IPO Gradings – Rationale and Prospects

P.K.Choudhury
Vice Chairman
ICRA Ltd.

Equity, needless to say, is one of the most important asset classes on the investments spectrum of the Indian capital market. It is interesting to note that over the last five years IPOs, rights issues, and other equity issuances have generated over Rs 90,000 crores as equity capital for various businesses. On the flip side, the same quantum of money, which by any standards is reasonably large, has been invested by equity investors – to rephrase in simple terms, there is a lot at stake in the equity instrument.

However, it is intriguing that despite such high stakes, professional and independent opinions on equity quality had not found a foothold in the financial market – at least not till now as professional advise on equity investing has largely been from market participants themselves, although SEBI's new initiative of IPO gradings by independent and professional agencies may be an important landmark in the development of a structured system of evaluating risk inherent in equity invested in. A factor that so far seems to have blocked the path of IPO gradings is the misconception of an IPO being an instrument to make quick money. It is more than often that the success of an IPO from the investors' perspective is subjected to judgement on the price the IPO lists at – which is normally not only a function of the issuer's long-term prospects but also of temporary market sentiment and environmental factors. IPO gradings are means of diluting this obsession with market sentiment and speculative tendencies while attracting attention towards inherent core quality, or the lack of it – which over a period of time is bound to impact the investor.

Further, a common debate in the matter is that such evaluation is not essential as equity by character is risk capital. That seems to be a fair hypothesis, however that still does not preclude the value of informed analysis in the decision making process of equity investing – more so when such equity is being offered to and invested in by public at large, even while the retail investor may have acquired greater maturity since the experiences of the mid-nineties. In other words, for an equity investment decision to be worthwhile, it should be based on reliable information and analysis. And it is precisely this that an independent agency with sophisticated analysis skills offers to investors through grading of IPOs. Being objective and independent, IPO gradings are designed to help investors strike a balance between their expectations and their individual risk appetites. Moreover, most investors, especially the retail or small ones, often may not have the expertise, resources or time to evaluate the quality of an equity offering or IPO and the decision is often influenced by the size, or the familiarity with name of the issuer. IPO Gradings can serve as an enabling and a comfort factor for such investors while improve market access of good, yet unknown companies irrespective of their size or visibility.

IPO Gradings - Conceptual Framework

The practice and experience of credit rating, which has contributed notably in the institutionalized financial markets worldwide, brings essential learning for a workable concept of IPO grading. As equity is risk capital, it does not have any fixed obligations to be serviced. This feature gives equity an indeterminate character in contrast to debt which can be regarded as an instrument with determinable outcomes since the interest charges and principal repayments are defined and the cash accruals of a company can be measured against these obligations to arrive at a 'cushion' (benchmarks) or safety scale (credit rating). The indeterminate nature of equity poses a problem of lack of benchmarks against which the performance of the company can be compared with. However, the need to evolve a mechanism to help differentiate between equity quality requires solutions to overcome these character constraints of equity in a manner that would encourage an investment process rather than fuel speculation in stocks. Such differentiation of equity is best done on fundamentals by creating benchmarks for key performance parameters. Consequently, the performance of a company can then be measured against these benchmarks and thus impart a determinate character to the equity analysis. At the same time, to enable the information (on quality of equity available through an issue) to be disseminated widely (to retail investors) and in a user-friendly manner, the opinion on the equity quality is communicated in form of a symbolic grade. Once there is a large enough universe of graded issues, the correlation between grades and performance benchmarks will emerge and enhance the investor's familiarity to the concept of equity grading. Moreover, more than a grade in isolation, a grade is a 'relative comment' which helps to distinguish between equities. This is true for the traditional concept of credit rating also because more than the absolute levels of safety, it is the relative levels of safety that matter. It is only after a large enough universe of debt instruments is rated that the underlying absolute levels of various performance parameters adopted by a rating agency emerge.

At the same time it is essential to recognize what IPO gradings are not. IPO grades are not forecasts of the future market price performance of the stock and do not indicate the companies compliance or violation of any statutory requirements related to the issue. Although it is commonly argued that equity returns (mainly capital appreciation) rarely follow any logic, the importance of fundamentals cannot be underestimated. Although market sentiment, rumours or insider information tend to de-link fundamentals from returns to investors in the short term (more so in the absence of a credible opinion on fundamentals from an independent agency), it is in fact the fundamentals that not only determine the return on the investment over the medium and long term, but also decide the resource allocative dynamics of the market. IPO Grading facilitates an information enhanced investment decision and in the process strengthens the hands of all those entities and participants in the capital market who want to help the flow of investible funds towards productive and competitive enterprise.

