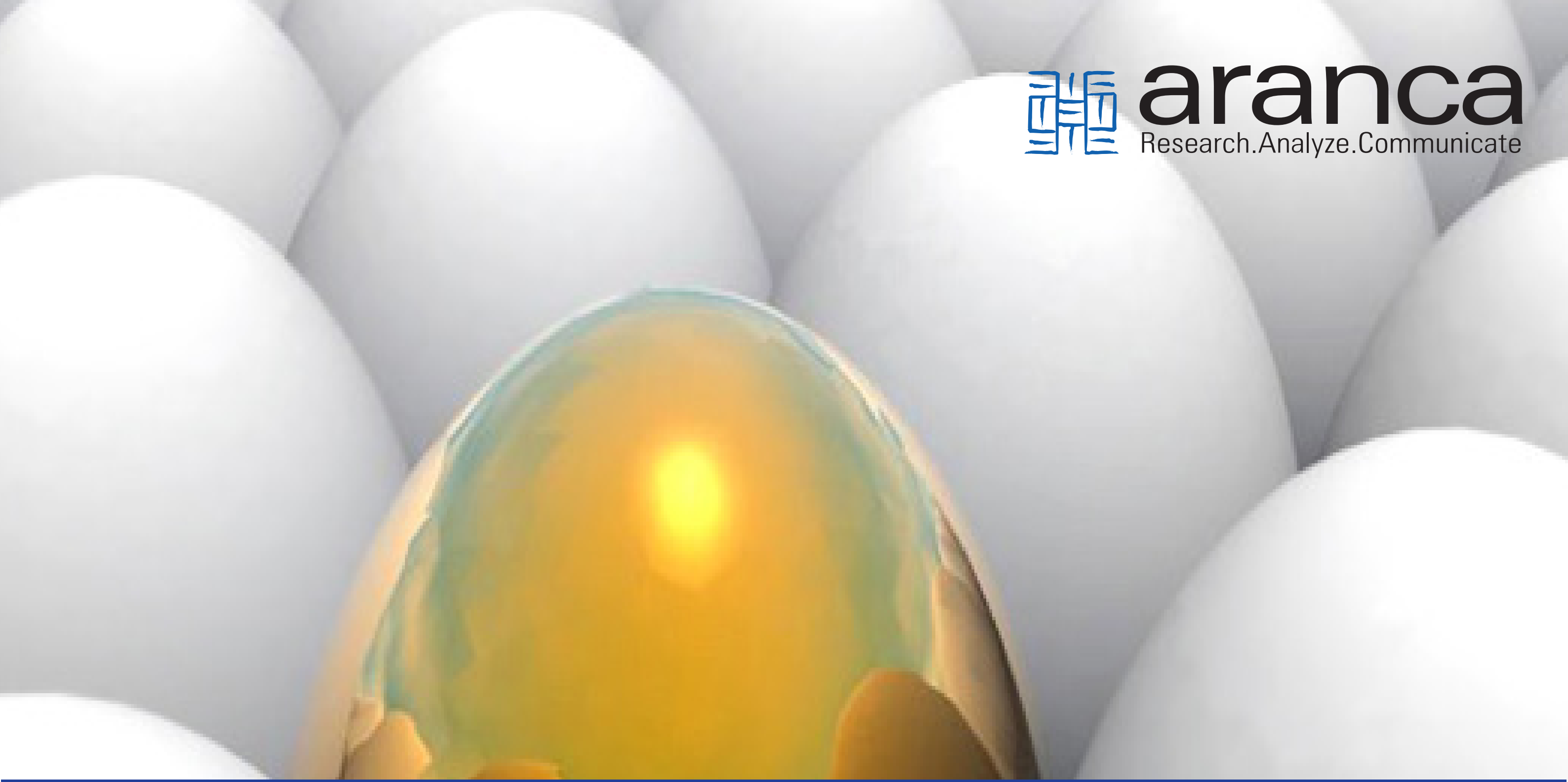

Indian IPOs

The Quality vs. Quantity Conundrum

Thematic Report by
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While the number of IPOs show only modest gains, it's the mix that's noteworthy

Amid all the talks about the IPO activity in India this year, we believe it is not the volume, but the mix of IPOs that is generating interest among investors and companies.

