Greetings!

Trishanku's heaven

That is the place where the otherwise worthy king of the Indian mythology fame found himself in as a result of his premature desire to sail into the high heavens. He was propelled by the formidable sage who had the firepower to make him go ballistic. The rest of the story may be quite irrelevant and may not even fit in. Never mind. The escape velocity was not good enough to get the king an entry into the exalted space. The sage then created a surrogate heaven and after some hard negotiations involving the gods of the real thing, the king was housed in the dummy look-alike. But as part of the deal, he hung upside down. With gravity lurking just below and waiting to take over, he could hardly have felt comfortable. The story ends there. We don't know whatever happened to him but we can guess.

The Indian market has all the requisite credentials of a worthy king. It is backed by robust growth prospects as we speak. The economy which lubricates the wheels of the market has now spent a lot of time on the ground doing penance as it were. The boon of earnings growth is about to be bestowed and the business cycle is on the ascendant. To be sure, stars are getting aligned and it should be India's decade ahead. The propellers of this market are powerful like the sage. They are many and with different agendas but united in that they all seem to possess the firepower. And then, they are only too happy to pack the punch. There is the Fed which is at the head of the pack but increasingly uncomfortable and unsure of its priorities. There are the institutions, global and homegrown, who are flush with funding fuelled by the quest for returns and alpha. The IPO superstars are on steroids and are losing no chance to turbocharge the propellers powering the stratospheric ascent of the market. There is the impatient (some say fearless) retail investor who is riding along as alternatives to equities don't exactly point towards the heavenly direction. The search for investment nirvana has seldom been more purposive. We have never moved with so much speed towards that goal. But then, we may have ended up in a surreal zone. Altitude sickness is palpable. Perhaps, the market is about to hang upside down.

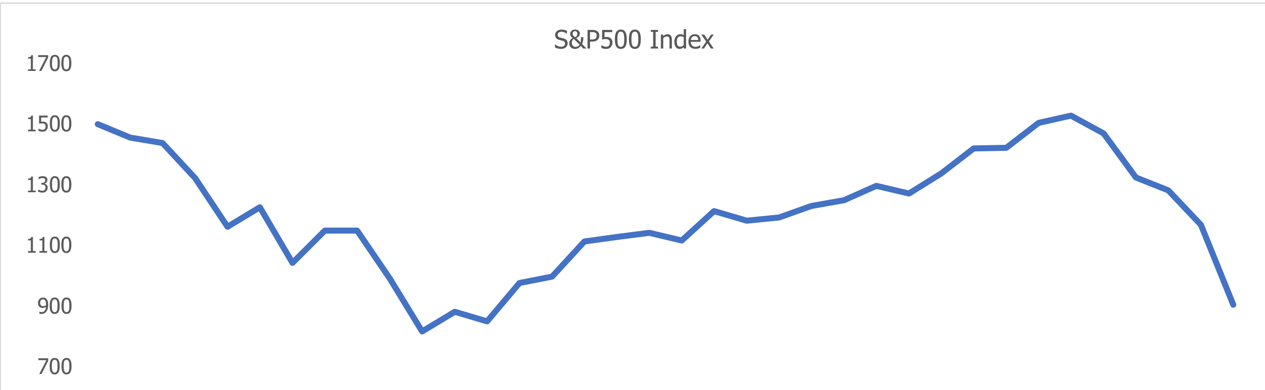
What might make it descend into the clutches of gravity?

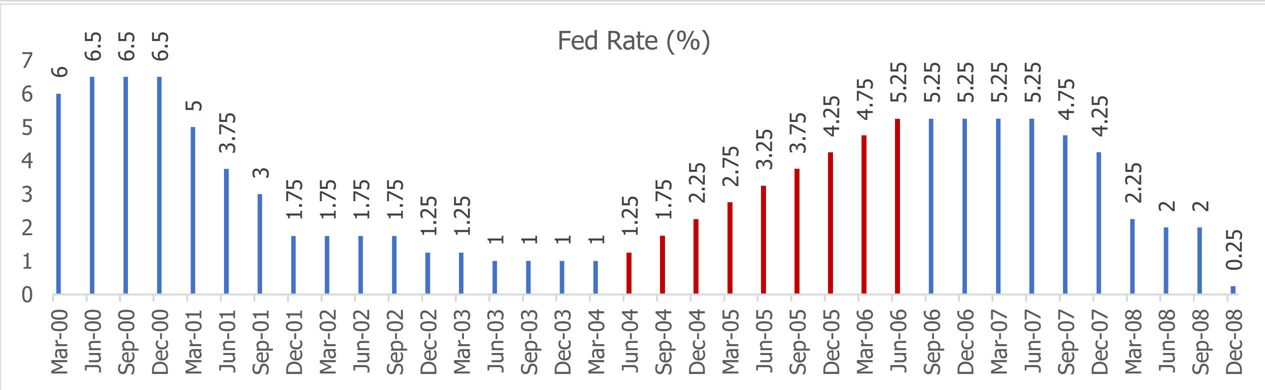
1. The US Fed
2. The Chinese Dragon
3. The IPO primetime show

