

IPO Grading: Another Perspective



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The primary capital market in India ushered in a new era when SEBI (www.sebi.gov.in), on 24th April 2006, provided an **option** to the issuers to get their IPOs, of equity shares or any other security later on convertible into or to be exchanged with equity shares, **graded** by one or more credit rating agencies like CRISIL and ICRA. It is said to be a globally unique concept introduced in India (see CRISIL IPO grading 'Overview' at www.crisil.com).

Investment decisions for IPOs, until then, were based on voluminous and complex disclosures made in the offer document / abridged prospectus, which pose a challenge to the investors, and more particularly to the retail investors, in arriving at informed decisions.

OBJECTIVES

In this context IPO grading was positioned as a service that:

1. Provides an independent relative assessment of **fundamentals** of the IPO in relation to the universe of other listed securities in India to aid comparative assessment that would prove useful as an information and investment tool for investors.
2. Was supposed to be particularly useful for facilitating the assessment of the offerings of companies accessing the equity markets for the first time, that is, where no track record of their market performance is available.

SALIENT FEATURES

The scheme as introduced by SEBI in April 2006 has the following distinct features:

1. Applicable to IPOs, that is, issues by **unlisted** companies only. Not for future public offerings (FPOs) by already listed companies.
2. Applicable only to **equity issue** or issue of any other security convertible into or to be exchanged with equity shares at a later date.
3. **Optional** for the issuer.
4. Grading obtainable from **one or more credit rating agencies** (CRAs) registered with SEBI.
5. Grading to be done on a **5 point scale** from grade 5 (indicating strong fundamentals) to grade 1 (indicating poor fundamentals).
6. **Disclosures** required in the prospectus and abridged prospectus:
 - Names of all the CRAs from whom grades obtained.
 - Grades obtained from all of them including the ones not accepted by the issuer.
 - Rationale/description of grades as furnished by the CRAs.
7. Grading once obtained, whether or **not found satisfactory** by the issuer, to be disclosed.
8. **Cost** of grading to be borne by Investor Protection Funds (IPFs) of stock exchanges or by Investor Education and Protection Fund (IPEF) of ministry of company affairs.

THE ROLE OF CREDIT RATING AGENCIES:

Case of CRISIL

Obviously the CRAs have to play a pivotal role in the grading process. Let us understand how CRISIL, the leading CRA of the country, is administering IPO gradings.

Grading Parameters

CRISIL maintains that its IPO grading service is an independent, reliable and consistent assessment of the **fundamentals of IPOs** that takes into account such issues as management quality, business prospects both of the industry and company, financial performance, corporate governance, project related factors, track record of legal and regulatory compliances, litigation history and capital history, etc. Clearly the quality of these factors is crucial for business success and, therefore, the assessment of this quality for facilitating informed investment decisions.

Grading Scales

CRISIL assigns grades to individual parameters as mentioned above and then aggregates them on a five point scale designed as under:

Sl. No.	CRISIL IPO Grade	Assessment
1	5/5	Strong fundamentals
2	4/5	Above average fundamentals
3	3/5	Average fundamentals
4	2/5	Below average fundamentals
5	1/5	Poor fundamentals

The design is self explanatory. The highest assessed companies will be assigned 5/5 and investors could be most comfortable with such companies subject to pricing adequacy and their own preferences.

Grading Report

CRISIL provides to the issuer company a report on grading which consists of:

1. A summary, that is, one page report highlighting the key elements of analysis, and,
2. A detailed report, that is, comprehensive commentary on the assessment parameters.

This report is only a **one time assessment**, meant only for the ensuing IPO, based on the disclosures in draft prospectus filed with SEBI, CRISIL's understanding of the industry and company fundamentals, information obtained from sources believed by it to be accurate and reliable and its interactions with the company management and other stakeholders.

Value to Investors, Issuers and Merchant Bankers

CRISIL claims that its grading service brings value to the investors, issuers and merchant bankers in the following manner:

1. It provides an independent and **unbiased assessment** of the fundamentals of the company.
2. The grade enables **easy comparison** between companies, irrespective of the size or the industry they operate in.
3. It is a **collaborative** initiative to widen and deepen market participation.
4. Increasing participation from new and foreign investors necessitates greater '**awareness**' about the company and its fundamentals.
5. It will help issuers to **benchmark** themselves and project their underlying strength better.

