

The great IPO rush: Never go by the big names that have invested

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SUMMARY

Marquee VC funds and other famed institutions associated with an IPO can make quite an impression. But look closer—they might be cashing out while you're buying in, and their financial motives may differ from yours. Here's what to watch out for.

Another year, another initial public offering (IPO) frenzy. Or should I say another century, another country and another IPO frenzy? Because a mad rush for IPOs has been around as long as modern stock exchanges have existed. In 1881, there were 400 IPOs on the Paris bourse, with street sellers hawking prospectuses.

Talking of IPOs, most investors look at the names of big investors who have invested in a stock as a sign of its credibility. If large institutional investors—mutual funds, venture capital (VC) funds, foreign institutions or others—hold or buy a stock, many take it as a *Good Housekeeping* stamp of approval.

The common investor thinks that all these institutions must have done their due diligence, and that by putting their money where their mouth is, they have already done the work, so smaller investors can go along for the ride.

But it doesn't quite work that way. A few pointers. There is a fundamental difference between a regular investor investing in a certain securities and a VC fund doing so.

The VC model works on the explicit assumption that most of the fund's investments will go down to zero. The ratio goes something like this: 60–70% of its investments will go to zero or near zero. Maybe 25% will make some money and 5–10% will be multibaggers, which is where the fund hopes to find the next Google or Facebook. VC analysis is from a totally different perspective from yours. You are deciding whether or not to buy a single security. But VC funds buy that security as one of a basket of securities. Their risks are spread out.

And, as we have seen in a host of companies, from WeWork in the US to Housing.com and Byju's in India, big marquee VC names often do not even catch explicit frauds, let alone any lack of execution by their investee companies on business plans. Hence, relying on them for having done their due diligence may be a bad bet.

The other question is whether you and the institutional investor are buying at the same price. There is usually a difference between the price at which the IPO investor buys and the valuation at which large institutions have invested in a firm. In almost every recent case, the IPO is at a premium to the price at which these investors have bought shares, even if the last funding round was as close as three or six months ago.

For instance, the big new-age IPOs that were launched in 2021 in the Indian market, from Zomato to PolicyBazaar to Nykaa, were all in this basket. The IPO valuations were at twice, thrice or four times those for the last round of money raised by these companies in the private market. The recent LensKart IPO is at about eight times the valuation of its recent fund-raise. The prospects of any stock differ depending on what price you bought it at.

Even more fundamental: Is your entry price the exit price for the institution? If the issue involves an offer for sale of shares, the IPO price is an exit price for the institutional or VC investor and an entry price for you. So the big names are 'selling' and not 'buying' at this price.

That is a fundamental difference! In other words, you, the common investor, are providing them an exit.

Then, there is the category of 'anchor investors.' These are mutual funds and other large institutions buying at the same price as the IPO, but which get firm allotment before the IPO opens.

Often, for even clearly overvalued IPOs, the list of buyers is packed with glittery names. But look a little closer and the glitter appears to fade. For one, most of them are putting in minuscule amounts of money. In the LensKart IPO, it is mostly around 0.1-0.2% of their equity assets under management. The question then is: Why are they buying it at all? As a former investment banker, I can tell you the game.

While allotment of units in the IPO itself is a lottery process in case of over-subscription, for the anchor investor portion, the investment banker can allot

shares at its discretion as it deems fit. This is similar to the process for qualified institutional placements (QIPs).

From personal experience, I can tell you when there is a scramble for an issue and you are its investment banker, various funds—domestic and international—are seen jumping up and down for allotment. There are cajolements and recriminations (ranging from ‘I am a big client’ and ‘I am your friend’ to ‘How could you have not allotted me as much as I wanted’... and so on).

If such a situation is exploited by investment bankers, they can arm-twist mutual funds and other institutional investors into investing at least a token amount in an obviously overvalued or unattractive IPO just so that they are not ‘forgotten’ in the allotment of a stock that they really wish to buy.

It becomes a *quid pro quo*, with the investment banker getting quality institutions to subscribe to substandard issues by using the carrot of providing extra allotment in coveted issues. In my view, this is an area ripe for regulatory intervention as big investor names are used to lure small ones.

The learning? Never be blinded by a list of entities recommending a stock or having invested in it. Always, and especially in financial markets, remember the classic dictum: *Caveat emptor*. Or buyer beware!

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