While the number of IPOs has risen this year, the increase is not sufficient to warrant this euphoria. The wide variety of entrepreneurs, business units, and business models making their debut at the primary markets is noteworthy. This marks a period of transition for the Indian markets, which until now have been largely a platform for bigger and safer companies with conventional business models.

India is likely to have begun its journey to become a more sophisticated market; it is currently only testing the waters. This year - with its breadth of IPOs - would allow all stakeholders to assess whether the investors have an appetite for new-age IPOs. Not just the investors, it would also put to test the readiness of the markets, entrepreneurs, and entire trading system for entering this new phase.

However, there are possible caveats. At a broader level, we believe the rally in markets needs to sustain to provide a bigger boost to the IPO activity. This may be a little difficult as other routes to raise funds could be preferred over IPOs. For instance, QIPs is a cheaper and less time-consuming option; and with India heading down a monetary easing path, debt could become an increasingly attractive option for companies to raise funds.

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The Quality vs. Quantity Conundrum

IPO Activity Way Below Previous Highs

While IPO activity has picked up this year compared with 2013 (5) and 2014 (6), the increase is not significant enough to match the recent highs in 2010 (56) or even the lower level in 2011 (32). This year, eight companies have been listed thus far and another 8–9 companies have filed for IPOs. However, we cannot consider the IPO market in isolation.

The IPO activity in an economy is closely linked with the overall performance of the equity markets therein. This, in turn, is indicative of the investor sentiment and the growth prospects of the economy. An increase in IPOs generally propels the markets, as it invites greater attention from foreign and/or institutional investors and looking at it the other way, a rally in the market could lead to more companies opting for IPOs, as companies tend to expect a higher valuation in an overall bullish environment.

However, if too many IPOs flood the market, it could sap the liquidity if the market is ill-equipped and not liquid enough to handle the inflow of IPOs. Taking the recent example of China that has had a crazy bull run having advanced close to 150% from the beginning of the year until mid-June. The market rally attracted a record number of IPOs, which in turn, further fueled the bullish sentiment among local and foreign investors.

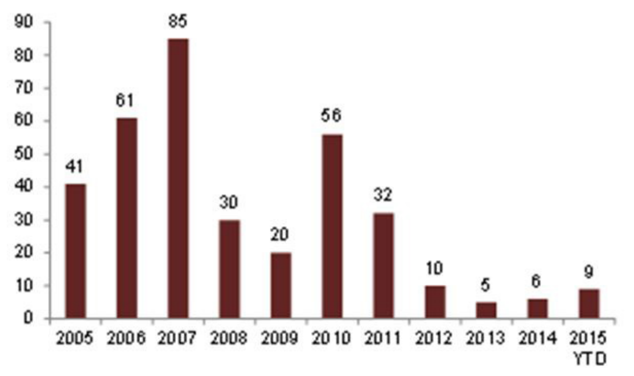
To rein in the situation, the government had to suspend the IPOs, which were expected to attract funds totaling USD 645 bn. This move was, however, warranted considering how investors were pulling out money from their current holdings to invest in the upcoming IPOs.

Coming back to the Indian markets, we took stock of the IPO activity in the last 10 years and its movement vis-à-vis the market performance.

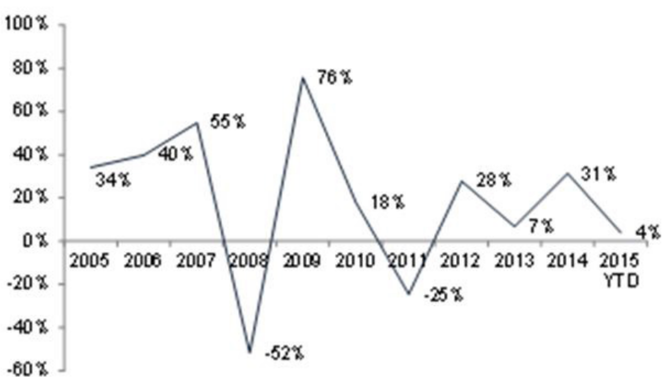
We observed that the market rally has not been in line with how heated the IPO market is or vice versa.

