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My advice to retail investors is not to think of IPOs as buying a lottery ticket: Devina Mehra

Synopsis
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The frenzy in a particular IPO or even just after that IPO listing, is not often a very good indication of the long term prospects of the company, says **Devina Mehra**, Chairperson & MD, First Global.

You have seen many cycles; the boom and the bust of TMT, the rise and the fall of infra and now startups which have become the new tech companies. What is your understanding of the new tech cycle? Is this a fad, mania or an indication of what lies ahead?

Yes, you are right that one has seen too many cycles and sometimes I wonder whether having too long a memory is a positive or a negative. In fact, very recently I was reading about this IPO frenzy on the Paris bourse back in 1881. Therefore IPO frenzies are not quite a very recent phenomena. Back then even shortened prospectuses used to be handed out along with food and so on. So the new listings catching the fancy of people is a very old phenomena. In India also, everybody remembers the Reliance Power IPO and that went bust. But even DLF was a hot IPO. It listed and doubled from the IPO price for the next few months and since then has not even seen the IPO price again. On the other hand Infosys was an under subscribed IPO, which not many people would remember.

So what I would like to first say is that whatever is the frenzy in a particular IPO or even just after that IPO listing, is not often a very good indication of the long term prospects of the company. One must always keep that in mind. Coming back to the new age tech IPOs, first off all many of them are not really tech companies. They are just using a digital platform to access customers which is a very different thing from saying that their core competence is technology which it is not. Therefore tech as an entry barriers is not there. Mostly the barrier is how much money can you spend to get to the customers. So whoever has deep pockets does well. That is a very big part of the story.

Actually the companies going for IPO are on a negative footing because leading up to the IPO whether it is Paytm, whether it is Zomato, or even Policybazaar, they cut back on marketing and promotional expenses to show slightly better numbers which usually means a reduction in losses and not really an increase in profit in the first place.

But now that they are in the public markets, they want to show some improvement, whereas they may be competing already or may compete in the future with others who still have access to practically bottomless pockets of the VCs. That puts them at a disadvantage. Now, the tech is a misnomer in some sense. I would call them consumer tech companies or most of them would be D2C companies which is directly selling to consumers on a digital platform, rather than a real technology company.

Between the four companies which have gone public, we have a combined market cap of about $50 billion and that is a sizable market cap. These valuations currently are commanding valuations based on where they were in terms of the private market. They have become public now. What happens to the price discovery in the public market for the startup space now?

One thing, you are saying that they are priced based on where they were in the private market. That is actually not true because most of them -- even if they have raised money as recently as three months or six months or 8 months ago - are going at a multiple of that number whether it is Nykaa or Policybazaar, Zomato or Paytm. So it is not even what the private equity guys or the VCs had actually come up with as valuations. Nothing fundamentally would likely have changed in three months or six months or eight months. But now the public markets are expected to, and maybe are willing to, pay a big multiple to that.

That is the word of caution right there. Any time in history, when you start to look at the valuation via new valuation measures, that becomes a red flag. During the dotcom era in 2000, it was that there was no need to look at profits or even revenues as long as they are getting the eyeballs.

So every time there is this kind of appetite for any kind of paper, then there is always a logic that is made up and also these companies have to not just execute on a one, two, three year basis, they would have to execute on a 15, 20 year basis to justify these valuations. So, one word of caution which I said earlier, scrutiny is needed. Even going into the IPOs, typically they tend to cut down on marketing spend. Thereafter also, there is that treadmill of quarterly results which means that there is pressure to be managed differently from how they were managed as a private company.

And it is not just about existing competition. If the niche has proven to be enough of an opportunity, you will see more people coming in and even some other existing players getting into that area.

The international experience in such companies post listing has not been great -- be it Uber, Lyft, Doordash and all. Nothing has done extremely well post listing.

I would say that if you are an investor, this is separate from exactly what you asked but if you are an investor, too much of people's mind share, if not their portfolio share, is going into focussing on this one area whereas I would advise retail investors not to think that it is like buying a lottery ticket which seems to be the mindset at times. So look at your portfolio and even at lower entry points you have good services which can advise you on making a basket for you and so on. So look at those things and rather than just focussing too much on this IPO, which at the moment looks like a gold mine -- at least till today. Step back a bit and do not get into that mindset.

Do you think the best way to look at these businesses is to look as if you are buying them in a different cycle, but you need to be patient for three to five years minimum before you will get market-beating returns. Is extending the timeline a different way of looking at them?

Whenever you extend the timeline, you are increasing the uncertainty and these are new companies. I am talking even about companies with a long history. Some years back, we did this exercise with all BSE listed companies and said that let us see whether they have shown any profit growth every year. Just that profit growth was greater than zero in every single year for 20 years. And out of those thousands of companies, we came up with a list of around 25 companies which had met even that minimal test. As analysts are punching in the numbers and doing a forecast whether it is for cash flows or profits, the forecasts almost always show that growth every year is a given. No, growth every year is not a given and if you look at these new businesses, in many cases, the moats are not that high.

Once you have a proven model, you will also have other players coming in. Look at Paytm for instance. Its market leadership position on the league tables has been dropping every year for the last four years or so. So, if the space is attractive enough, more people come in.

About 20 years ago, Hindustan Lever was getting into atta and at that time I had met Amul and I said like what do you think? They said we do not think it is an attractive market but if Lever manages to prove that it is an attractive market, we will get in. What is the big deal?

So many times people wait for a business model to be proven and then more people jump in. So it can be justified maybe five years, 10 years later, who knows? The point is that even if they deliver on all that they have said, what they will deliver on is not that already priced in? That is the second question. If they do all of what they are supposed to do, it is probably already in the price - not in every single IPO, but broadly as a category. Whereas if they slip up at any time, there is more competition and that then means that you paid too much.

Also, I often debate this internally whether it is a good thing or a bad thing to have positive earnings. Nykaa has earnings, so you can calculate PE and you can also compare with say Ulta in the US which is in a similar business. If you do not have a PE, then you are scrambling around for what innovative valuation parameter to use to justify it.

I have seen reports which are saying that this is the PE on 15 years out earnings. That's good for a laugh. But who knows what the situation will be 15 years from now? Something which has been in existence only for a handful of years, what visibility can that have after 10 years? And you are pricing it to perfection assuming all of that gets executed, that is the point.

If I force you to buy a new tech company for the next five years, would you buy any one? Not really. Not at these valuations.