The Words of Caution

However, CRISIL cautions that its IPO grading is not to be construed to mean:

1. A **valuation** of the equity offering; present or future.
2. A comment on the **issue price** or the likely price on listing.
3. An assessment of the **market risk** associated with equity investments.
4. An audit or a **recommendation** to invest.
5. A **forensic exercise** that can detect fraud.

Grading vs. Valuation

It is to be distinctly understood that IPO grading is not an opinion on valuation of the issue price. The IPO investment decision making process has three key components, namely, analysis of **fundamentals**, analysis of **returns** on the issue price and Investor **preference**. IPO grading, singly and comprehensively, assesses only the fundamentals. **Factoring the pricing** into the investment decision is left to the investors. CRISIL cautions that a **5/5 graded IPO at a very high valuation may be a bad investment**. What it means is that unjustified pricing may have a negative impact on the investment worthiness of even the highest assessed IPO. CRISIL however believes that, over time, IPO grading will emerge to be a useful valuation tool also for equity shares.

DISCLOSURES IN THE PROSPECTUS:

The case of Bhagwati Banquets and Hotels Ltd. (BBHL)

Let us understand how companies make disclosures on IPO grading in their offer documents in pursuance to the SEBI norms. Let us take the case of BBHL. It is the latest company, till the time of writing this paper, to come out with a graded IPO. Its issue opened on 18 April, 2007. The following exhibit shows the disclosures made by it in the prospectus on its IPO's grading.

Exhibit	Bhagwati Banquets and Hotels Ltd. Disclosures on IPO Grading in the Offer Document
<p>IPO Grading The Company has obtained IPO Grading from Credit Analysis and Research Limited (CARE) and Credit Rating Information Services of India Limited (CRISIL). CARE has assigned an “IPO Grade 2” and CRISIL has assigned an “IPO Grade 1” to the proposed initial public offering of the company.</p> <p>About “CARE IPO Grade 2” CARE has assigned a ‘CARE IPO Grade 2’ to the proposed initial public offer of Bhagwati Banquets and Hotels Ltd. (BBHL). ‘CARE IPO Grade 2’ indicates Below Average Fundamentals. CARE assigns IPO Grade on a scale of 5 to Grade 1, with Grade 5 indicating strong fundamentals and Grade 1 indicating poor fundamentals. CARE’s IPO Grading is an opinion on the fundamentals of the issuer. The Grade assigned to any individual issue represents a relative assessment of the “fundamentals” of the issuer. The grading takes into account BBHL’s well established operations in the hospitality industry at Ahmedabad, its strong position in banqueting and Food & Beverages (F&B) segments which contribute significantly to the income and satisfactory debt servicing track record. The grading is, however, constrained by significantly large size of the proposed hotel project at Surat as compared to existing operations, relatively short track record of operations and modest corporate governance practices.</p> <p>About “CRISIL IPO Grade 1” CRISIL has assigned a CRISIL IPO Grade “1/5” (pronounced “one on five”) grade to the proposed initial public offer of Bhagwati Banquets and Hotels Ltd. (BBHL). This grade indicates that the fundamentals of the issue are poor relative to other listed equity securities in India. A CRISIL IPO grade represents CRISIL’s overall assessment of the fundamentals of the issue graded in relation to other listed equity securities in India. CRISIL IPO gradings are assigned on a five-point scale from 1 to 5, with a CRISIL IPO grade 5/5 indicating strong fundamentals and a CRISIL IPO grade 1/5 indicating poor fundamentals. The grading reflects CRISIL’s opinion that the business prospects of the company’s planned 5-star hotel in Surat are significantly sub-par. The grade also reflects the underdeveloped corporate governance system in the company, the fact that other promoter owned entities operate in similar lines of business and that the current management team may need to be strengthened to carry out the company’s plan of entering the 5- star hotel business. However, CRISIL notes the exceptionally successful track record of the promoters in the catering business in Ahmedabad aided by its large centralized kitchen and large banqueting facilities at ‘The Grand Bhagwati’.</p> <p>Disclaimer by CARE and CRISIL The prospectus also contains separate disclaimers by CARE and CRISIL which basically revolve around cautionary statements as noted earlier. It is specifically mentioned by both that grading is not a recommendation to buy/ sell or hold the graded instrument.</p>	

It is interesting to note that the two CRAs have assigned **two different gradings** and **two different sets of reasons** for the unsatisfactory grading by both.

