

Profit Booking, Limited Liquidity: Why Several SME IPOs Didn't Take Off In 2023?

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One of the common reasons for small businesses fail is a lack of business acumen by the management team or business owner, observers say

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For small and medium enterprises (SMEs), the year 2023 turned out to be a great one. Well, that is what most industry people stated, however, one incident that grabbed eyeballs was that the SME initial public offering (IPO) market faced a significant setback, with several offerings failing to meet investor expectations and experiencing lacklustre performance.

According to the data, about 179 SME IPOs were listed in 2023. However, while citing statistics, online wealth management platform Kuvera in a report stated that data from 2023 showed that about a fourth of SME IPOs turned flops eventually. In comparison, investors lost money in just one in 12 IPOs on the main board. Also, the average listing day gain on the SME exchanges was a tad lower than the main board.

The returns generated on the SME exchanges have been much higher. The median return after listing to date on the junior exchanges of the NSE and the BSE has been 47 per cent for investors. This is a full 1500 basis points more than that on the main board (32 per cent), Kuvera's report revealed.

"Inadequate preparation and due diligence by SMEs before going public can lead to failures. Some companies may lack the necessary financial transparency, governance structures or robust business models required to attract investors' confidence. Overvaluation can be a significant issue. SMEs may overestimate their worth, leading to inflated IPO prices that are not justified by their actual performance or growth prospects. When these discrepancies become apparent post-IPO, investors lose confidence, leading to poor stock performance," said Pallav Agarwal, Chief Executive Officer (CEO) and Founder, HTS Solutions.

While talking about why few SME IPOs didn't tackle off last year, experts told BW Businessworld that several factors such as market conditions, volatility and uncertainty in the financial markets played a role which cautioned investors from participating in IPOs, especially those of smaller companies perceived as riskier investments.

However, Vijay Kalantri, Chairman, MVIRDC WTC Mumbai stated, "We cannot judge the outlook of SME IPO based on what happened last year. There are some stray instances of listing failure and mismanagement in the past. We feel this was just a temporary aberration and we feel investors have taken lessons from the fiasco and learnt to do due diligence before selecting the right investee firm."

The Big Question

Sometimes aggressive valuations are the probable reason for failure. Also, compared to the main board, founders are either very new in terms of experience or absorbing pressure. Another common reason small businesses fail is a lack of business acumen by the management team or business owner, observers said. In some instances, a business owner is the only senior-level person within a company, especially when a business is in its first year or two of operation.

"While the owner may have the skills necessary to create and sell a viable product or service, they often lack the attributes of a strong manager and don't have the time to successfully oversee other employees. Without a dedicated management team, a business owner has greater potential to mismanage certain aspects of the business, whether it be financing, hiring, or marketing," said Prateek Srivastava, Founder and Managing Director, Droneacharya Aerial Innovation.

Moreover, competition from larger, more established companies also overshadow SME IPOs. Investors may prefer to allocate their funds to companies with proven track records and stability rather than taking a chance on smaller, less-known entities. Lastly, regulatory hurdles and compliance costs can weigh heavily on SMEs post-IPO, diverting resources away from core business operations and hindering growth prospects. These factors collectively contribute to the challenges faced by SME IPOs in 2023.

Kresha Gupta, Founder, Chanakya Opportunities Fund said, "The factors contributing to the underperformance of these SME IPOs are multifaceted and unique to each case. Crucially, the outcome hinges on the investor community's acceptance of the company's valuation, its overall performance, and various other contextual variables. In essence, the challenges faced by this subset of SME IPOs underscore the importance of a discerning approach to company valuation and strategic decision-making in the dynamic landscape of initial public offerings."

Regulatory Frameworks

While talking about regulatory hurdles, HTS Solutions' Agarwal said, "Regulatory challenges were significant hurdles for SMEs during the IPO process in 2023. Compliance with stringent regulatory requirements imposed by governing bodies such as the Securities and Exchange Commission (SEC) in the United States or the Financial Conduct Authority (FCA) in the United Kingdom (UK) proved to be a daunting task for many smaller companies."

These regulations often entail extensive documentation, reporting standards, and disclosure requirements, which can be resource-intensive for SMEs with limited manpower and financial capabilities. Navigating through complex legal frameworks and ensuring full compliance with regulatory standards added layers of complexity to the IPO process, often resulting in delays and increased costs.

"Additionally, regulatory changes or uncertainties in the regulatory environment can further exacerbate the challenges faced by SMEs, making it imperative for these companies to stay abreast of evolving regulatory landscapes to mitigate risks and ensure successful IPOs," Agarwal added.

