YOUR MONEY

TACKLING RICH IPO VALUATIONS

Watch post-listing performance before committing capital

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Securities and Exchange Board of India (Sebi) Whole-time Member Kamlesh Chandra Varshney recently expressed concern over inflated initial public offering (IPO) valuations and underlined the need for stronger guardrails to protect minority shareholders. Retail investors, on their part, must conduct careful due diligence to assess whether an IPO is reasonably priced.

Bear in mind that IPOs are riskier than already-listed stocks. "This is because of information asymmetry and limited disclosures," says Pranav Haldea, managing director, PRIME Database Group.

Negative consequences

Overvalued IPOs often lead to weak post-listing returns. "Market enthusiasm fades and fundamentals catch up with price. High valuations can result in capital erosion, limited upside potential, and longer payback periods," says Sandeep Parwal, founder, SPA Capital. High valuations also reduce the margin of safety against macro or business-specific risks.

"IPOs should ideally be priced at a significant discount to listed peers to make them attractive," says Nipun Lodha, head of investment banking, PL Capital.

Assess quantitative parameters

Investors must examine valuation metrics such as price-to-earnings (P/E), price-to-book (P/B), enterprise value-to-earnings before interest, tax, depreciation and amortisation (EV/Ebitda) and price-to-sales in relation to the firm's earnings growth, profitability, and return ratios (return on equity and return on capital employed).

"Benchmark the IPO's valuation against established listed peers within the same sector, adjusting for differences in size, growth, leverage, and business mix," says Parwal.

A premium valuation may at times be justified when the company demonstrates strong earnings visibility, robust cash flows, competitive advantages, or operates in a high-growth industry with limited competition. "A premium is also acceptable if the company demonstrates superior margins, consistent return metrics, management quality, or stronger governance," says Parwal.

Hype and other red flags

Ensure that the premium valuation being demanded is not based on aggressive forward-looking narratives without a track record. "Watch for overly optimistic growth projections or management guidance that exceeds industry or peer benchmarks," says Feroze Azeez, joint chief executive officer, Anand Rathi Wealth. "A high offer-for-sale (OFS), where promoters or investors offload large stakes, may signal low confidence in near-term growth," he adds.

Examine how IPO proceeds will be used. If most of the funds are meant for debt repayment rather than expansion or upgrades, it may indicate limited growth potential.

Market, sectoral conditions

Avoid getting caught in exuberant pricing cycles. Broader liquidity condition and risk appetite shape IPO pricing. "Excess liquidity leads to stretched valuations, while tightening liquidity or rising rates cool demand," says Azeez.

Macro factors — interest rates, inflation and global risk sentiment — also affect mood within the market. Sectoral exuberance also requires being careful. "Sectoral hype, especially in new-age or policy-linked themes, should be approached with caution," says Kamraj Singh Negi, managing director – investment banking, Pantomath Capital.

Tech in 2021 and renewables in 2024, for instance, saw valuations drift away from fundamentals. "Defence and electronics offer high growth and margins but carry customer concentration risk. Consumer-tech IPOs (like Zomato, Nykaa, Swiggy, and Lenskart) should be approached with caution because true price discovery happens post-listing over six months," says Lodha.

If IPO is richly priced

Patience is the best response in such cases. "If valuation seems expensive, wait and watch post-listing performance before committing capital," says Azeez.

Aggressively priced IPOs tend to correct once enthusiasm fades. Paytm, Ola and Nykaa are IPOs that saw steep corrections after listing. "Better entry points emerge once price and fundamentals realign," says Negi. Finally, rely on credible information rather than speculation. "Instead of relying on tips and grey market talk, or following finfluencers, use the available information — red herring prospectus, broker reports, and so on — to arrive at an investment decision," says Haldea.

Mistakes to avoid

- Avoid chasing hype
- Narratives in bull markets may run ahead of numbers
- Avoid chasing every IPO for listing gain
- Euphoric phases lead to aggressive pricing, reducing chances of gains
- Do not view past listing gains as predictors
- Do not be swayed by brand hype or grey market premiums

The writer is a Mumbai-based independent journalist