The US Fed

The bears always knew better than to fight the Fed. This time around, the Fed is making overtures towards an opening gambit at decoupling from its modern-day avatar as the defender of last report for the bulls. But then the bull brigade is telling you that the Fed is just teasing the market. It will keep the market in fine fettle. It means well for the bulls. So goes the spin.

Going back a couple of decades, the Fed started tightening in 2004 when the bull market had just finished warming up.





Source: Bloomberg, Spark Fund Research

It took nearly four years of convincing by the Fed before the markets buckled. The short points are two. One, the Fed usually holds its horses once it sets itself on a path. It is unlikely to change its decision to pivot away from infusing unlimited liquidity. Two, the Fed action could be a slow burning fuse if history were to repeat. How slow is slow will be the stuff of how history will be re-written.

The Chinese Dragon

When it comes to interfering in free markets, China has done it with aplomb. They have always had it their way (almost always) when it comes to micro-managing their macros. Be it the Tiananmen episode ages ago or the banking crisis in the 1990s or the aftermath of the global financial crisis or the shadow bank meltdown or the many real estate and infra boom-busts. Be it the various other obstacles they faced along their journey to what is now a powerful modern economy. China has handled every crisis on its own terms. The Dragon has always emerged with an upper hand. So far so good. Look at how big the Dragon has grown.

	2007			2020		
Particulars	**China**	**US**	**World**	**China**	**US**	**World**
GDP (USD Trillion)	3.6	14.5	58.1	**14.7**	20.9	84.7
Daily Oil consumption in barrels (millions)	7.8	20.2	85.9	**14.2**	17.2	88.5
Annual Steel consumption in million tons	413.7	111.2	1,221.0	**995.0**	80.0	1,771.8
Market Cap (USD trillion)	3.9	17.7	59.2	**10.9**	42.6	103.2
Debt / GDP (%)	164.0	64.0	-	**323.0**	105.0	-

Source: World Bank, BP – Statistical Review of World Energy, worldsteel.org, Bloomberg, Spark Fund Research

As we negotiate the current saga of Evergrande and the crackdown on big tech, the one thing that has changed is that China is now far bigger. The dragon is now the proverbial elephant in the room as well. Yet it remains as inscrutable as ever. Stakes have never been higher. We have few options other than to keep our fingers crossed on this risk and keep watching out.

The IPO primetime show

Make no mistake. The achievements of the Indian unicorn brigade are impressive. This has been the biggest success story for India after the birth of the IT services industry. The promise that it holds to transform India is truly remarkable. The wealth creation that it heralds is stupendous. It is giving rise to the thought that India may be at that proverbial tipping point to take off. Great show.

Hey, wait a moment. Take a deep breath.

What promises to be great for the economy and the technology ecosystem NEED NOT necessarily be good for investors ALL THE TIME. Zomato listed with a bang in the NSE and so did Freshworks in Nasdaq. Many more are lining up now. In all the excitement, we cannot help noting the point that businesses can only be valued on profits/operating cash flows at the end of the day. The day could be very long but the moment of reckoning cannot be pushed out forever. What is astounding is that in all the brouhaha, it has become sacrilege to discuss profits. From multiples of profits to multiples of profits in the somewhat distant future to multiples of EBITDA, the IPO pricing is moving on to multiples of revenues and much worse. We noted this last month and note this once again that valuation benchmarks are being set in the unlisted space which is largely unregulated. The price at which assets are changing hands within a closed ecosystem of entities with certain common interests (such as unlimited appetite for greed) form the basis for valuations upon listing and the price discovery process hinges only on one of the key guiding principles of free markets – Caveat Emptor. Investors are wading into this area and are inherently blindsided on how the transactions have panned out in the pre-listing stage except that the facts are buried somewhere in the offer document. The whole process lacks the rigour which the companies will invariably face some day once in public markets. Some other key pillars on which free markets have been built are conspicuously weak in this whole process.

IPOs have created excitement in all the previous bull runs. In the 1990s, there was the controller of capital issue which fixed IPO pricing and the listing price was eventually governed by the amount of oversubscription. After the excitement came the bloodshed and tears. Changes to the IPO pricing and norms followed.

