Why you should approach SME IPO mkt with caution

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SME initial public offerings (IPOs) have been coming thick and fast. According to data from primedatabase, as many as 104 SMEs (small and medium enterprises) have used BSE and the National Stock Exchange's (NSE) SME platform to raise ₹3,405 crore in FY25 so far. This figure already surpasses half of the total funds raised by SMEs in FY24.

Most of these IPOs are heavily oversubscribed, driven by "heightened momentum in the primary markets and and lot of liquidity floating around," according to Deepak Jasani, ead of retail research at HDFC ecurities. However, Jasani arns that many SMEs can ade below their issue price thin six months to a year after ting.

oncerns are shared not only arket analysts but also by the Securities and Exchange Board of India (Sebi), which has issued cautionary advisories regarding the frenzied activity in the SME markets.

SME platforms on both NSE and BSE were created to help smaller companies raise capital through stock markets. Unlike large firms, SMEs may lack the resources to meet the rigorous compliance and regulatory requirements of a mainboard listing. Consequently, SME platforms have lower eligibility criteria and fewer disclosure requirements.

For instance, a company pursuing a mainboard IPO must have at least ₹15 crore in average operating profit over the last three years. In contrast, an SME IPO requires operating profits in just two of the last three financial years.

The compliance thresholds also differ. Companies listed on the SME platforms are only required to submit half-yearly earnings, while mainboard-listed companies must report quarterly results.

Before investing in an SME IPO, it's crucial to assess the quality of disclosures in the company's DRHP. ISTOCKPHOTO

Despite the relaxed regulations, both SME and mainboard IPOs share the same lock-in requirement, mandating that promoters maintain at least a 20% stake in the company for three years post-listing.

Additionally, on both platforms, SMEs must maintain a positive net worth. For the BSE platform, the company must also have net tangible assets of at least ₹3 crore. The exchanges may also impose additional criteria as needed.

Before investing in an SME IPO, it's crucial to assess the quality of disclosures in the company's draft red herring prospectus (DRHP) alongside its fundamentals. Important financial metrics to consider include the company's debt-to-equity ratio, total debt, and profit growth. If the company shows negative growth, the DRHP should provide a clear justification.

"If there is any sudden jump in profits of 30-60% in any one of the three years preceding the IPOs, that is a red-flag. Why would company be needing capital if it is doing so well on its own. It could just be to generate investor interest. A quick background check also helps. Look up for the products of the company, are they legit, any cases or outstanding dues pending. And of course, valuations are most important. What's the market cap the company is seeking as against its profits," explains Anuj Agarwal, an investor tracking the SME segment. Equally critical is the purpose of the IPO.

Sebi recently issued an advisory regarding the risk of misrepresentation by SME promoters, who, post listing, project an unrealistic picture of their operations. They make announcements that create a positive picture of their operations, and follow it up with corporate actions like bonus issues, stock splits, preferential allotments, etc. These actions can artificially boost investor sentiment, prompting them to buy shares at inflated prices, allowing promoters to offload their holdings at elevated valuations. Sebi advised investors to exercise extreme caution in these cases.