However, we do realize that companies often file for IPOs on the basis of the current market situation, taking into account an approximate sense of how and where the market could potentially be once these IPOs are listed and the companies' shares start trading. Considering this, we believe there could be a marginal dilution in the correlation between the two. However, we maintain that the two may not always be perfectly aligned, considering a whole host of other unforeseen factors that determine market movements.

Number of IPOs*



Nifty Index YOY Returns



*Source: NSE, Bloomberg; *only includes IPOs listed on NSE*

Variety of IPOs Points Towards a Beginning of Transition

The mix of companies filing for IPOs has not gone unnoticed by the investor community. This is being touted as a new phase for Indian markets. Companies in the e-commerce, entertainment, and consumer space have not been a regular sight in the primary markets thus far and reasonably so. However, a look at the list of awaited and recent IPOs for 2015 throws up some interesting names: Coffee Day Enterprises, Infibeam Incorporation Ltd., Manpasand Beverages Ltd., VMV Holidays Ltd., and Matrix Cellular (International).

It would be interesting to note how the investors respond to these companies' debut on the stock markets, as not all companies have the safest models or supporting business conditions to ensure sustainable revenue and profit growth. Manpasand Beverages (listed in July 2015) is a fruit drink manufacturer, with presence in semi-urban and rural markets. The company is mainly known for its flagship brand Mango Sip and is looking to expand its capacity in other product categories and areas, for which it intends to use the proceeds from the recent public offering. In a market fraught with giants, such as Dabur (Real) and PepsiCo (Tropicana), it is somewhat tricky for investors to understand the potential for value creation, considering the company has a concentrated portfolio in terms of products as well as markets.

Coffee Day Enterprises runs India's largest coffee chain Café Coffee Day. A household name, at least in urban India, the company is still recording a net loss. The company plans to use the IPO proceeds to pay its debts, open new outlets, set up new plants, and manufacture vending machines. Matrix Cellular provides international SIM cards and helps reduce the calling rates for Indians traveling abroad. With most network providers slashing their international roaming rates, the overall outlook for this company's business model is beset with concerns over sustainability and growth.

Another problem an average investor would face is lack of peers for comparison, as most of these companies have a unique business model, which does not match closely with any other established Indian companies already trading on an exchange. Infibeam Incorporation Ltd., which is the first Indian e-commerce firm to be listed on the bourse as well as the youngest, having started operations only in 2010. Most other e-commerce companies, such as Flipkart and Snapdeal, and other Indian e-tailers are currently being funded by a mix of Indian and international PE firms and are reluctant to go public, as they are not ready for the level of monitoring often warranted for firms whose shares are traded publically.

If the rally in the markets is sustained and the first few IPOs among the startups perform well, we expect more PE firms to choose IPO as an exit option and book higher profits on their investments.

We believe new-age companies are still dabbling with the idea of going public and others in the industry are closely monitoring how this unfolds. This year would offer great insights into whether the market and the investors have an appetite for companies with unconventional business models. More companies would most likely follow suit after the teething problems, which would surely be present in abundance, are resolved.

IPOs Could Play a Role In Getting More FIIs

Globally, while equity markets have shown resilience to certain important events, such as the uncertainty surrounding the US Fed raising rates, markets have also overreacted to panic triggers, such as the Greece impasse (which is still unresolved) and the China stock market bubble burst that erased trillions of dollars in its wake. With markets more connected than ever, events of such magnitude and gravity pose a continuous potential threat to markets globally. Furthermore, emerging markets typically suffer the most as in any adverse situation. Foreign investors do not think twice before pulling out their money from riskier propositions and parking it in safer options (read as US and the relatively safer European economies). Therefore, it would be interesting to observe the role of IPOs in attracting FIIs to India during a phase riddled with high-impact events worldwide.

