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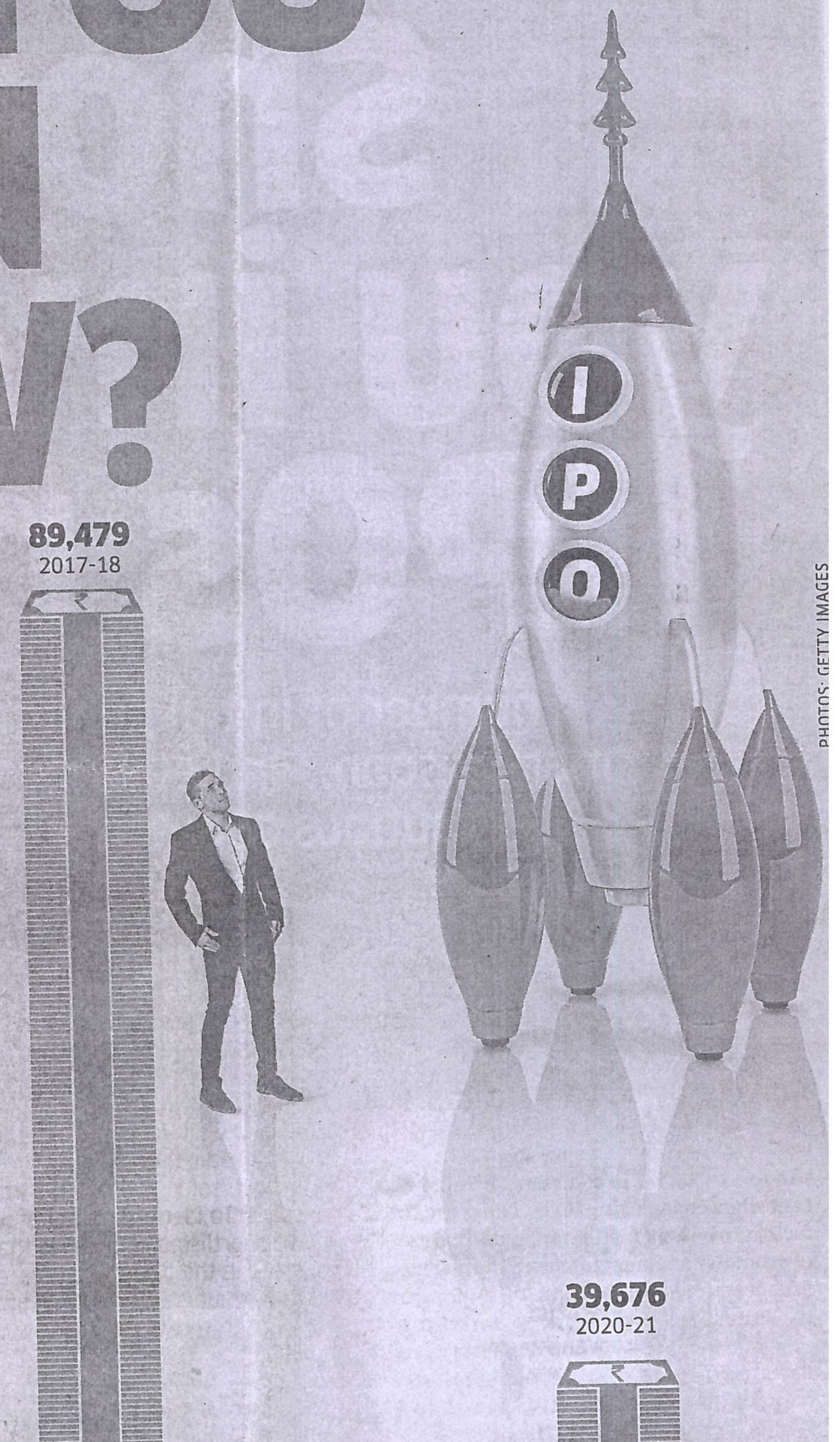
SHOULD YOU INVEST IN IPOs NOW?

A number of initial public offerings will hit the market in the coming days. Find out why you need to be cautious about investing in these.