The readers will appreciate that **these disclosures represent only a summary of the grading report and not the full report**. This raises question mark on the adequacy of information provided and purpose served by it.

THE MARKET EXPERIENCE

We now proceed to carry out an assessment of the IPO grading experience that the primary market has had so far. As per the information available, till the time of writing this paper, 7 companies have floated graded IPOs. Table 1 contains their details:

Sl. No.	Company	Issue Opening Date	Offer Price (Rs.)	Issue Amount (Rs. crore)	Pricing Method	Grading			Times Subscribed
						CRISIL	CARE	CRA	
1	Shree Ashtavinayak Cine Vision Ltd.	14/12/2006	160.00	52.80	BB	2/5	5.88
2	Cambridge Technology Enterprises.	29/12/2006	38.00	15.40	FP	...	2/5	...	6.71
3	Evinix Accessories Ltd.	12/02/2007	120.00	42.00	BB	...	2/5	...	3.42
4	AMD Metplast Ltd.	15/02/2007	75.00	68.22	BB	...	3/5	...	4.42
5	Orbit Corp. Ltd.	20/03/2007	110.00	100.10	BB	...	1/5	...	4.48
6	Hilton Metal Forging Ltd.	18/04/2007	70.00	38.12	FP	1/5	NA
7	Bhagwati Banquets & Hotels Ltd.	18/04/2007	40.00	73.82	BB	1/5	2/5	...	1.40

- **Source:** PRIME Database.
- **BB:** Book Building.
- **FP:** Fixed Price.
- **NA:** Not available till the time of writing this article.

Table 2 depicts their market performance, that is, return to the investors.

Sl.No.	Company	Post-Listing Closing Price at NSE			
		First Day		Latest Day	
		Date	Price (Rs.)	Date	Price (Rs.)
1	Shree Ashtavinayak Cine Vision Ltd.	10-01-07	225.40	18-05-07	179.05
2	Cambridge Technology Enterprises Ltd.	07-02-07	100.90	18-05-07	58.05
3	Evinix Accessories Ltd.	07-03-07	74.05	18-05-07	91.65
4	AMD Metplast Ltd.	19-03-07	77.90	18-05-07	67.70
5	Orbit Corp. Ltd.	12-04-07	128.20	18-05-07	221.65
6	Hilton Metal Forging Ltd.	...	NA	...	NA
7	Bhagwati Banquets & Hotels Ltd.	17-05-07	49.05	18-05-07	49.20

- **Source:** www.nse-india.com
- **First day:** The first day of trading.
- **Latest day:** At the time of writing this article.
- **NA:** Not available at NSE/BSE till the time of writing this article.

An analysis now follows:

1. The first graded issue (Shree Ashtavinayak) opened almost 8 months after the scheme was formulated. That means issuers and merchant bankers adopted a **cautious approach** as is generally the case with new schemes.
2. Of the 7 IPOs, 5 were book built while only 2 were fixed price issues.
3. The highest grade scored was 'average' that too in one case only. Rests were graded 'below average' and 'poor'.
4. All issues except one (BBHL) opted for grading from a single CRA only. Interestingly in its case the two CRAs assigned **different grades** and not the same.
5. Three issues were priced above Rs. 100 ranging between Rs. 110 to 160. Interestingly the first graded issue was priced the highest in the lot. Four issues were priced below Rs. 100 ranging between Rs. 38 to 75.
6. All the issues were reasonably well sized in terms of amount raised except Cambridge Technology which raised less than 20 crore Rupees.
7. Despite very low gradings all the issues managed decent oversubscription except BBHL. It had the lowest oversubscription despite double grading. Even in its case the oversubscription margin was not bad. **Thus despite low gradings none of the issues bounced.** Interestingly **AMD Metplast, despite the best graded issue in the lot, managed not the highest oversubscription but the second lowest after BBHL.**
8. CARE emerged to be the most sought after CRA though gradings provided by all the CRAs were in the same range.
9. All the issues closed above issue price except Evinix Accessories on the first day of trading. Evinix price has improved thereafter yet remains far below the issue price. AMD Metplast opened marginally higher but gone down below issue price as on date. **Despite the best graded issue in the lot, the investors have lost in it, even though it was not the highest but median priced.** Orbit Corp. has moved up very high after listing. BBHL, in two days trading, remains more or less on same level. Shree Ashtavinayak and Cambridge Technology, though gone down after first day trading, are quoting above their issue price as on date. To sum up 5 issues have returned gains to the investors on the first trading day and 4 out of them are still profitable as on date. **And these gains are despite low gradings.**

