YOUR MONEY

EXPENSIVELY PRICED IPOs

High valuations must be justified by growth visibility

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At an event in Kolkata, Securities and Exchange Board of India's Whole-time Member Kamlesh Chandra Varshney urged merchant bankers to adopt realistic pricing strategies for large initial public offerings (IPOs). Excessively high valuations, e said, often lead to post-listing slumps, eroding retail investors' trust.

Why IPOs are priced high

In 2024, 337 companies went public, raising nearly ₹1.67 trillion. "When market sentiment is euphoric, promoters frequently view these windows as an opportunity to unlock maximum value. In such conditions, and if the sector has an exciting story, investors almost always pay a premium," says Trivesh D, chief operating officer, Tradejini.

Not everyone agrees that IPOs are overpriced. "The proof of realistic pricing is that the IPO gets subscribed. If the pricing was too aggressive or greedy, investors would reject it, as has been the case for several issues in the past. After all, no one is forced to buy an IPO," says Pranav Haldea, managing director, PRIME Database Group.

Risks arising from high valuations

Expensively priced IPOs can be risky even for short-term punters. "Historically, aggressively-priced IPOs lacking strong fundamentals have not delivered listing gains and even listed at a discount," says Yash Sedani, assistant vice president, investment strategy, 1 Finance.

Post-listing, many such stocks slip below the issue price, leading to losses even if investors extend their holding period. "Stretched valuations leave little margin for appreciation," says Trivesh.

The hype created during an IPO rarely lasts. "Once the excitement fades, the market realigns to fundamentals," says Riddhesh Dalvi, founder, Emerald Investments. High pricing, he adds, puts pressure on companies to deliver.

The impact of overvaluation extends for at least six months, until the lock-in period for anchor investors and promoters expires. "Volatility tends to remain elevated during this period. Unfavourable business updates or macro headwinds trigger selling," says Sedani.

Go beyond the numbers

Assess multiples alongside growth trajectory, customer base, margin profile, competitive positioning, and management quality. "Combine quantitative and qualitative assessment and rely on multiple data points instead of just one," says Sedani.

Compare valuations with peers. "A valuation above sector averages, without clear growth visibility, is a red flag...it must be justified by growth, returns, and cash flows," says Dalvi.

Do's and don'ts

A strong company with competitive edge and growth potential often comes at a high price. "For a long-term investor, participating in such an IPO may be a viable proposition," says Jyoti Prakash Gadia, managing director, Resurgent India. Alternatively, investors may wait for six months and then take another look at the stock.

Understand the end use of funds. It should ideally be for expansion. "If the promoters are diluting their stake, study carefully from the regulatory angle and evaluate long-term strength of the corporate," says Gadia.

Most investors enter IPOs for listing gains. "Mostly, they track whatever is happening in the grey market. If there is a premium, they invest," says Haldea. Many lack the ability to carry out valuation. "They should follow the anchor book and qualified institutional buyers (QIBs) who are participating and take cues from how they are responding," says Haldea.

The writer is a Mumbai-based independent journalist

Which valuation metric should you use?

- Valuation metrics must match the nature of the business model
- Price-to-earnings (P/E) ratio is suited for profitable companies
- Price-to-book value (P/B) is appropriate for financial businesses like banks and NBFCs
- EV/EBITDA is often used for firms with operating profitability but net losses, including capital-intensive or early-stage businesses
- Revenue multiples (EV/sales) are used for loss-making new-age technology companies with no meaningful earnings base

Source: 1 Finance