By **Narendra Nathan**

The benchmark indices are still below 52-week highs, but retail investor interest in the stock market shows no sign of waning. Companies are cashing in on this increased interest by lining up initial public offerings (IPOs) to raise money. There was a significant spurt in IPO collections in 2020-21 (*see chart*)—the second highest in the past 10 years. As the secondary market witnessed a correction on the back of a raging second covid wave, the roll out of IPOs slowed down. Now a small ebb in covid cases has again improved market sentiments, making the secondary market stable and the companies are back to filing IPOs again (*see table*).

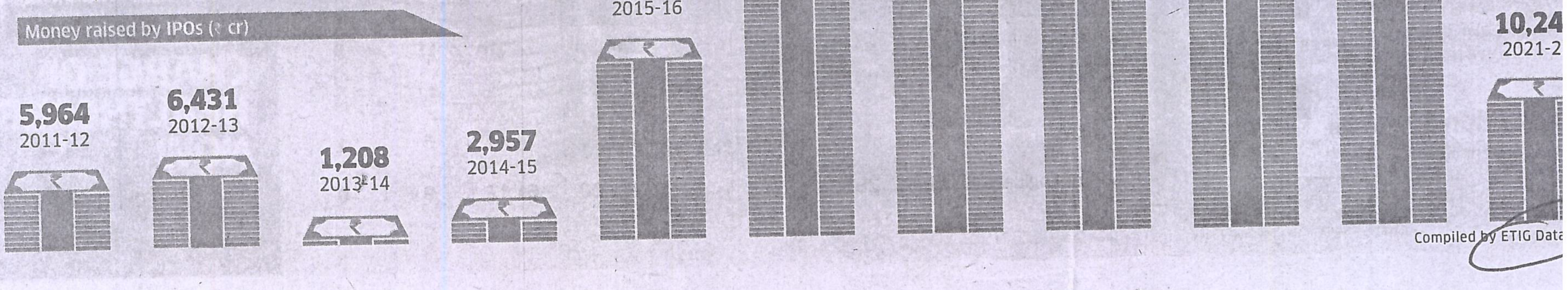
Does this filing rush make the Indian IPO market overheated? It may not be the case yet but it is heading that way. "Though there were a lot of filings in the past week, it will be some time before these are actually launched and secondary market sentiments need to improve further for this to happen," says Pranav Haldea, Managing Director, Prime Database. In addition to the recent filings, several big-ticket IPOs that filed documents earlier are also on wait and watch mode and may hit the market at any time. These names include Zomato with an estimated issue size of ₹8,250 crore, Aadhar Housing Finance (₹7,300 crore), Sona BLW Precision Forgings (₹6,000 crore), etc. Samir Bahl, CEO, Anand Rathi Advisors feels the secondary market is ready for IPO filings by more companies. "The market is not overheated yet and benchmark indices are just back to pre-covid days. With the stability in economy, I expect a healthy IPO pipeline in



Trend indicates number of IPOs hitting market this year will be high

Large issues tend to suck liquidity out of the market and are, therefore, negative for the market.

Money raised by IPOs (₹ cr)



Compiled by ETIG Data

the next 12-18 months," he says.

This week, let us explore how investors can successfully navigate this imminent flood of IPOs.

Be choosy

The stock market is characterised by excesses during bull runs and the primary market is no exception. So, be ready for a number of issues, including from dubious promoters or businesses. The first rule is to be choosy. Don't try to invest in all the IPOs hitting the market. "Around 90% of the IPOs are not worth considering due to bad business or high valuations," says Richa Agrawal, Senior Analyst, Equitymaster. Though merchant bankers manage the show during issue time and for a few days after the listing, the quality of the stock becomes apparent only when it begins trading. While Nazara Technologies, a unique company into mobile gaming, is trading at ₹1,681 compared to its issue price of ₹1,101, Kalyan Jewellers is trading at ₹60.50 compared to its issue price of ₹87 (*see table*).

Riskier segment

Don't be under the impression that the primary market is less risky than the secondary market just because you are buying shares directly from the company. Several factors make this segment even riskier. "Investing through IPOs is riskier because the information available on primary offerings is much less compared to existing listed companies," says Haldea. The volatility is also more. It is a high risk-high return game and therefore, you need to choose IPOs carefully. The market condition also plays a major role. IPOs usually generate bigger returns in the bull phase and bigger losses in bear markets.

