



HUGH SANDEMAN

*The author is a senior advisor to Langham Capital. He can be reached at hugh.sandeman@langhamcap.com*

# India innovates

**The most valuable job the new SME markets can do is to offer equity to small and growing businesses**

If they are successful when finally launched, India's new SME stock markets will play a different role in the economy than the growth company markets elsewhere that have been studied for so long by regulators and market officials in preparation for the new experiment.

What sets India apart is that it already has efficient and well-regulated stock markets that can deliver small and early-stage IPOs. But, at the same time, India suffers from a gulf that separates its relatively modest organised corporate sector from the vast informal economy of fragmented businesses often run by small entrepreneurs with big ambitions. Official policies on labour and reserved industries have conspired to make the gulf wider and harder to cross. The most valuable job the new SME markets can do is to offer equity to small and growing businesses that are caught on the wrong side of this divide.

The pioneers among small company markets, led by the London Stock Exchange's AIM (Alternative Investment Market), addressed three problems. The listing rules for established markets were too restrictive for early stage companies, the institutional investors that dominated the market were too big to care about small IPOs, and bankers could not make money from doing small deals. A further major problem specific to the UK was high capital gains tax, which meant that it was not worth investing in risky stocks for capital gains. Much of AIM's early success was due to tax breaks.

These problems either do not exist in India, or can be resolved within the existing market structure. In 2007-08, SEBI reports that of 124 public equity deals (IPOs, follow-ons, rights issues), 37 raised Rs50 crore or less. Brokers can make money on small deals. Retail investors' interests are not overshadowed by big institutions. SEBI and the stock exchanges have shown that they can adapt their rules to early-stage business models, though this could be taken further. And of course the tax system rewards investments made for capital gains.

When the debate about whether India needed a small company market got started again in 2005 (Over-The-Counter Exchange of India, or OTCEI, had failed due to a variety of reasons), led by Ravi Parthasarathy, chairman, IL&FS, the idea was to identify what gaps if any

there were in public equity markets in India. The provisional answer by SEBI in its May 2008 consultation – after an unprecedented IPO boom when exceptionally large and very small deals alike made it to market – was that the equity funding gap was at an early stage indeed. An SME market, SEBI suggested, could finance companies that do not have easy access to angel, venture or private equity funding, and that find listing costs too expensive. This is a different proposition from the funding gap – the absence of a public market as an additional financing source to private equity, or as a means to liquefy private investments – that AIM and its first imitators addressed.

For this reason, the structure SEBI outlined last year for India's new SME market, now being finalised, still looks broadly right. What is on offer is effectively an electronic platform for unregulated private equity placements, a solution that matches the funding gap identified by SEBI. The market – or rather, three of them, run by BSE, NSE and MCX – will be mainly institutional, with retail discouraged by a minimum trading lot (Rs5 lakh was SEBI's tentative number). If SEBI sticks to its suggestion of restricting eligibility to companies with a book value immediately post-offering of Rs25 crore or less, it will be anticipating offer sizes of perhaps Rs5-10 crore. At this size of initial free float, there is not going to be much trading anyway, whether or not retail investors are involved.

This is an experiment, and like all experiments, it can only be useful if it has the potential to fail as well as succeed. But given the urgent need in India to create millions of jobs, the suggestion by the finance ministry's K.P. Krishnan at last month's CII conference on SME markets, that broader issues like taxation and de-listing should be sorted out before any new markets are launched, seems a little leisurely.

The priorities should be to get the new platforms working, and make sure that if they go wrong, they don't infect the rest of the capital markets – or the reputation of the regulator. Keeping retail investors away, licensing banks, and eliminating any vetting by SEBI, should be enough to inoculate the rest of the financial system from problems in the SME markets. If things go right, India will have invented a new form of early stage capital market that could be copied in a lot of other countries. ♦