New age IPO valuations are too disruptive

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By MS Sahoo & CKG Nair

A spate of public issues by some 'new age' companies have raised serious concerns over their valuations and Initial Public Offer (IPO) pricing. Several explanations — new methods of valuation, network effect, business acquisitions, future profitability, etc. — have been adduced by these companies and the pundits backing such pricing.

Before the investors could fathom what was going on, these companies accomplished their mission, mainly exit to 'early' investors at hefty premia via offer for sale (OFS). Post listing, many of the scrips are biting the dust, leaving the market with lasting scars.

The good old IPO days

Gone are those days when good issues would hit the market with equity prices at face value or with a modest premium. Though dictated by the rigid formula of the erstwhile Controller of Capital Issues (CCI), Reliance Industries and HUL in the 1970s, and post CCI, Infosys in 1993, are a few such well-known examples.

Such a pricing strategy attracted investors and promoted an equity culture in our country. Even some of the global favorites were modest in their pricing and initial issue size. Amazon in 1977, Apple in 1980 and Microsoft in 1986 are prominent examples. They raised prices and amounts mobilised in their follow-on offers, as they grew in size, value and profits in their journey towards what they are today.

The advent of high IPO premium

The paradise of IPOs was largely lost in India circa the late 1990s. Even before the advent of adventurous, new-age avatars, 'right' pricing of IPOs had been a major market and regulatory concern, particularly with internet and tech companies. Many of them sought regulatory relaxations as well to enable access public markets through IPOs.

However, before even addressing those concerns the new age entrepreneurs 'raided' the markets with vaulting ambitions and mystified valuations. It is not even like "nothing left for the calf after milking", but downright leaving the calf and cow to the butchers, along with all the new investors.

A further innovation is emergence of new age technology companies, who raise funds for 'Funding of Inorganic Growth Initiatives', which include future acquisitions, investing in new business initiatives and strategic partnerships, but do not identify the target acquisition or specific investments to be made out of issue proceeds.

The regulations, however, require an issuer to state the objects of the issue in the offer document, which may earmark up to 25 per cent of the issue size for general corporate purposes (GCP). As a rather late realisation, SEBI came up with a discussion paper in November 2021, prescribing a combined limit of up to 35 per cent of the issue size for deployment on such objects of inorganic growth initiatives and GCP, as raising funds for unidentified objects leads to uncertainties.

While such an approach as micro level steps may have some impact, they do not address the major, macro level concerns. How can public money be raised for unknown purposes or acquisitions? Does it not amount to investors writing blank cheques? For valuation and pricing, how does the market consider unknown cash flows from unknown businesses, where the issue proceeds would be utilised, in an unknown future into today? How does one monitor utilisation of issue proceeds? What about future investors and their returns if future profits are encashed today? What about the company's future itself, when they are asset light and nimble footed?

These are times when a pleasant website, marque address (may not even exist as SEBI found out in an investigation that a company's address was 42nd floor of a posh building in Singapore; though that building had only 24 floors!) and a few exotic graphs and numbers (with small font size) could bring in lot of business and valuation multiples. [Think of the world of cryptos and stablecoins, such as Luna, and those companies' bravado of assuming as 'para central banks'!].

Future acquisitions, expansion of client base, rider base, employee base, etc., are possible only if there is a 'future' for the company. These days, the shelf-life of companies itself is shrinking. The average lifespan of a company has, reportedly, reduced to about 15 years as compared to 90 years a century ago.

Being completely footloose, technology/network companies can be folded up in a matter of minutes. This is evident from the rapidity with which the promoters encash and quit via the OFS attached to the IPO. Sometimes, with OFS going up to 70 per cent, some IPOs appear to be only a facade.

Fundamentally, there should be nothing different for valuation whether a company is a tech, network entity or a brick-and-mortar one. Valuation should be based on visible, if not tangible, assets and value propositions. Are there only tailwinds for the new-age companies and headwinds for the well-established ones? Is "promised land" better than well-established places? Fairytales, like in the crypto world, are not sufficient. Disrupters want to disrupt even these principles and fiddle with the "equilibrating" capabilities of markets.

Collateral damage

It is ironic that the same pundits who praised the fairytale valuation of the new-age entities had serious doubts on the valuation and pricing of the LIC IPO. A company with proven track record of growth and profitability and sitting on mountains of the securities and other tangible and financial assets had to downsize its IPO and reduce the IPO price drastically. LIC had to mostly depend on itself: its own policyholders and companies in which the insurer holds substantial stake.

Probably, the relative role played by the merchant bankers needs scrutiny, as under their oversight this distorted valuation and IPO pricing have flourished, as did the vanishing companies in the 1990s. The opportunity cost of others' over-ambition is borne by LIC and other IPOs in the offing; which have become the 'collateral damage', impinging on capital market's ability to allocate resources.

Nair is Director, National Institute of Securities Markets, and Sahoo is Distinguished Professor, National Law University Delhi. Views are personal