Do your own analysis

In investing, it is always sensible to do one's own research and not depend on random tips. This becomes more important when considering IPOs. The critical factors to be kept in mind include quality of promoter and management, industry prospects and how the company is placed in the industry, etc. The management quality can be gauged by comparing what it has claimed and what has actually been done. For example, the management quality can be considered poor if it has talked big about R&D, but the actual allocation towards it is low. Though size is not a basic criterion, it makes sense to stick with reasonably sized issues of well known promoters and from reputed merchant bankers. You can also fix several quantitative filters. "Avoid over leveraged companies," says Bahl. "Concentrate on companies with at least 14% ROCE," says Agrawal.

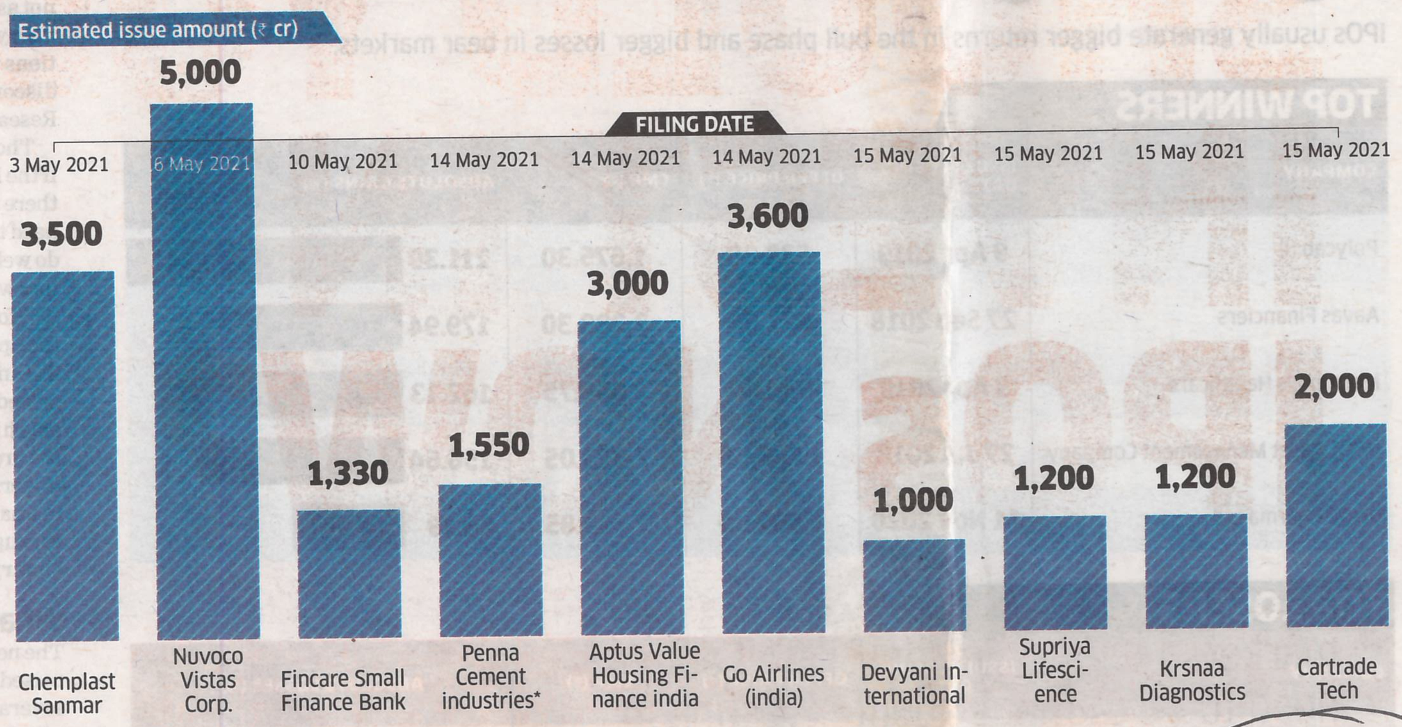
If you are not able to analyse the company yourself, see what reputed research houses are saying. If analysts are advising you to avoid a particular issue, listen.

Valuation is critical

Three kinds of companies usually use the IPO route—fundamentally weak companies, high priced fundamentally strong companies and reasonably priced funda-

Many IPOs have been filed recently

Investors need to be careful because clubbing of large issues signal market peak.



