Mind the gap

Funding drought is a term rattling the private equity ecosystem after the US interest rates started to lift off. Unlisted companies funded by private equity must get ready for an IPO or get absorbed through an M&A at some stage. The handover from private markets to public markets is a matter of great interest to us as public market investors. The whole area is a landmine. Here is why,

1. Private equity investors have interest in public markets only so far as the public markets remain buoyant enough for them to get good exits.
2. The pre-IPO market is largely outside the purview of regulation until the time of IPO. The imputed market valuation of unlisted companies waiting to get an exit has become sizeable in India. Any unregulated market which assumes size develops cracks.

There are many trends and traits in the unlisted space that should engage our attention. Here are a few,

1. Jargon

Private markets throw up a lot of jargon. By itself, this is a trivial issue. The problem is that the chorus of narrative tends to create hype. Here is a sampler of the jargon that we see being tossed about and the rough equivalent from yesteryears.

Current terminology	From an earlier era
Path to profitability	Gestation period
Unit economics	Contribution margin or Gross margin
Gross Merchandise Value	Gross Sales (including excise)
Nth closure or Series X funding	Equity dilution
Mezzanine Funding	Promoter funding

While the equivalence hinted above is not a universal truism, the nub of the matter is that the concepts touted about as mantras are nothing new. Eloquence in terminology should not be equated with value creation. We have been there before.

2. Evolution of regulation

The start-ups (when they are truly starting up) need lot of elbow room and regulation should not cripple innovation. There was a much-maligned entity of the crossover era from license raj to the free market that regulated IPO pricing. The entity was boringly christened Controller of Capital Issues or the CCI. The CCI determined the price at which the baton was passed on. There was no mechanism for discovering what the buyers are willing to pay. There was little differentiation based on the quality of the business or the outlook. CCI took on the mantle of determining what might be fair for investors. This led to rampant grey market machinations, oversubscriptions and post-IPO pangs.

When SEBI started aligning regulations with international practices, the emphasis shifted to disclosure. Since that material shift, it has always been about better disclosure and trusting the market to discover the true price. In the end, the market may have always figured out the price – in the CCI days and thereafter. But then, that process was never smooth; then and now. Investors must factor this in before jumping into the fray.

3. One way surge in risk appetite

Private markets have seen a huge surge in risk appetite. The post GFC liquidity binge has consumed all that stood in the way. Assets have been bid up. New metrics have been used to justify asset pricing. We have heard concepts which boldly explain that the losses incurred by Unicorns are mere accounting losses and should be viewed as investments in intangible assets. The earlier era had its own way of addressing the timing mismatch between spending to build a business and making money out of it. When capital structure had debt which funded addition of hard fixed assets like factories, the interest paid on loans prior to commercial production was capitalised. This bloated the fixed assets at that time. When capacities were not utilized fully and losses were reported, that was operating leverage waiting to unleash itself. The nature of investments in business may have changed and so has the capital structure. Nothing has been discovered afresh.

Yes, the business models in recent times rely on scalability through use of technology. Creative destruction can often times result in shareholder value. However, such value should flow through in terms of profits. Profitability is not a favour bestowed by the new age businesses on investors. The path to the same is not an option. The unwillingness or inability of those allocating capital to not stress this may go down as one of the biggest acts of dereliction of fiduciary responsibility. When risk appetite was assumed to have upward mobility without a limit, everything may have been okay. Now that gravity has taken over, skeletons are tumbling out. Caveat Emptor.

4. Transparency with a twist

Transparency is the antidote that free markets offer against attempts to create value out of thin air. Buyers are supposed to walk away if an asset is too hot. There is a catch.

In the absence of regulation, transparency can get lopsided. For instance, the volume of shares traded in the pre-IPO market through secondary sales is not a required disclosure. The price at which those transactions happen is not known either. What is known at the time of the IPO is the number of fund-raises done, when and how much. While this is good, there is no context to why valuations may have gone up in a relatively short span of time before the IPO.

Public markets provide a framework where relevant data is available seamlessly so that there is a context to price discovery. There is continuous scrutiny. Regulations have been evolving to make the process more robust. Private markets are way too opaque. This is not a good set-up for post listing price discovery.

5. **Stickiness of prices**

   What goes up without good reason should come down. In the current environment, that does not always happen easily for stock prices. It has been contended that stock prices are relative. If a stock has been accorded leadership status and enjoys high valuations, everything else gets referenced against that. If there is a huge demand for an IPO and that results in a high listing price, the reference value creates a stickiness on the downside. If the IPO issue price itself derives respectability because of pre-IPO deals done, that could be a heady mix. It takes many months – even many quarters or years before the price discovery settles down. It may be argued that the prevailing price is the fair price in the interim. We have to agree. The concept of margin of safety is given an unceremonious burial in the process.

