MULTI-ACT®
Built by investors for investors

Prannoy Bhargava
Head of Research

IPO Investing : Economics First, Narratives Later

Participating in primary markets via Initial Public Offerings (IPOs) can be a powerful route to wealth creation. They offer early access to fast-growing companies at the very start of their public journey, often accompanied by compelling growth narratives and strong market visibility. Successful IPOs are well-positioned to leverage the newly available capital and capture scale and visibility. IPO investors can benefit from this growth if they keep a long-term view. Further, a large cross-section of investors look for listing gains as well, exiting the stock on listing with an intent to make outsized gains. However, considering the significant activity in the Indian IPO markets, it is important for investors to be highly circumspect while subscribing for IPOs. We have created a short guide for investors to identify the red flags and accordingly be more informed while investing in IPOs.

Red Flag 1

Premium Pricing, Fragile Fundamentals

When making equity investing decisions, a key pillar is valuations. Simply put, the price has to either justify the valuation or the potential growth. For value investors, the former is critical. In the case of IPOs, the promoters often have some flexibility on the valuation front as the stock has not yet been listed and there is limited opportunity for price discovery. Thus, the most common red flag across high-profile IPOs is a disconnect between valuations and fundamentals. It has been observed that many companies approach the primary market with pricing that exceeds sector averages and valuations that are significantly higher than listed peers. These companies sell an overoptimistic play on future profitability and growth. In several cases, the IPO valuation assumes hyper-growth similar to early-stage venture-funded years, ignoring the natural lifecycle of a company—hyper-growth → maturity → eventual slowdown.

It is important to recognise that valuations assigned during private funding rounds can often be misleading. The sharp increase in business value seen across successive rounds is unlikely to continue as business growth normalises with lifecycle progression. Such valuations are typically shaped by negotiated optimism and forward-looking expectations rather than sustainable and market-tested fundamentals.

Our Solution

Assess the valuation through a multi-scenario framework that evaluates revenue growth bands, margin trajectories, capex and working capital needs and fits them into optimistic, base, and pessimistic scenarios. The objective is to arrive at the valuation range which is largely in line with the fundamentals of the company.

Red Flag 2

Opaque Path to Profitability

Our analysis reveals that many recent IPO candidates have displayed fragile business fundamentals which generally includes thin or declining margins, poor unit economics, high customer acquisition costs, stretched working capital itself implies inventory lockup among other things and an inordinately high dependence on external capital for growth. There is a higher degree of concern when it comes to companies that fail to exhibit any credible path to sustained profitability, despite rapid revenue expansion.

Our Solution

Our research framework integrates fundamental, financial, and competitive analysis to determine whether business models possess true scalability or is there simply optical growth masking financial weakness. Common patterns that we analyse include assessment of profit volatility, history of persistent losses, a mismatch between cash flows and profitability, high dependency on aggressive discounting or incentives to shore up revenues, artificially improved EBITDA via exclusions or adjustments, and lack of moat or differentiation.

Red Flag 3

Liquidity Event (OFS) vs Growth Funding (Fresh Issue): Decoding the Real Winner

The way an IPO has been structured can be fairly telling. Other things constant, a large Offer For Sale (OFS) component indicates that early investors or promoters might be exiting. This exit could be due to a belief amongst early investors and promoters that valuations have peaked or that the IPO proceeds are not going to significantly benefit the company. The logic here is fairly simple. If company insiders have faith in the future growth prospects of the company, then they are likely to continue holding their share and benefit from future growth. But in practice, many IPOs with high OFS see early and repeated promoter/VC sell-downs. On the other hand, even in fresh issue one should look out for vague utilisation statements like:

- General corporate purpose
- Organic and inorganic growth opportunities
- Future expansion plans

These offer little accountability on how the capital will generate returns.

Our Solution

The analysis focuses on return on incremental capital, growth visibility, and whether the capital being raised is proportionate to the business's actual funding needs.

Red Flag 4

Misuse or Ambiguity in the use of Proceeds

This is a serious concern. There have also been several instances in the past when founders have either been ambiguous about how they are going to utilise the proceeds from the IPO or worse still, misused them. General-purpose funding categories are often misused, allowing capital diversion, questionable acquisitions to inflate revenue or value leakage through related-party transactions. Some promoters also strategically use acquisitions post-listing to **temporarily boost fundamentals**, creating price support before additional promoter sell-down when their lock-in ends.

Our Solution

The core idea is to understand if capital raised must have a measurable purpose, a defined return expectation, and transparent accountability. Ambiguity in deployment is often a precursor to capital erosion.

Red Flag 5

IPO Timing and Financial Engineering

Companies often time IPOs during favourable market conditions or when their recent financials look temporarily strong. While market timing alone isn't always a concern, it becomes a red flag when paired with **earnings manipulation**.

Common tactics include booking one-time gains, altering depreciation or accounting policies, cutting discretionary spends to inflate EBITDA, aggressive revenue recognition, capitalising expenses, or shifting losses off the balance sheet. Financial engineering often surfaces in the IPO run-up, with fundamentals magically improving just in time to boost positive sentiments. Loss-making businesses miraculously turn profitable, margins expand, returns improve often right before the IPO papers are filed. These measures often result in profits normalising post-IPO, disappointing investors.

Our Solution

Focus on **Quality of Earnings (QoE)**, not just reported profits. Sustainable, repeatable, and transparent earnings matter far more than short-term, engineered numbers.

Considering the fertile interpleural landscape in India, there is plenty of opportunity for investors to partake in the growth of excellent companies. However, in a market where narratives, marketing, and temporary financial optics often overshadow fundamentals, independent and rigorous research becomes the most reliable defence against IPO mispricing and post-listing underperformance.

Statutory Details:

Multi-Act Trade and Investments Private Limited ("MATI") (SEBI Registered Investment Adviser – Registration No. INA000008589 and BSE Enlistment No. 1398)

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