Look at the performance of IPOs that hit the market in the pre-Global Financial Crisis period (1999-Q12008). Returns are reckoned from the listing price to the respective dates. October 27, 2008 was the market low during the global financial crisis and we have highlighted the performance from listing until the worst point in the market. We have further shown the returns till now to illustrate how the longer term has panned out for these IPOs. The Nifty index returns are from the average level of the index in 2007 which was the year when the market peaked. Many IPOs under-performed from their listing price despite the fact that the Nifty returns are calculated from the higher base of 2007. The data clearly demonstrates that all IPOs do not perform post their listing. Significant wealth creators like TCS managed to do that because they have been great businesses. It is also obvious from the table below that large IPOs (> Rs. 1,000 cr was large those days) tended to result in froth. This does not mean that all huge IPOs need to go that way but this is a good enough reason to be cautious.

IPOs with issue sizes > Rs. 1,000 cr:

		CAGR till	
Company name	Issue size (Rs. cr)	27-Oct-08 (market bottom)	30-Sep-21
Reliance Power	11,700	-84.87%	-21.03%
DLF	9,188	-55.93%	-2.31%
ICICI Bank	8,898	-58.26%	9.97%
NTPC	5,368	15.87%	5.39%
ICICI Bank	5,101	-18.84%	12.82%
TCS	4,713	-1.89%	21.52%
PNB	3,120	-0.62%	-4.17%
Power Grid Corp	2,984	-30.20%	8.11%
Vodafone Idea	2,125	-40.51%	-10.06%
Jet Airways	1,899	-44.27%	-13.89%
Adani Ports & SEZ	1,771	-58.93%	11.98%
HDIL	1,699	-60.34%	-27.49%
REC	1,639	-69.70%	7.07%
Bank Of Baroda	1,633	-1.06%	3.64%
Suzlon Energy	1,496	-28.73%	-17.18%
IDFC	1,372	-19.62%	0.60%
NIFTY Index*		-36.04%	9.92%

**CAGR from 2007 average*

IPOs with issue sizes < Rs. 1,000 cr:

			Median CAGR till	
IPO size range	No. of companies	Total amt raised (in cr)	27-Oct-08	30-Sep-21
500-1000 cr	18	13,635	-40.83%	0.72%
0-500 cr	171	22,502	-35.39%	2.36%

Source: Ace Equity, Bloomberg, Spark Fund Research

The large IPO fund raises reveal a chequered track record over the long run. One lesson from previous bull runs is that investors overpay for stocks in the bull market frenzy and big IPOs are sugar-coated for extra effect. The much-hyped IPO of Reliance Power proved a watershed moment and coincided with the market shifting into reverse gear. Some parallels are inescapable.

1. The absence of profits
2. Questioning those who question
3. Depiction of future with spreadsheet as a key tool
4. More action and/or focus on the balance sheet as against the P&L

The optimists would say that this time is different. They say that the quality of companies is much better now. That the current crop of entrepreneurs has been cut off a different mould. That the disclosures are a lot better. We will not disagree.

Let us also mention what remains the same. Markets are driven almost entirely by greed in the zone where we are in right now. We also note what is different now which is rather new as well.

1. The game has become much bigger (see the table)
2. The action in the unlisted space is far bigger

Total IPO money raised in 2021 + The pipeline (in cr)	211,817
Annual average IPO money raised from 2003-07 (in cr)	22,042
2021E vs 2003-07 average	**9.61 times**

Source: Ace Equity, Bloomberg, Spark Fund Research

Both these bring about risks of a scope and magnitude our market has not contended with. While remaining staunch optimists on India and acknowledging the virtuous cycle that the development around unicorns promises to bring, we reiterate that this need not mean good things for ALL investors ALL the time. When IPO markets are on fire, the investors in the listed space may be left to clean up the embers. The mother of all IPO booms may be upon us. We choose to highlight the risk that this brings to the markets. Smart investment is getting the alignment right. At this point, investors in secondary market are beginning to be seriously mis-aligned to the heroes of the unlisted space and the beneficiaries thereof.

Might as well end what was started with a titbit from mythology with another one. The market now looks like the Bhasmasura who turned all who stood in his way to ashes as he had the ability conferred on him to do so by merely placing his hand on their heads. Then came a day when he tried his head for a change.

We are still in a bull market. We are still in good hands if we know our hand. But mind the chasm and tread with caution.

Warm regards,

P Krishnan (CIO) and Team Spark Fund