Source: Prime Database

Note: Only companies with an estimated issue size of ₹1,000 crore or above included in the list.

Stocks worth picking

PRIMARY MARKET investors are not immune to normal greed and fear. While most rush to buy fancied IPOs, they totally avoid the ones that get listed at lower prices or go below issue price. However, there is no need to avoid all stocks that are quoting below their issue price. Since the sentiment is negative, smart investors can pick up some good stocks from this space. To identify potential winners, we shortlisted companies that got listed in the past five years, excluding those that got listed in the past year. We then sorted the stocks on the basis of their potential upside.

Three of the four stocks are small time financial institutions, pulled down mostly because of the financial market crisis and negative impact of covid on their earnings. While things stabilised after the first wave, the second wave threatens to torpedo their earnings again. Though analysts are cutting their earnings estimates, they retain buy. "Though we are reducing our earnings estimates for 2021-22 by 21%, we retain long-term buy on Bandhan Bank, given strong liability build-up, asset diversification strategy away from MFI, superior return profile and reasonable valuations," says a recent Emkay research report. The situation is similar for Spandana Sphoorty and most its buy recommendations are based on its underperformance in the past one year—only 22% return in a year when the Sensex returned 65% during the same period.

However, the situation is different for RBL Bank. Though it has outperformed the Sensex on yearly basis, it has underperformed in the past three months, mostly because of the concern about the second wave. RBL Bank also missed the earnings estimates for the fourth quarter of 2020-21 and its first quarter of 2021-22 outlook looks bleak. However, several brokerages have decided to upgrade this stock to buy because it is still quoting at reasonable valuation. "We think the current valuation of RBL Bank (0.8 times its adjusted book value in 2022-23) is undemanding and provides a good margin of safety if we take into account 11% ROE by 2022-23," says a recent Nirmal Bang report. Varroc Engineering, an auto component company, also did well on yearly basis, but is suffering now because of the lower intake by auto companies. However, analysts feel that this bad phase will be behind Varroc soon.

Investors can tap stocks quoting below issue price

COMPANY	ISSUE CLOSING DATE	OFFER PRICE (₹)	CMP (₹)	LOSS (%)	ANALYST VIEWS			TARGET PRICE (₹)	POTENTIAL UPSIDE (%)
					BUY	HOLD	SELL		
Bandhan Bank Ltd.	19 Mar 2018	375.00	284.39	-24.16	18	5	6	356.00	25.18
RBL Bank Ltd.	23 Aug 2016	225.00	196.95	-12.47	21	4	4	242.89	23.33
Spandana Sphoorty Financial Ltd.	7 Aug 2019	856.00	587.10	-31.41	6	1	0	930.33	58.46
Varroc Engineering Ltd.	28 Jun 2018	967.00	376.00	-61.12	9	0	1	556.50	48.01

CMP as on 17 May. Compiled by ETG Database

IPO investing is a high-risk high-return game

IPOs usually generate bigger returns in the bull phase and bigger losses in bear markets.

TOP WINNERS

COMPANY	ISSUE CLOSING DATE	OFFER PRICE (₹)	CMP (₹)	ABSOLUTE GAINS (%)
Polycab (I)	9 Apr 2019	538.00	1,675.30	211.39
Aavas Financiers	27 Sep 2018	821.00	2,298.30	179.94
Metropolis Healthcare	5 Apr 2019	880.00	2,306.75	162.13
HDFC Asset Management Company	27 Jul 2018	1,100.00	2,823.05	156.64
Gland Pharma Ltd.	11 Nov 2020	1,500.00	2,792.85	86.19

TOP LOSERS

COMPANY	ISSUE CLOSING DATE	OFFER PRICE (₹)	CMP (₹)	ABSOLUTE LOSSES (%)
Sterling & Wilson Solar	8 Jul 2019	780.00	243.60	-68.77
Varroc Engineering	28 Jun 2018	967.00	376.00	-61.12
Chalet Hotels Ltd.	31 Jan 2019	280.00	148.10	-47.11
Spandana Sphoorty Financial	7 Aug 2019	856.00	587.10	-31.41
Kalyan Jewellers India	18 Mar 2021	87.00	60.70	-30.23

