investment banks. International banks have a fee benchmark, which is sizeable in the Indian context, which permits only handful Indian deals to be eligible for global banking advisory. Given the cost structure of the bulge brackets, with several partners and dozens of associates and analysts getting fat paycheques, it makes sense for them to enter a deal only when the fees are enough to take care of the crew. For that the deal size ought to be Rs 200 Cr or more.

The surge of small ticket PE deals has also remained the strong reason for the entry of these boutique banks to tap the growing market of small-sized M&A deals. While there were 430 deals in the sub $100 Mn category in FY17, against 423 in FY16, there were only 10 and 16 deals above $500 Mn in FY16 and FY17 respectively. Industry believes that the changes in the Ibanking space are part of the slowdown. Also, boutique banks have limitations in the IPO domain where they will not be able to handle the distribution, while they can manage the valuations. However, co- existence of investment banking advisory with a supermarket approach by offering broking and asset management services sheet investment banks (essentially for funding needs of clients) and boutiques (real advice to clients) will co- exist.



Source: VCCedge

** For data available*

Another fact which reinforces our belief is that midsized banks will continue to co-exist or sometimes be a prominent player is the continuous flow of entrepreneurship in India. Not a day passes without a new story emanating. Such initiations needs capital and more importantly the hand holding during the fund raise. These big banks neither have the patience nor the ability to work on small fee. Boutiques are happy to even convert their fee into equity in the respective venture and fee paid post the fund raising. This definitely is on account of positive mood in the market.

India is land of home grown business and the need for boutique Ibanks playing an important role cannot be underestimated.

I conclude by saying co-existence of large IBanks and Boutique is a recipe for the new economy unfolding now. Challenges will be for these banks who get squeezed in between.