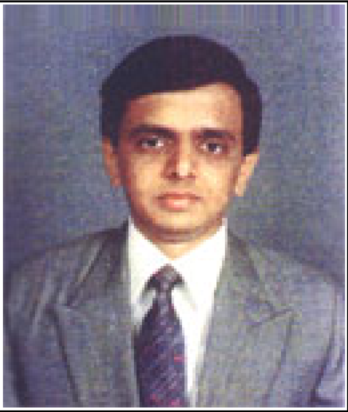
Integrating the Indian IPO Market with Global Markets



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India has one of the world's oldest stock markets with one of the highest number of listed stocks in any country. Until the mid 1990s, access to capital markets and the ability to meet ongoing funding requirements through public offerings were considered to be sources of competitive advantage for many Indian corporates. However, this trend has declined in recent years, as Indian investors have shunned the equity new issue markets, and corporates have been increasingly reticent in accessing equity capital to finance growth. This may be explained to some extent by market irregularities and manipulations, which have led to wealth erosion for the average investor, as well as the heightened global and local market volatility during this period. Indeed, despite a falling interest rate scenario, investors are still keen to invest in low yielding but less risky investments like bank deposits.

In this article, we have attempted to gauge the need and address how to integrate India's capital markets within the global marketplace. We believe that such integration can result in significant improvement in the functioning of the local markets and will facilitate large-scale capital formation by re-channeling funds from India's large investor base to the corporate sector.

As we have seen in Asia's tiger economies (e.g. Korea, Taiwan, Singapore), integration of the capital markets and revitalisation of the domestic investor base has been a critical step towards broader integration within the global economy and for capturing global capital flows. Furthermore, the example of our neighbour China's rapid growth also reveals the extent to which global capital flows have fuelled corporate spending and asset expansion. Integration within the global markets is not only the next step in ongoing economic liberalization for India, but can serve to establish the country as a destination of choice for international investment and help establish and fund Indian companies as they become truly global enterprises.

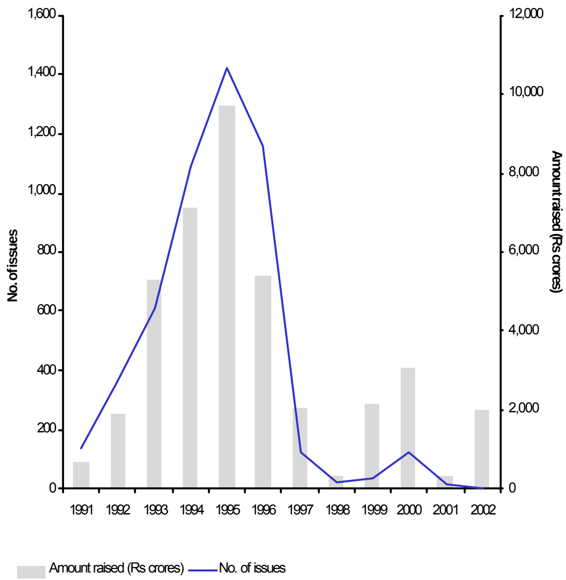
THE INDIAN IPO MARKETS

An analysis of the performance of the Indian capital markets over the last few years reveals several key trends, including:

Reduction in equity issuance

After the highs of the early to mid-1990s, there has been a steep fall in new equity issuance. Whilst the Technology and Internet boom between 1999-2000 raised hopes of a revival, this momentum has not been sustained. Indeed, India's markets have been far slower than the U.S. and other Asian markets to recover from the shock of the Internet bust, as both demand and supply have waned.

No. of Public equity offerings and amounts raised (1991-2002)



Source: Citigroup, Prime Database (as of December 31, 2002)

Over the last two years, equity raising has largely been limited to companies from select sectors such as Banking or Technology. Whilst there has been a gradual recovery in "Old Economy" sectors, most companies have sought to either fund in the local debt markets or through internal accruals and several have accumulated large cash balances as corporate capex spending has slowed down. This has led to significantly diminished new equity supply.

