Book-Building - Lessons Learnt and the Road Ahead

Rajagopal A.

Chetan Savla
Kotak Mahindra Capital Co.

Indian equity capital markets have undergone substantial liberalisation since 1992 with the abolition of Controller of Capital Issues, formation of SEBI and ushering in of free pricing. However, one important lacuna in the system of public offerings has been the lack of investor participation in the pricing decision and a mechanism of “price and demand discovery” in Initial Public Offerings (IPOs). In major international markets, book building is the methodology used for IPOs which facilitates price discovery through the mechanism of investors bidding for stock.

In India, while the book-building guidelines were issued by SEBI in October 1997, for more than two years, there was no issue completed under these guidelines, though there were a few unsuccessful attempts. In September 1999, Hughes Software Systems Ltd. tapped the domestic IPO market using the Book Building route for the first time wherein investors had an equal role in pricing as issuers and merchant bankers. This ushered in a paradigm shift in the way issues are priced and marketed and the composition of investors participating in IPOs also changed significantly. Indian companies are not new to book building – all issuers who have done GDR/ADR issues have followed the book building process, which is the most widely used method of pricing issues in the developed markets.

Book Building is the capital market equivalent of an auction process – given the fundamentals of the issuer company, investors ‘bid’ at various price levels for certain quantities of stock. Aggregation of bids at different price levels leads to the ‘book’. The book is then used by the company and the merchant bank to determine the price of the shares offered – however, unlike conventional auction, in book-building the pricing need not be at the highest bid price. Pricing is a function of a number of factors, the important ones being – quality of investors at different price levels, the over-subscription at a particular price, regulatory requirements like minimum reservation for small investors and expected listing price. We, at Kotak Mahindra Capital Company have priced transactions at the highest possible price, the lower end of the band and even below the lower end of the band. In many ways, pricing is a function of demand, supply and external market scenario.

In addition to the investor participation in the pricing decision, book building offers certain other advantages over conventional ‘fixed price’ issues. In fixed price issues, on account of the uncertainty of allotment, large institutional investors like Mutual Funds, FIIs, Banks and Financial Institutions do not participate. In fixed price issues, allotments to all investors are on proportionate basis; this leads to uncertainty of allotment, with funds getting blocked up for a minimum of 30 days. This has a direct interest cost and institutional investors, managing money on behalf of others, have traditionally stayed away from fixed price issues. Book building offers discretionary allocation facility to institutional investors and payments are made once allocation is known. This has led to large scale participation of institutional investors in book built transactions.

Book building also reduces the time-gap between completion of the issue and listing of the shares – in fixed price issues, the time available is 30 days while in book built issues it is 15 days. Shorter time to listing reduces exposure to market volatility for investors and issuers alike. In fact, in overseas markets, trading commences either on the same day as pricing or the next day.

In doing the first two book built transactions – Hughes Software Systems and HCL Technologies – there were numerous hurdles. Most of these hurdles stemmed from the fact that, except SEBI guidelines, other statutes did not have a provision for book building. In close co-operation with SEBI, the Registrar of Companies, the National Stock Exchange, the Bombay Stock Exchange and the Reserve Bank of India, Kotak Mahindra put together the framework under which book building is currently done in India. These include the concepts of Draft Offer Document, the Escrow Collection Mechanism, the Confirmation of Allocation Note and the Bid-cum-Application Form, all of which have become market norms for doing book built transactions in India.

Our experience with book building shows that there are further improvisations which need to be introduced which would make the process smoother. These include amongst other 'Red Herring' or the Draft Prospectus circulated at the time of bidding has to be recognised as an official company registered document, time-to-listing needs to reduced further to make the process more akin to international transactions and separate listing of the book built portion and fixed price portion could be considered. Doing the entire book building on the Internet could also be explored. Having one comprehensive book (book built & fixed price together) could also make the whole process more cohesive.

SEBI amendments in June 2000 on IPO norms have made book building the de facto method of raising equity capital. Book building for IPOs has in many ways introduced global practices in the Indian markets and continued improvisations will ensure emergence of this process as the most widely used method of doing IPOs in the years to come.