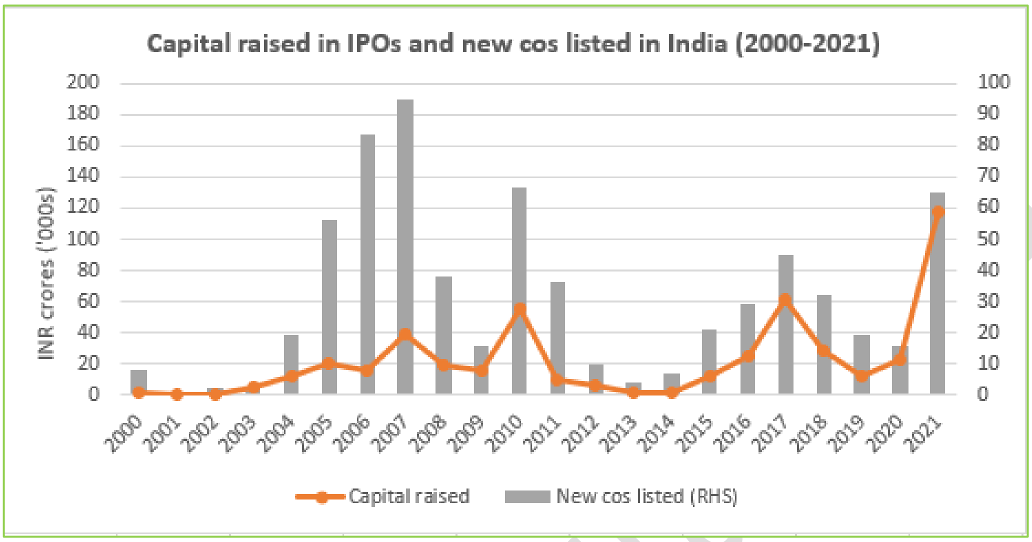
Some thoughts on Initial Public Offerings (IPOs)

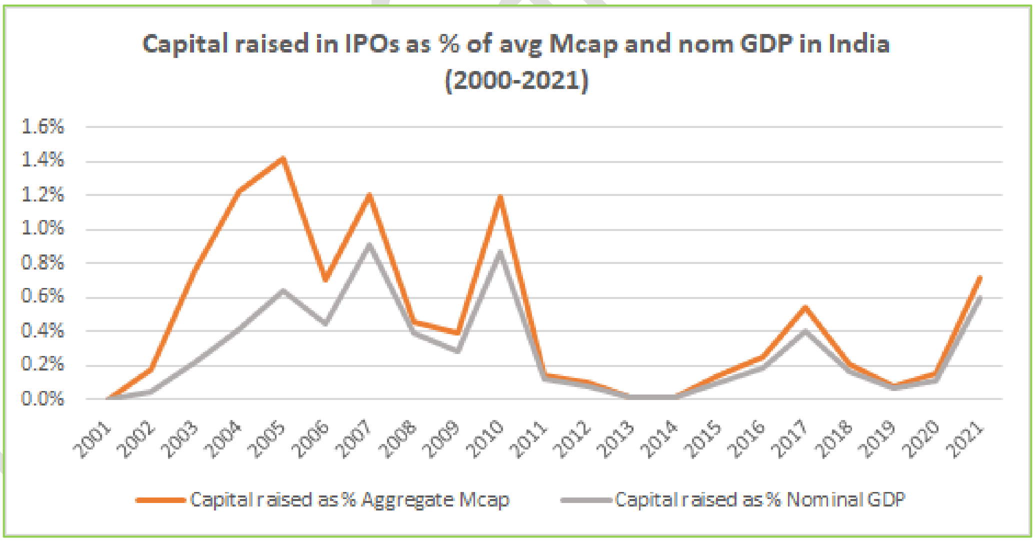
Initial Public Offerings (IPOs) refer to the listing of privately-held businesses on the stock exchange. IPOs were much discussed in the last one year likely because it was an outlier year for listings, judged by the either volume (number of new companies listed) or value (amount of capital raised).

Chart 1: Capital raised in IPOs and new companies listed in India (2000-2021)



