Integrating Indian IPO Market with Global Markets

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Introduction

The domestic primary market, in particular the Initial Public Issues (IPO) s market as it existed a few years ago was a picture of complete distrust. In the mid-1990s, the market was characterized by many companies entering the capital market to raise funds from the public for the first time. Most had common thread running amongst them. The promoters had little or no experience in business undertaken, were first generation entrepreneurs and these IPOs having undergone a proper feasibility evaluation by a financial institution was rare. No wonder during this period, many fly-by-night operators abused the market and investors who had subscribed to their IPOs suffered significant losses.

Other important characteristic of the IPOs in the mid-nineties were absence of Foreign Financial Institutions (FII) participation. In that sense there was no integration of the Indian IPO market with global markets and almost all the offers were marketed to domestic investors. The capital market regulator, Securities and Exchange Board of India (SEBI) had been in existence for only a couple of years and regulatory norms were still evolving. Moreover, the Indian corporate sector was in the midst of a structural transformation with the old economy companies stocks doing badly in the face of global competition while software companies delivered outstanding financial results.

As SEBI was moving towards a QIB (Qualified Institutional Buyers) market, the poor quality of IPOs by companies with no track record was a matter of concern for the new regulator.

The present

However today the scene is quite different as quality of primary issues has undergone a radical change. The rules pertaining to issuance of fresh equity are stringent and the economy is in a much better condition than it was during the transition phase. The GDP growth rate in 2005-06 was a robust 8.4 per cent compared to around 5-6 per cent earlier. In FY'05-06, 102 IPOs and follow-on public offers (FPO) entered the capital market raising almost Rs 24,000 crore. QIBs / FIIs have whole heartedly participated in quality Indian papers.

Apart from a record number of IPOs that hit the market, FY' 2005-06 was also a remarkable year for the stock markets as the indices scaled new peaks and foreign inflows crossed an eye-popping US$ 10 billion for the first time in a fiscal. Large portion of the FII inflows into IPOs come in broadly through four to five categories. The first comes through India-dedicated funds that are raised from the investors with a specific mandate to invest in the Indian markets. The second category of investments comes in as part of the allocation to India from emerging market funds. The third are inflows through the hedge funds, which are also currently long-term investments. Further, there are long-term pension funds such as Fidelity, which also takes 5-7 year calls. Whichever way they come, one thing is clear. With the Indian economy being fundamentally strong, FIIs are here to stay. Because for them eventually fundamentals and nothing else matters even though global liquidity plays its part.

Thanks to FIIs, levels of transparency and corporate governance standards have vastly undergone a change for the better in the corporate sector. Coupled with SEBI disclosure norms, the last five years have seen FIIs playing a major role in making companies more transparent. This has resulted in huge benefits to the shareholders.

Under the current SEBI norms for QIBs and FIIs, the latter are allowed to take part in domestic IPOs under the QIB category. Companies coming out with their initial public offer desire FII participation as it helps their cause tremendously. In a sense it is imperative for the success of the IPO hence their keenness is high. Similarly FIIs too are eager to invest in quality IPOs. A recent case in point is the overwhelming response to Reliance Petroleum which attracted over five billion in QIB procurement. This is integration.

In recent times, retail investors have not remained invested in IPOs for a long time. And with they anyways bringing only a small amount at the time of IPO, it is the FIIs who have invested in IPOs that saw tremendous interest in IPO's and FPOs such as ICICI Bank, Suzlon, HT Media, IDFC, Reliance Petroleum and Indiabulls.

Importance of FIIs

In most cases FII enter the IPO much before the actual IPO takes place. The entry can be as early as one year before the IPO, either through the investment banker or directly. It is also an important thing in the price discovery process of an IPO. Companies often rely on foreign investors to determine the pricing for their IPOs. As mentioned already, from the point of view of the company doing the IPO, this is clearly a great way to extract a maximum valuation in the primary market. The entry of a FII definitely helps in bringing about some amount of confidence in the company.

Most major global investors focused on emerging markets and India has participated in the recent IPOs. The global institutional investors' response to these IPOs has been very positive. The best names in the global fund industry and they are all here. Nearly two-thirds of the total institutional money has come from foreign institutional investors. IPOs have been a boon to new foreign investors.

The roadshows for these IPOs has helped increase awareness about India. So integration of Indian IPO with the global market is already a reality if not complete. This is evident from the fact that all the major public issues are marketed abroad through roadshows – where FIIs reside and at important financial centres such as New York, London, Singapore, Hong Kong. The roadshows give the FIIs an opportunity to learn about the company's products and solutions, core technologies unique value proposition and advantages over competitors in the market. Such exercises are imperative in the process of integration if IPOs have to have a good response. No promoter can afford to turn a blind eye to this development. In many instances, after QIB portion has been oversubscribed, the retail investors get interested and subscribe

Moreover listing of good quality papers like Infosys, HDFC Bank on overseas exchanges like NASDAQ, New York SE, London SE, Luxembourg and Singapore is another way in which integration has been enabled. Even mid-sized companies have benefited from the integration process. Indian IPOs have provided decent returns in short duration. Over the long term some of them have proved to be multi-baggers examples being Infosys, HDFC Bank etc.