A major component of this supply in the domestic market has been in the form of Initial Public Offerings ("IPOs"), as opposed to follow-on offerings by listed companies who wish to raise primary capital. While unlisted companies have been successful in raising funds, existing listed companies who have wanted to tap the capital markets for their ongoing financing requirements have faced significant structural hurdles and tended to issue depositary receipts listed in U.S. or Europe. An essential component of the integration of Indian capital markets within the global marketplace will be to address the perceived structural risks and regulatory hurdles still faced by Indian companies, in order to ensure that overall risks associated with equity financing are minimized.

Stronger equity pipeline but is there enough investor interest?

We believe that the Indian equity pipeline is recovering, with proposed equity issuances in excess of US$1 billion over the next six to twelve months. The market is expected to witness some large offerings by companies such as Tata Consultancy Services, Maruti Udyog, NALCO and BPCL, to name a few. Much of this is due to a revitalized privatisation calendar, a process which has been instrumental in many countries in the development of the domestic capital markets and a critical part of economic liberalization.

While a strong equity pipeline is good news from a supply point of view, it increases the difficulty for smaller companies to crystallize their fund-raising plans, since there is an apprehension that larger issues will dominate investors' attention and allocation to the equity markets, resulting in limited demand for smaller issues. The key issue that needs to be addressed is how to stimulate further demand into the equity capital markets, in order to ensure that all issues get sufficient focus.

Investor classes that should be addressed and provide large pools of potential demand include Indian retail, domestic mutual funds, domestic high networth clients, NRIs, FIIs, international retail investors as well as non-FII global institutions. Based on Citigroup, OECD and the National Association of Mutual Funds estimates, there is over US$6.5 trillion in mutual fund assets and US$5.5 trillion in pension fund assets in the U.S. alone.

Valuation disparity

Globalisation has made it possible for Indian companies to access international capital markets, and in some cases this has been necessitated by their global expansion plans. However, in certain instances, there is a disparity between the valuations enjoyed by such issuers in India and abroad. The disparity is attributed to unsatisfied investor demand in the overseas markets, due to limited listed float and regulatory restrictions which prohibit complete fungibility between the Indian stock and the ADRs/GDRs.

Regulatory restrictions

Regulatory restrictions and lack of full capital convertibility are key factors which result in segmentation of Indian capital markets from the global markets. In the recent past, there have been certain relaxations such as permitting ADR/GDR offerings involving secondary shares. However, regulatory issues like lack of complete fungibility between DRs and local shares, the domestic IPO process, inability to structure follow-on offerings, stringent norms for FII registration, restrictions on foreign companies listing in India and lack of certainty on tax treatment for FIIs continue to inhibit complete integration of Indian markets with global capital markets.

The factors listed above call for greater integration of the Indian capital markets with global markets. The functioning of the Indian markets is still restrictive compared to other leading international markets. Increased alignment with international standards and easing of some restrictions can provide a platform for global investors to reallocate their sizeable funds to India, which will hugely facilitate larger capital issuance. As demand from domestic investors is also stimulated through ongoing privatisations and redistribution of national assets to shareholders, and Indian corporates begin to view the equity markets as a comparatively liquid and less risky source of funding, a dynamic can be created for a virtuous circle of demand and supply.

INTEGRATING WITH THE GLOBAL MARKETS

As highlighted previously, integrating the Indian marketplace with global markets is a key step on the path of economic liberalization and one which has benefited many other major economies in the world. In the following section, we have outlined some suggested areas of reform which may help in aligning the Indian capital markets with global standards.

1.Facilitating foreign institutional investment

Based on Citigroup, OECD and ICI estimates, the total investible funds of global institutions are estimated at over US$20 trillion, which is approximately 40 times the size of India's GDP. This clearly indicates that even if a fraction of this demand is tapped, it can result in a tremendous inflow of funds into the Indian capital markets. This will require liberalizing some restrictive regulations such as:

Complicated FII registration

The current process for FII registration is complex. As a result, several institutional investors have been using alternative investment structures to circumvent the regulations.

Lack of clarity on tax issues

There is uncertainty on whether Mauritius registered FIIs will continue to enjoy capital gains tax exemption in India. It is time that the tax authorities clarified their final position on this issue.