ISSUES THAT ARISE

As per the PRIME press release dated 14 May, 2007, on annual review of public equity offerings of 2006-07, out of total 85 issues raised during the year, most of the 79 non-graded issues evoked very good response from the public and yielded good returns. Same are the findings about the graded issues as per the above analysis **despite low gradings**. This contrast forces one to think:

1. Does it mean that grading, and that too a low grading, is **not a factor** in investors' decision making process?
2. Or was the **pricing** of the issues attractive vis-à-vis their fundamentals? Does it mean that the CRAs be required to provide a **comprehensive grade** combining the fundamentals and the pricing?
3. Or is it due to **bullish secondary market** conditions that poor issues also clicked?
4. Does it mean that the real impact of grading on the investment decision will come to fore only during **abearish secondary market**?
5. Or is it that **compulsory grading**, of all IPOs, alone will make a distinguishable impact on the investment decisions?

These are the issues to ponder over and discuss at appropriate forums and within SEBI for further improvements in the grading system.

REFORMS IN APRIL 2007

SEBI reformed the existing IPO grading norms on 30th April 2007 with the following major changes:

1. Grading made **mandatory**.
2. All the related **disclosures**, as at present, to be made in all **issue advertisements** as well.
3. **Cost** of grading to be borne by the **issuer company**.

SEBI has not assigned any reasons for these changes. May be the last issue raised above triggered the move. One can only make a guess. It will be good if SEBI provided a statement of reasons and objectives when it introduces new norms or revises them.

THE ROAD AHEAD

Now that grading has been made mandatory, many issues, both functional as well as structural, arise that SEBI needs to look into. These are:

Assessment of Issue Price

All said and done, grading in its present form is only a half cooked cuisine. Why it can not factor the issue pricing in deciding the grades? CRISIL itself cautions that **a 5/5 graded IPO may be a bad investment if pricing is not justified**. Why not the investors be provided with a complete guidance then to serve its real purpose? Abolition of CCI pricing, its non-disclosure in the offer document and adoption of free pricing further strengthen this argument. As noted earlier, the belief of CRISIL, that over time IPO grading will emerge to be a useful valuation tool also, is probably indirectly suggestive of favouring a comprehensive grade ultimately. The move will also lead to more transparency in the market.

Single Grading

Are gradings from two or more CRAs, when they are different as seen in the case of BBHL, a source of information or misinformation? Do they facilitate the investor or confuse him? Should issuers not be required to get only one grading?

Full Grading Report in the Prospectus

We have seen above that summary rationale of grading required to be disclosed as at present is inadequate to facilitate an investment decision. Otherwise also, in view of the plethora of information contained in the prospectus, which constrains its reading and understanding, will the full 2-3 page report not be a better decision tool for the investors?

Flab in the Offer Document

Incidentally, in view of an independent grading available and otherwise also, should not the excessive flab in the offer documents running into 200-300, and even more, pages be squeezed?

Eligibility Norms

Is there a case any more now to impose eligibility conditions of net tangible assets, net worth and distributable profits, etc., for floating an IPO?

QIB Placement

Grading is supposed to provide enough efficiency to the capital market where all investors can make independent investment decisions. Therefore, is the reservation for the QIBs in book built issues still relevant? Why should other investors be still made to look to QIB response as a guide to their decision?

FPO Grading

Why keep FPOs out of grading requirement? Simply because their market price track record is available? But it is not the only factor in investment decision making as noted above. Fundamentals are still to be assessed. More over market prices might have been manipulated also.

Finally we have to wait to see how the market responds to compulsory grading. Only the time will tell as to how this investment decision tool is applied by the investors. One can only wish that investors made a well thought out, discernible and meaningful use of this decision tool.

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