In India, SMEs are considered the key drivers of economic growth and are expected to play a major role in attaining a USD 30 trillion economy by 2030. However, RBI's UK Sinha Committee report, they face a funding gap of upto Rs 25 lakh crore. Other challenges include raising collateral-free bank credit even though their contribution to the non-performing assets (NPAs) of banks is low. Notably, India has a huge consumer market and MSMEs need capital to grow their manufacturing capacity to meet the growing domestic consumption.

At an industry event organised by WTC Mumbai and the All India Association of Industries (AIAI), CA Sumeet Mehta, CEO, Paradigm Advisors stated that At a time when interest rates on bank loans have risen considerably, SMEs can leverage the current boom in the primary IPO market to meet capital requirements.

Mehta advised SMEs to grow their net worth, improve their debt-equity ratio, strengthen balance sheet and enhance their credit rating by raising equity capital on the dedicated SME platforms of the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE).

“So far, 464 SMEs have raised Rs 5727 crore equity capital on the BSE platform, while their overall market capitalisation has grown to Rs. 97,488 crore. Similarly, around 234 SMEs have raised Rs 3,100 crore on the NSE platform and their market capitalisation has exceeded Rs. 8,000 crore because of strong investor interest in SMEs with promising business prospects. SMEs generating profit at least in the last two years can go for IPO to dilute the shares of promoters, reduce debt, invest in new projects or build a war chest for mergers and acquisition,” Mehta said.

What Next For Cash-strapped SMEs

In 2023, investors exhibited a notable and positive sentiment towards SME IPOs, reflecting a paradigm shift in their preferences and trust in the potential return generation from these enterprises. The buoyant atmosphere was characterized by a series of impressive statistics that underscored the robust acceptance and enthusiasm surrounding SME IPOs.

“A large section of market participants believes that some of these numbers are too good to be true and require the urgent attention of SEBI and the exchanges. More importantly, the regulator is also examining whether unfair market practices have made their way into the SME segment as increasingly there is talk of unregistered entities conniving with promoters to get issues hugely oversubscribed and ensure that shares list at a huge premium,” mentioned Droneacharya Aerial Innovation’s Srivastava.

Notably, there are more than two crore Udyam registered MSMEs, most of them having sound business models. Interestingly, experts see a bright outlook for SME IPOs in the coming months ahead as investors are looking for promising business models, with high growth in revenue and profitability. They expect that SMEs in tourism, hospitality, education, chemicals, engineering and other sectors to hit the capital market in the coming months.

“At a time when interest rates are high, the capital market offers a promising avenue for SMEs to raise capital to meet their long-term growth needs or to retire their existing debts. We advise SMEs to review their financial ratios, maintain proper books of accounts, manage receivables, optimise cost structure and have professional management and ethical governance principles before hitting the capital market,” added Kalantri.

Also, the number of IPO companies with Qualified Institutional Buyer (QIB) participants surged to approximately 74 in 2023, a significant leap from 12 companies in 2022 and merely 4 companies in 2021. This upswing in institutional participation signals a growing confidence among larger investors in the potential success of SMEs entering the public domain.

Equally striking is the fact that around 59 companies in 2023 witnessed a subscription rate exceeding 100 times, indicating an overwhelming demand from investors. Moreover, the participation of retail investors in eight companies surpassed a remarkable 500%, highlighting the trust and enthusiasm of individual investors in SME IPOs.

“As for lessons learned from SME IPOs that faced challenges in 2023, the nuanced evaluation of factors contributing to their underperformance becomes essential. Investors can derive insights into the importance of scrutinizing company fundamentals, entry prices, and strategic exit points. This reflective approach will contribute to refining investment strategies and decision-making processes in the ever-evolving realm of SME IPOs,” stated Gupta.

Despite the ongoing geopolitical crisis, several experts stated that the outlook for SME IPOs in 2024 remains optimistic, building on the positive trends observed in 2023. The upward trajectory is expected to continue for the next three to four years, driven by the substantial returns generated for investors. Confidence in SMEs from retail, HNIs, and institutional investors signals a robust and resilient market despite external challenges.

However, HTS Solutions’ Agarwal told BW Businessworld that the outlook for SME IPOs in the current year remains uncertain, drawing on trends observed in 2023. The success of SME IPOs will depend on a multitude of factors, including market sentiment, regulatory environments, and the individual characteristics of each company.

Geopolitical tensions can contribute to market volatility, impacting investor confidence and appetite for IPOs, particularly those of smaller, riskier enterprises. Moreover, heightened uncertainty may prompt SMEs to delay their IPO plans, waiting for more stable market conditions.