Source: Own analysis based on Ace Equity data

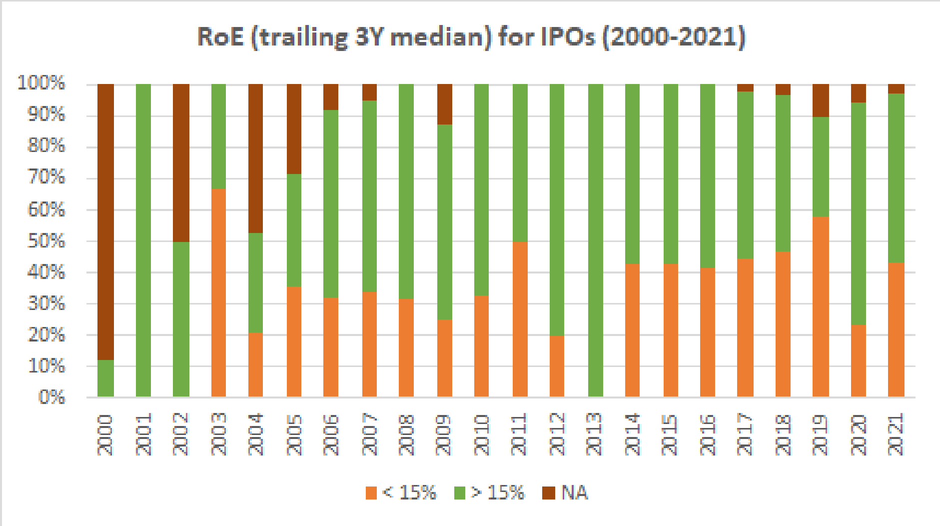
Chart 2: Capital raised in IPOs as % of average market capitalization and nominal GDP in India (2000-2021)



Source: Own analysis based on Ace Equity data

As seen in Chart 1 above, the last calendar year (2021) had the highest absolute amount of capital raised in the last 20 years, and was in the top 5 in terms of number of new listings as well. As can be seen in Chart 2, even when the amount of capital raised is adjusted for inflation by comparing to prevailing total market capitalisation or the size of the Indian economy, the capital raised through IPOs last year ranks among top 5 in the last 20 years, and the highest in the last 10 years.

Chart 3: Return on Equity (trailing 3Y median) for IPOs (2000-2021)



Source: Own analysis based on Ace Equity data

As an aside, an interesting observation: while a number of the high-profile and sensationalized IPOs last year may have represented loss-making companies, Chart 3 indicates that last year's share of IPOs with low returns on capital (assuming <15% Return on Equity on reported basis as the threshold) is not that different compared to the last 20 years.

More generally speaking, IPOs have been (and likely will be) a topic of much interest for investors at most times. Reasons for this include the curiosity-(and gossip)-inducing novelties and idiosyncrasies of some of the entrepreneurs and businesses brought to the limelight by IPOs. More importantly, the interest in IPOs possibly stems from the potential to make outsized financial returns in a short period of time, perhaps within the first trading day ("listing date") itself. This financial reason becomes even more exaggerated when there is enough (and more) leverage provided through IPO financing loans, as has been the case in recent times. So much so that there have been public anecdotes of anger and resentment caused by the inability to obtain enough allocation in "successful" IPOs, where success is usually defined by the performance on just the listing date.

So, it is understandable when we are asked about our interest in IPOs, or a specific IPO. Unfortunately for the asker, we are clear that we will not consider investing in IPOs, unless in extremely special circumstances. It won't surprise you to know that the Fund has not applied for (let alone invested in) any IPO so far.

To be clear, there is nothing illegal or immoral about considering IPOs. While there are some acceptable grouses about the opacity and arbitrariness of some parts of the IPO process, the public listing of private listed companies is indubitably an important part of the capitalistic economy. This assumes that stock exchanges were primarily conceived to enable a more efficient allocation of capital for the entire economy (and not just for speculation and other forms of entertainment).

Thus, we are not philosophically against IPOs. However, we are very wary of investing in IPOs mainly because of the information asymmetry that persists between the buyers (those who buy into an IPO) and the sellers (the insiders who are existing shareholders) of the business, who are able to pick the appropriate time, and thus high enough valuation, to list their company. Given our intention only to buy stocks of high-quality businesses at reasonable valuations (if not better), IPOs will hence most likely fail our requirement for reasonable valuations. This is not to say that there cannot be IPOs that are undervalued, perhaps even drastically so, but we would contend that the odds are significantly against the same. In fact, we could also argue that such an undervalued IPO may represent an undesired capital allocation mindset of the majority shareholders, since they may have preferred to undervalue their business, for some reason, to the detriment of existing shareholders, including themselves. On that note, the only time we would possibly consider investing in an IPO would be when there is enough evidence of a distressed seller of a good business, where the amount being realized from the listing (and hence valuation) is less important than liquidity for the seller (say, a Private Equity Fund nearing its own maturity). We expect such IPOs to be very rare instances, if they occur at all.

That said, there is a positive for us from all the recent IPOs, which is that that our investable universe increases by a little. Our best guess is that recent IPOs (~100 in last 3 years) will provide 20-30 more new companies for us to research, of which 5-10 may qualify to be defined as high-quality. Even these 5-10 yet-to-be identified high-quality businesses are unlikely to be actionable soon after listing, given the unattractive starting points for valuation for afore-mentioned reasons. However, it is possible that valuations may become more attractive over time, due to market, sector or stock-level dislocations, as with any other opportunity we look at. More specifically, “failed IPOs”, loosely defined by us as stocks whose prices have fallen 30-50% from their listing price over 12 months or so after their listing, may be a good hunting ground for opportunities, with those businesses having garnered some negative associations due to the poor performance of their stock prices, amidst limited investor awareness in that short period of time. We will be looking out for such opportunities.