The FII influencers

So what are the factors that act as motivators? No doubt a strong secondary market is a precursor for IPO market to prosper. FIIs optimism for the primary paper is often a spillover of their perceptions about the secondary market. Integration of the market is speedier when business plans by corporates aiming to raise money through IPOs are crystal clear, there is transparency in management and the vision and quality of management is not ambiguous. Similarly the economy wide factors like the GDP growth, the fiscal and monetary policies support economic growth, there is political stability in the country – the democratic form of Indian political system has been proved over the years. The industry growth rate has to be decent and the company's growth rate better than the industry rate. The company needs to have a sustainable profitability and growth record. Most important of all IPO issuers has to guarantee that enough value is left for the investor to earn, if foreign bodies participation is required. In other words the valuation has to be reasonable.

Role of SEBI

Integration has also been helped by the fact that past experiences in the IPO market has resulted in SEBI formulating stringent IPO norms. SEBI is committed to protect the investors' interests and to increase the transparency and efficiency of the primary market. Stringent disclosure and eligibility norms have been issued. Further, various operational procedures for the issuers have been simplified to facilitate smooth mobilization of resources. In this regard, SEBI has set up various committees, which constantly review the guidelines

Over the years, SEBI has worked towards systematic reforms in the stock market – all of which have made the markets safer, cleaner, more transparent and modern. Some of the important measures since the abolition of capital issues control are tightening of capital issue norms and introduction of QIB market, improved disclosure requirements, framing of regulations and code of conduct for merchant bankers, underwriters, mutual funds, bankers to the issue and other intermediaries. All these have helped the IPO integration process with global FIIs.

Primary market has immensely benefited from the increased disclosure based regulation brought in by SEBI. In the field of continuing disclosure, listed companies are now required to disclose unaudited financial results on a quarterly basis, and these results are subject to limited auditor review. The Accounting Standards Board set up by the accounting profession is engaged in a major exercise to bring Indian accounting standards on par with those of the IASC (International Accounting Standards Committee). SEBI has also implemented the Corporate Governance Code through the listing agreement. Under this code, companies are required to have a minimum number of independent directors, and to have an audit committee.

The tight norms have also kept fly-by-night operators from taking investors for a ride. Firstly, willful defaulters have been barred from making debt issues. Secondly, issuers have to tie up means of finance prior to primary issue to ensure financial closure of the project for which public money is raised. Thirdly, SEBI has introduced the concept of 'net tangible asset' to ascertain a "minimum tangible existence of the company seeking to access the capital market."

Further to enhance the quality of issues in the primary market, SEBI's IPO norms state that IPOs of issue size upto 5 times the pre-issue networth shall be allowed only if the company has track record of profitability and networth.

The book building route has been made compulsory for companies, which do not have such track record. Further, 60 per cent of the offer made by them should be allotted to Qualified Institutional Buyers (QIBs) comprising financial institutions, banks, mutual funds, FIIs and VCFs registered with SEBI. Inability to meet this condition would mean failure of the issue. The book- building route has also been made compulsory for IPOs with issue size more than 5 times the pre-issue networth and for public issues by listed companies worth more than 5 times the pre-issue networth. In these cases also, success of the issue requires allocation of 60 percent of the offer to QIBs.

Dematerialised form is compulsory for listed companies making IPO of any security for a sum of Rs 10 crore or more. Paperless format has enabled speedy growth and played a key role in integration. When IPOs are in demat form, it saves time and cost. Quick credits to demat accounts are possible. SEBI has further mandated that all new IPOs compulsorily should be traded in dematerialised form only.

Role of Investment banks

Investment bankers have a major responsibility. They have to ensure proper due diligence in an IPO. A lot of things go into this. Transparency is very important. Disclosures have to be upto date. Credentials of the investment banker are also looked at when FIIs/ QIBs consider an IPO investment. Each company issuing securities has to enter into a Memorandum of Understanding with the lead merchant banker, which specifies their mutual rights, liabilities and obligations. The lead merchant banker has to exercise due diligence and satisfies himself about all aspects of offering, veracity and adequacy of disclosures in the offer document. All the other formalities like, allotment, refund and dispatch of certificates are also taken care by the lead merchant banker. The lead manager should also ensure that the issuer company has entered into agreements with all the depositories for dematerialization of securities.

The road ahead

So what is the road ahead? Integration exercise and newer ways to attract FIIs towards investing in Indian IPOs will continue. It needs to be restated that transparency, fair valuation are taken care of at all times. In the present context, the need is to ensure that regulations are followed in spirit. Proper qualitative issues /IPOs are properly marketed to key audiences. It also means transparency, fair valuation and reasonable quota for FIIs / QIBs

According to recent story in the Economist magazine only a few Indian companies are fully ready to compete internationally, with professional managers independent of the owners' meddling. Most Indian business is still in the hands of family firms, and most people take it for granted that this will continue. Most of the companies are still family concerns. Professionalisation of management and separation of ownership of companies raising IPOs will hasten the integration process. As we go ahead reluctant families will have to cede control of Indian companies if they are to be international successes. That may well be true of many smaller firms. The larger ones, however, are being forced to become more transparent and “professional” by the demands of the stock market and of globalisation.