We delved into the details of how stocks have behaved after IPO. What matter for us as secondary market investors is the behaviour of a stock from the listing price and not the IPO issue price. Here is a snapshot of the results.

Money raised from IPO from August 2018 to July 2023 (Rs. Cr)	2,15,530
Number of IPOs	356
Median annualised returns	10%
Number of IPOs beating Nifty CAGR from listing price	169
Number of IPOs trading below listing price	138

Source: Ace Equity, Spark Fund Research

Top 25 IPOs in terms of size

S.no	Company	Amount raised (Cr)	Listing Price	CMP	CAGR (%)	FY23 PE(x)
1	One97 Communications (Paytm)	18,300	1,955	854	-37	NM
2	Life Insurance Corporation of India	15,381	867	645	-20	11
3	Zomato	9,375	115	98	-10	NM
4	SBI Cards And Payment Services	7,571	658	817	8	34
5	Star Health and Allied Insurance	6,401	849	635	-16	59
6	PB Fintech (Policy Bazaar)	5,952	1,150	774	-23	NM
7	Sona BLW Precision Forgings	5,550	302	597	32	88
8	Nuvoco Vistas Corporation	5,000	471	337	-15	766
9	Indian Railway Finance Corporation	4,633	25	50	32	10
10	Patanjali Foods	4,544	850	1,231	35	50
11	Gland Pharma	4,536	1,701	1,738	-2	37
12	Mankind Pharma	4,326	1,300	1,810	40	57
13	Chemplast Sanmar	3,850	525	520	-8	54
14	Vedant Fashions	3,149	936	1,262	22	71
15	Delhivery	3,046	493	441	-13	NM
16	CarTrade Tech	2,999	1,600	549	-43	75
17	FSN E-Commerce Ventures (Nykaa)	2,980	2,001	134	-46	1914
18	Adani Wilmar	2,819	221	360	42	80
19	Aptus Value Housing Finance	2,780	330	270	-10	27
20	ABSL AMC	2,768	712	390	-27	19
21	Macrotech Developers	2,500	439	670	21	66
22	Computer Age Management Services	2,244	1,518	2,376	18	41
23	Sapphire Foods India	2,073	1,311	1,424	2	36
24	Vijaya Diagnostic Centre	1,895	542	522	-7	57
25	Devyani International	1,838	141	195	18	90

Note: PE(x) mentioned as NM are not meaningful due to losses in the FY23; IPOs from Aug-18 to July-23; Price as on 31st Aug 2023.
Source: Ace Equity, Spark Fund Research

1. The median PE of the stocks performing better than Nifty (which is a smaller number) remains high – in fact very high. While this may be explained away as PE being a bad measure, most of these companies don't also stack up on metrics such as free cash flows.
2. It is generally believed that higher growth prospects may be supporting valuations. However, a closer examination reveals that the real reason is behavioural. Sector or thematic story-telling has resulted in stocks being driven up and they remain sticky on the downside.
3. To be sure, some of these companies may yet make it as long-term wealth creators. We need to be very selective and objective. Caution is in order.

The writing on the wall

The read through for secondary market investors is clear.

1. The baton that is passed on by the primary market to the listed market has proved to be a flimsy one for most part. Tread with caution.
2. The alignment of many (not all) managements of companies getting listed has often been with the private investors who earlier funded their growth. Minority investors in public markets don't owe them anything and there is no need to be over-awed with them.
3. The drying up of funding in private markets has led to re-sets in valuations. The show may just have begun. The saga of one big company in education space is there for all to see. Valuations can come down and there can be serious value destruction even in private markets.
4. There is no sense in deriving comfort from the reflected respectability that big names may seem to bring as investors in the pre-IPO version of a company.
5. Losses should never be taken lightly, even if they are accounting losses and there may be merit in a deeper look. Public markets subject stocks to daily scrutiny and there is nothing great about a company that keeps reporting losses or profits that are tiny compared to the market value.
6. Public market investors have enough choice. There is no need to fall into the TINA trap.
7. Public markets can be forgiving in certain situations and extend a long rope. Every rope has an end.

Yes – A lot of the wealth creators in public markets once came out with an IPO and all of these were not profitable from day one. However, every company did not end up as an Asian Paints, HDFC Bank or Bajaj Finance. The history is cluttered with failed companies. One more fact. Even if we had invested in Infosys or HDFC Bank after missing a lot of their early run through the roller-coaster of the secondary market, it did not matter. Even after it was apparent that these are winners, there was enough money that was left on the table.

There is no need to behave like kids in a candy shop with limited stock. Time to have grown up may have passed. Better late than never.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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