In the aftermath of the Chinese crisis, there is a possibility that investors betting on emerging markets may shift some of the funds they have pulled out of the Chinese markets into Indian markets. While Indian markets reacted to the crash in China's equity markets, this was more of a momentary blip and the market stabilized soon after. The larger sentiment is that Indian markets have a chance to gain from the events in China, as foreign investors would not penalize India for the misguided rally in China and invest in India on the basis of the dynamics pertaining specifically to the Indian economy and the Indian markets.

We believe a September rate hike by the US Fed is unlikely, with inflation expectations still well below the Fed target of 2.0%. Even after a rate hike, we believe most foreign investors would continue to show interest in India, as most of these investors chase long-term opportunities.

IPOs Outperform Markets But Record Unimpressive Gains

IPOs Listing	Price (INR)	CMP* (INR)	% Chg	P/E (Current)
Manpasand Beverages	300.0	328.2	9.4%	NA
PNC Infratech Ltd.	387.0	417.8	8.0%	18.4
UFO Moviez India Ltd.	600.0	616.6	2.8%	50.8
MEP Infrastructure Developers Ltd.	65.0	61.9	-4.8%	NA
VRL Logistics Ltd.	288.0	356.1	23.6%	33.6
Inox Wind Ltd.	400.0	448.9	12.2%	30.2
Adlabs Entertainment Ltd.	162.2	161.4	-0.5%	NA
Ortel Communications Ltd.	160.1	185.8	16.1%	83.7

*Source: Bloomberg, NSE; *as of July 16, 2015 on NSE*

Two companies that got listed this year are currently trading at a discount to their listing prices, and the remaining have outperformed the market (except UFO Moviez), but have not recorded impressive gains in doing so. VRL Logistics, which raised close to USD 1.8 mn, is the leading gainer among this year's IPOs trading at a 24% premium to its listing price. The Indian market is currently trading at a 1-year forward PE of 16.9x, which represents a 5% discount to its 10-year average of 17.7x. While most companies listed this year are trading at a considerable premium to the current market levels, some of the premium can be explained by the sectors in which these companies operate.

Investors, both retail and institutional, have not displayed a particularly strong risk appetite this year, as far as the primary markets are concerned. They have either followed certain themes they believe would provide good returns in the near to mid-term future or chosen certain sectors as their favorites based on their understanding of which sectors are likely to perform well. Investors have also taken cues from the fundamentals of individual companies coming up with an IPO and have decided the fate of these IPOs on the basis of their valuation.

SEBI Plays its Part to Re-energize the IPO Scene

To narrow the gap between the market expectations and investor sentiment during the book building process, and closing of the IPO and the time when an IPO is finally listed on the bourse, SEBI is in the process of introducing changes to certain processes. This would be a relief to investors and companies and bode well for the primary markets. IPO activity that has shown some ripples in the recent past is likely to pick up amid the introduction of these changes, as this would ensure a relatively faster process for companies looking to raise funds from equity investors. Some of these steps include the following:

Faster listing after IPO closure

From 2016, IPOs would be listed within seven days of the closure of the IPO process compared with the current 13-day period. While this duration is even lower in developed countries, such as the US (it takes 3 days for the investors to start trading after the allotment of shares), it is a good start for India. SEBI has said it would further reduce the time period. It would have to eventually shift to an e-IPO setup to allow investors to bid online, thereby expediting the process through elimination of physical transfer of application forms and cheques with investors.

Separate platform for startups

SEBI has taken up the challenge to make India a more sophisticated market for new-age startups, which until recently were almost exclusively looking for PE and VC funding to expand operations. As in most developed markets, India would have a separate platform - Alternate

Capital Raising Platform, for startups to raise funds through IPOs with regulations better suited to the nature of these businesses. These IPOs would only be available to institutional investors and HNIs for subscription, while retail investors would be kept away for now, considering the risks associated may be difficult for an average investor to understand. Furthermore, the pre-issue capital would be placed with all the shareholders with a lock-in period of six months. SEBI would also relax the disclosure norms for start-ups when filing for an IPO. This move could help dissuade companies based on innovative models with high-growth potential from approaching foreign PE companies. ■

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