Rationale driven by methodology of grading

Tips and timing of investment are the ways of speculators, while 'fundamentals' are tools of investors. The methodology of grading focuses on relative fundamentals of a company offering the equity which in turn encourages investment in a company rather than speculation on the stock market – more so in instances where the company does not have a track record in the capital market and may be approaching the public for the first time.

In light of the above, the quality of equity being issued is determined by examining the fundamental factors that drive the performance of the company issuing the said equity. In other words, performance is seen as the logical outcome of certain underlying factors. At the end of it all, the grading assigned communicates to investors what they might rationally expect on the performance front, given the issuer's fundamentals. In fact, grading can thus be a key ingredient that could make all the difference between speculation and calculated risk taking.

Consequently, IPO Grading is designed to examine equity in the long term context. The analytical exercise is essentially forward looking. The grades are comments on the relative inherent quality of equity reflected by the earnings prospects, risk and financial strength associated with the specific company. These factors in turn are an outcome of a complex combination of variables which are both internal and external to the company and may be broadly categorized as:

- The Management quality
- The industry outlook
- Corporate operations and competitive character
- Financial strength

Among external factors the key one is the industry and economic/business environment for the issuer. Among internal factors are: competence and effectiveness of the issuer's management; profile of promoters; marketing strategies; size and growth of revenues; competitive edge; technology employed; operating efficiency; liquidity; financial flexibility; asset quality; accounting quality; profitability; and hedging of risks. It may be noted that quality of management and governance are of utmost importance from the grading perspective. Pragmatically, the financial results and other performance measures are only a reflection of management competence and governance quality in the business environment of the company.

The analysis of the factors as above further suggest the level, growth and composition of earnings as also the financial strength which may be expected in future. This opinion is arrived at through comprehensive information acquisition, interaction with management of the corporate, critical analysis and a collective judgemental process.

The Proccess

The grading process is initiated by the issuing company mandating the grading agency to undertake the exercise, following which the agency seeks relevant information through primary and secondary sources and consequent to a rigorous analysis and diligent examination the analysts present the case to a committee which in turn assigns the grade. The complex combination of various factors is encapsulated in a symbol to appropriately reflect the strength of the fundamentals of the issuing entity measured on a five point scale ranging from IPO Grade 5 (indicating strong fundamentals) to IPO Grade 1 (indicating poor fundamentals) - so much on the mechanics of the process. However, in the mechanics of the process and the emphasis on the outcome (the grade) what gets lost is the importance of the process itself which is anything but an academic exercise and which more than rationalises the usefulness of IPO Gradings. While investor protection or rather investor information is the primary objective of IPO gradings, the interactive process which brings the benefit of an independent and detached agency's observations on the business of the issuer and the attendant communication of the same to the promoters and management invariably adds value to the conduct of the business of such issuer company.

In Practice

The function of the grades is to help the investor choose between investment options at a given point of time. For example, at the time of investment, the investor may have the option to invest in an issue graded IPO Grade 4 (Good fundamentals) at Rs. 20 per share, or another graded IPO Grade 2 (weak fundamentals) at Rs. 10 per share, and/or another graded IPO Grade 4 (Good Fundamentals) at Rs. 50 per share. With the availability of such information the investor may first eliminate what he does not want, say IPO Grade 2. He then chooses between two companies with the same level of fundamental strengths. The investor may thus choose to invest in shares of the stock graded IPO Grade 4 at Rs. 20 per share rather than the shares of the company priced at Rs 50 although the grading is the same.

Therefore the grades act as additional input in the investors ongoing efforts of portfolio maintenance. Although equity grading is designed to help investors in their decisions, the grades are not recommendations to buy, hold or sell, since it is left to the investors to decide for themselves what they prefer.

Looking Ahead

With increasing number of lesser known companies accessing the capital markets in future, IPO gradings hold promise to benefit all stakeholders in the system including the investors, issuers, intermediaries or regulators. While the issuers are likely to recognize the supportive and beneficial nature of the exercise rather than being intrusive, and the benefits of which are likely to more than offset the fear of grading being another level of scrutiny, IPO gradings are poised to serve an important role in making capital raising an efficient and transparent process. As IPO gradings are instruments of reducing market imperfections, it is also likely to face resistance from players who thrive on such market imperfections only at the cost of ordinary unsophisticated investors. However, it is an idea which seems to be ripe for the market to enjoy its taste now.