IPOs: Beware valuation and information asymmetry risk

Investors must exercise greater due diligence compared to secondary market investing

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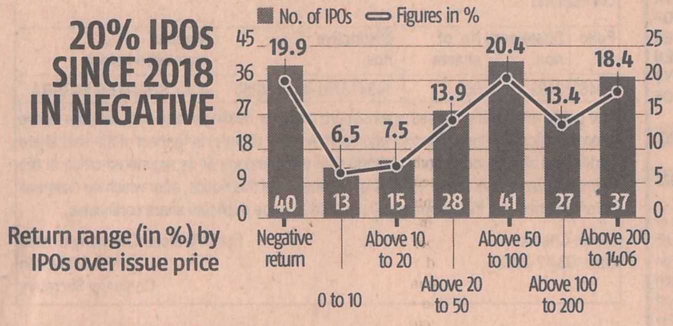
Forty-six companies have raised ₹41,095 crore via initial public offerings (IPOs) this year. Another 161 small and medium enterprises (SMEs) have raised ₹4,084 crore. The pipeline is strong. About 33 companies have approval to raise ₹33,390 crore, while 35 are awaiting approval to raise ₹37,750 crore, according to PRIME Database.

"Primary market activity always follows secondary market buoyancy with a lag of two-three months. Once the secondary market recovered from its March lows, primary market activity also picked up from June-July onwards," says Pranav Haldea, managing director, PRIME Database.



Note: 201 IPOs were considered, having an offer size of at least ₹ 100 crore, issued since the start of 2018.

Source: Bloomberg
Compiled by BS Research

Multiple risks

Investors run multiple risks when they participate in the primary market.

A seller's market: Promoters bring IPOs to the market when there is ample liquidity, sentiment is stable or bullish, listed peers belonging to the same sector are trading at attractive valuations, and investors are prepared to pay a higher price. "It's the promoter's asset, so he naturally tries to get the best possible price for it. But such pricing is often not favourable for the buyer," says Ankur Kapur, investment advisor, Plutus Capital.

Unlike earlier times when most IPOs were fresh issues meant to raise growth capital, nowadays most issues are Offers for Sale (OFS). "During their rapid growth phase, companies go to private equity (PE) firms for capital. After achieving a reasonable scale, they come up with IPOs at rich valuations, whose primary goal is to offer a good exit to PEs. Such offerings hardly leave anything on the table for IPO investors," says Jatin Khemani, managing partner and chief investment officer, Stalwart Investment Advisors LLP, a New Delhi-based Sebi-registered Portfolio Management Services firm.

Limited information available: IPOs are done when the company's financials look attractive. But with only three or four years' data shared in the red herring prospectus (RHP), it becomes difficult to assess how it will fare in less favourable parts of the business and economic cycle.

"Assessing management quality and corporate governance standards is difficult based only on what is revealed in the RHP. If the promoter has a group company that is already listed, something would still be known about them. But in the case promoters of smaller or lesser-known companies, the evaluation becomes difficult," says Sneha Poddar, assistant vice president, retail research, broking and distribution, Motilal Oswal Financial Services.

Management quality and corporate governance standards only become apparent after analysts have been tracking a company for a few years. A lot of window dressing also happens. "IPO preparations often begin three to four years in advance. Companies clean up their balance sheets and businesses to put up a tidy face before the markets. It is only after the IPO that many of the issues come to the fore," says Raghvendra Nath, managing director, Ladderup Wealth Management.

Key checks you must run

Business: Check whether the company belongs to a rapidly growing industry. Its positioning is crucial. "It should preferably be among the top three players in its industry," says Poddar. According to S G Raja Sekharan, a Bengaluru-based value investor who has taught Wealth Management at Christ University for more than 10 years, "Check whether the company has a long-term moat, that is, a sustainable competitive advantage."

Financials: Free cash flow, level of debt and return ratios are critical considerations.

Valuation: The IPO must be fairly priced. "Avoid overpriced IPOs," says Poddar. Raja Sekharan suggests comparing both financials and valuations with those of other listed peers from the same sector.

Promoter: Check the RHP for related-party transactions. "Numerous such transactions with group companies are a red flag," says Poddar. Promoters involved in scams in the past should be avoided. "Lack of adequate disclosures in the RHP is another cause for concern," adds Poddar. Nath suggests checking whether the promoter is a technocrat with the expertise to run the business. He adds that one should also check whether the business is family-run or is managed by professionals.

Avoid investing for listing gains

Retail investors often participate in IPOs, especially during bullish markets, not from a long-term investment perspective but for listing day gains. "If the stock is oversubscribed, the chances of allotment go down. If you are lucky, you may at the most get one lot," says Haldea.

Even if one does get an allotment, there is always the possibility of a loss on listing day. "One bad outcome can wipe out the gains of many prior gainful exits," says Khemani.

Grey market premium is not a reliable indicator of listing gains. Between the day of applying and the day of listing, market sentiment can change, resulting in losses. Participants should be clear about their objectives. "If you come in for listing gains and that does not happen, exit the stock. Do not hold on to it since you have not done any analysis of the stock's prospects before investing," says Haldea.

What you should do

Choose from one of 5,000 plus listed businesses. "Better deals are available in the secondary market where price discovery occurs through a natural auction mechanism among thousands of buyers and sellers," says Raja Sekharan.

Patience can be rewarding. "Post-listing, sanity often returns to valuations of newly-listed businesses within six to nine months. Buy then," says Kapur.