2. Greater fungibility between local stock and ADRs/GDRs

Currently, ADR/GDR holders are permitted to convert their ADRs/GDRs to local shares. However, re-conversion of local shares into ADRs/GDRs is permitted only to the extent of available "headroom". Due to lack of capital account convertibility, Indian resident shareholders are not permitted to convert their local shares into ADRs/GDRs. These restrictions create valuation disparities which should not be present if markets are efficient. Allowing complete fungibility can help reducing the valuation disparity and potentially allow Indian companies listed both in India and abroad to enjoy more uniform but higher valuations.

3. Differences in Equity Offering process

The bookbuilding process currently in practice for Indian equity offerings has certain variations, when benchmarked against international standards. The key differences and our recommendations are highlighted below:

- Corporates who raise funds through 100% bookbuilding route are required to communicate a "Floor Price" to investors at least three working days prior to Bid Open. We believe that the process of setting a Floor Price significantly undermines the process of "price discovery". To date, domestic IPOs have not been successfully priced above the Floor Price, and this remains a cause of concern for many potential issuers. In an international offering context, jurisdictions typically require a price range to be set for IPOs (for example, in the U.S., Hong Kong, Singapore and Japan) and announced publicly at launch of the transaction. Issuers are also given the ability to revise the price range publicly within a certain amount (i.e., revise the range up or down by 20%). This flexibility will benefit prospective Indian issuers, both to enhance the price-discovery mechanism as well as to insure against failure of deals because of a rigid Floor Price.

- It is common practice in most international markets to have a Greenshoe option, i.e., the option to allot more shares to the investors than the issue size. This plays a crucial role, particularly in a Follow-On offering (where securities are already listed), in stabilising the trading price of the shares following completion of a public offering, by balancing the demand for and supply of the shares in the market.

  Under a Greenshoe, the underwriters allot shares in excess of the issue size to the investors and create a short position. In the event the shares trade below the issue price, the short position is covered by a purchase of shares by the underwriters in the after-market, resulting in an increase in the trading price. In the event the shares trade at a price above the issue price, the short position is covered by the underwriters exercising their overallotment from the issuer, resulting in more shares being sold in the market. The bottom line is that a Greenshoe can play a crucial role in stabilizing the stock price after listing, and reduce the post-listing volatility IPOs have witnessed in the past.

4. Simultaneous listing

Indian companies currently aspire to achieve a domestic listing and then seek a follow-on international listing after demonstrated performance in the local markets. However, if companies achieve significant scale prior to listing, the offering size becomes extremely large in view of high valuation that the company enjoys. To illustrate, the expected size of the Tata Consultancy Services IPO is in the range of US$500-600 million, despite the offer size just being 10% of the capital.

In such cases, the companies can greatly benefit if they are permitted to achieve a simultaneous listing on the Indian and international bourses. This will enable targeting a wider investor base and potentially increase liquidity. Additionally, complete fungibility between exchanges can also help promote liquidity in both markets.

There are currently several impediments to a simultaneous dual listing, which SEBI is seeking to address in its public consultative paper. Many of these issues are common practice in the global markets, and will greatly benefit the development of the Indian market. They include:

- Review period available to regulators, and confidential review process to limit effects of "public" process on corporate activities;
- Use of filing Price/Size range rather than Floor Price method;
- Reduction in settlement period to listing/trading to T+3 international standard; and
- Use of the Over-allotment Option to ensure aftermarket stabilization for issuers.

CONCLUSION

The suggestions listed above are just some ways in which Indian capital markets could be integrated with global markets. Achieving complete integration is a long-term objective and the key is to initiate steps in this direction and continually monitor the status of integration. SEBI has already instituted a number of steps to prevent and monitor potential market irregularities and protect the interests of small investors. We believe that greater integration with global markets will further smoothen the functioning of Indian markets.

We are not advocating an unfettered access to the Indian markets by global investors. We believe that the current regulatory environment has shielded the Indian markets from shocks such as the Asian currency crisis in 1997 and frequent economic disruptions experienced by Latin American countries. However, timely steps towards integrating Indian capital markets with global markets will go a long way in providing greater depth to the Indian markets and re-establishing investor confidence, in a more sustainable manner, for the longer term.

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