CMP as on 17 May

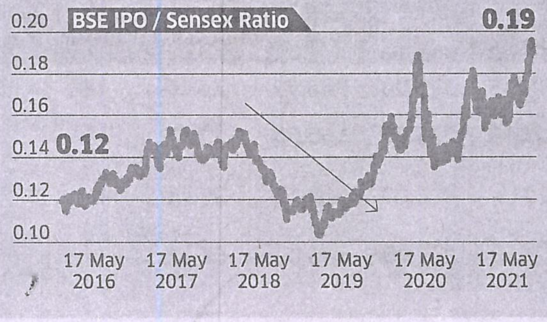
Note: Only large issues (₹1,000 crore) that launched in past three years considered here. Compiled by ETIG Database

Why a large number of IPOs is a warning sign

RELATIVE PERFORMANCE from IPOs starts deteriorating with the total collection. For example, the BSE IPO index started underperforming the Sensex after huge IPO collections during 2017-18. A bigger worry is a bigger collection may threaten the secondary market rally too. "Primary market activity is linked to secondary market rally and a large number of IPOs comes during the late stage of the bull market," says Mayank Khemka, CIO-India, Deutsche Bank. Hasit Pandya, Director, HPMG Shares & Securities concurs with this view. "If you look at the history, you will notice that there will be reversal in broader market after large number of IPOs coupled with large issues (above ₹10,000 crore) hit the market," he says. In addition to dubious companies hitting the market during an IPO rush, large primary offerings also suck the liquidity from the secondary market.

IPOs started underperforming after the 2017-18 rush

Since collection is going up now, investors need to be careful.



mentally strong companies. Once you eliminate the fundamentally weak companies using the above mentioned methods, the next step is to concentrate on valuations. Remember the price discovery is not as transparent as in the secondary market. So, always keep a margin of safety. "Compare the valuations with listed peers and go only if it is coming at a discount," says Siddhartha Khemka, Head of Retail Research, Motilal Oswal.

Though implementing this rule becomes difficult if the IPO is from a niche segment company and there are no listed peers to compare with, there is no need to avoid such IPOs. In fact, such IPOs usually do well after listing because institutional investors want to add more diverse businesses to their portfolios. As of now, there is a lot of buzz around the upcoming IPO from Zomato because it is one of its kind and investors can consider it provided it is priced reasonably. The chance of overvaluation is also high in unique companies because the seller is the promoter or earlier investors, who have better understanding about the company. "Price band in primary issue is decided by the company and not through a transparent process like that in the secondary market," says Haldea.

What is the money for?

The next step is to see why the money is being raised. This question becomes important because several venture capitalists (VCs) and private equity investors (PEs) also piggyback IPOs to make a decent exit. "As a thumb rule, money raised for company's growth is fine and secondary sales by existing investors are not," says Mayank Khemka, CIO-India, Deutsche Bank.

Should you follow institutions?

Since large financial institutions have better analysing power and access to management, they will be able to value the companies better. So, heavy oversubscription by institutional investors is a good indicator. Continued stock market gain after listing is also a function of continued institutional demand. However, this is not a foolproof strategy. "While retail investors can track institutional activity, they need to do their own homework. The chance of getting allotment also goes down once the issue is heavily oversubscribed," says Bahl.

Avoid the listing game

Avoid the flipping on listing strategy—selling as soon as the IPO is listed. This is because if the IPO quality is good, you will not be able to benefit from the long-term performance of the stock. "Flipping on listing is a bad strategy because equity investing, whether through primary or secondary market, should be for the long term," says Bahl. The listing game also depends on how the market mood swings between the issue date and listing date. Thanks to Sebi's initiative, this gap has reduced considerably and hopefully, it will come down further.

While the grey market premium gives some idea about possible listing price, it is risky to bet on it. "Grey market is less liquid and therefore, it can be influenced or managed," says Sidharth Khemka. Betting small amounts on most IPOs simultaneously hoping for listing gains is another mistake. "Several retail investors take additional risk saying that my investment here is only small (say ₹15,000 to ₹20,000). This is wrong because every rupee counts. Instead of betting like this, they should buy listed stocks with that money," says Nitin Shahi, Executive Director, Findoc Financial Services Group.

Please send your feedback to etwealth@timesgroup.com