IPO Grading – Pilot Project and the Future

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The Regulatory initiative in the recent past to create an environment conducive to IPO Grading through a Pilot Project with the supportive role played by the leading Stock Exchanges was a great beginning. The idea was to test the water; assess the level of comfort and understand its utility as a decision support tool for the investors. The endeavor, on the one hand was to get a feel for the services through real life exercises and, on the other hand, to assess its impact with reference to different players in the capital market. As the IPO Grading under this Pilot Project was more on voluntary basis, the sample size was not large enough to arrive at certain definite conclusions based on empirical evidences. However, one thing that was established was the importance of IPO Grading as a decision support tool in the hands of the investors. The importance of opinions arrived at through a rigorous due diligence process, using the analytical tools and techniques by competent team of professional analysts who could provide valuable inputs by way of opinions was well appreciated.

The Regulators have since made IPO Grading a mandatory requirement and, in the process, all the Issuers, who propose to access the Stock Market, need to undergo the exercise and make the Grading public through the Offer Documents. This has generated considerable amount of debate on its desirability, relevance and effectiveness.

The process of IPO Grading, in its present form, is somewhat unique to India and also is in its formative stage at present. The debate and constructive criticism would make significant contribution in improving the conceptual framework and would also enable the systems and processes to undergo need based modifications so as to make it robust.

The major Credit Rating Agencies operating in India for almost two decades now have been able to demonstrate a reasonably successful track record in terms of their analytical skills, process of due diligence and ability to take fair and unbiased Rating decisions. This has raised the levels of expectations. The Regulatory requirement of mandatory IPO Grading has thrown a new challenge to these Agencies. The analytical and judgmental skills, tools and technologies as well as the extent of due diligence requirements would be more or less identical in case of IPO Grading. However, there are certain finer distinctions that make IPO Grading all the more challenging.

The Rating Agencies would have to face certain challenges, at least during the initial stage, till the process stabilize and enough awareness is created among the participants in the Capital Market about the utilities and limitations of the services being offered.

The conventional skill of a Rating Agency is its ability to assess the extent of risks inherent in a specific transaction with certain degree of certainty and also ranking these transactions in terms of relative risks into some groups. This provides an investor with a tool to measure risk and enables him to compare the same with the 'offered' return before taking an investment decision based on his individual perceptions and preferences of Risk-Return Co relations. The Rating Agency is only providing one side of the story, i.e., the risk side. The returns are 'given'. Whereas in an IPO Grading the expectations are that the Agency has to provide information about both these variables.

In this situation, the first question that comes up is conceptual. What is the definition of return? Is it dividend? Is it capital appreciation (which possibly it is) and, if so at what point of time? The second question is what is the 'optimum' return for a particular level of risk? The other side, i.e., the risk side raises another question. The risk of what? The risk of not receiving the returns (dividend, appreciation)? The risk of not receiving the principal (on liquidation)? A Rating Agency in a Credit Rating exercise aims at providing opinion with regard to (future) ability and willingness of an obligor to service the obligations as per terms of the contract. In that case, a Rating Agency may reasonably be expected to have the appropriate skills to project the future cash flows (the ability) and also, with the analysis of historical trends and track records (the willingness) of the Issuer of the debt instruments. In case of IPO Gradings, the complexity lies in defining or even identifying the 'obligations'. The Agencies are supposed to evaluate the relative fundamental strengths of the Issuing companies on business risks, management quality, financial prospects (i.e., past track record and ability in future to generate shareholders returns, e.g., RONW, EPS growth, etc. in comparison to other peers), corporate governance, litigation history and management quality. .

If one looks at the discussions and debates that has been taking place during the last few months, the most important issue that came up was does it serve any purpose for anyone. Is the opinion precise enough? Is the process transparent enough? Are the Agencies trying to play safe; (a) by giving number of disclaimers, and (b) by assigning unduly harsh Gradings? Is it adding to the overload of information and creating more confusion for the investors without any value addition? Let us now try to discuss some of these issues.

The view is that as IPO Grading does not comment on reasonableness of the Offer Price in an IPO, it does not serve any purpose so far as the investors are concerned. It is true that IPO Grading does not give an opinion on the Price, present or future. The opinion is more on 'fundamentals' of the business of the Issuer entity, whose IPO is being Graded. It is a symbolic expression of the opinion of the Rating Agency based on the assessment of fundamentals backed by appropriate research and analysis. The emphasis is on evaluating the prospects of the sectors in which the Company operates. The risks inherent in its business vis-à-vis its competitive strength that would enable it to address/ mitigate such risks. The future earning prospects and the risks associated with such earning prospect in the event of any change in the circumstances is an important element in such analysis. The analysis factors in the management quality and the corporate governance standards. One needs to appreciate that price of Stock, either in primary market, or in secondary market is not only a function of fundamentals underlying the business operation of the issuing entity, but is also significantly influenced by other external reasons. At the same time, it is very unlikely that on a relative basis, the fundamental strengths and the price at a particular point of time would move in two different directions. While, it is difficult to establish a precise one-to-one linkage between the two, it can reasonably be expected that, barring short-term aberrations, they should be co-directional. It should not happen that better the fundamental strength, lower the stock price. The utility of IPO Grading lies in its ability to provide an input to the investor in his investment decision. It aims at differentiating the offerings of Stock issues by placing them under different 'groups' according to their relative fundamentals. This definitely is a value addition being an important tool in the hands of an investor.

The other issue is the extent and quality of disclosure made by the Rating Agencies in the rationale they publish for IPO Grading. There are anxieties that the Rating Agencies may try to play safe in terms of language they use in the rationale they publish for the Gradings assigned and the disclaimers they put in to protect themselves. The rationale may not be precise enough to arrive at certain definite conclusions and may be amenable to multiple interpretations. The expressions may be cautious and guarded so as to avoid any embarrassment and controversy. The statements may be very general in nature.

A Rating Agency expresses its opinion through Rating Symbols. These Symbols are not conditional or subject to 'ifs' and 'buts'. The statements that define the Symbols are also definite and consistent. These are used as a standard in all the identical cases. Therefore, there is no scope of vagueness so far as the Grading is concerned, nor is that amenable to multiple interpretations. The rationale of the Grading deals with the critical issues that have influenced the Grading decisions. These are additional information and are usually precise, focused with logical sequencing. While nothing is perfect and there is always scope for improvement in the quality of write-up, the Rating Agency cannot get away by making vague statements which does not enable the reader to evaluate reasonableness of a particular IPO Grading. Also, the Analysts in Rating Agencies are always available for discussion on issues that may not be clear enough to a reader. The disclaimers are again standard. Any professional opinion, particularly where judgmental and subjective issues are involved and the opinion is futuristic in nature can not be guaranteed for its accuracy. When a doctor diagnoses a disease, there could be a probability of going wrong despite all his sincere efforts, in a few cases. However, that should not lead to the conclusion that doctors are not required or they should not be protected. One should appreciate that no disclaimer can protect someone against negligence, malafide and professional misconduct. Besides judicial authorities, there are Regulatory authorities to redress such grievances.

There is another view that as the IPO Grading is an 'One-time' exercise and there is no continuous process of surveillance, the investors do not get the benefit of the opinion of a Rating Agency about the issuing entity's performance under changing circumstances. First of all, the role of Grading is more critical at the IPO stage as the adequacy of research coverage and availability of appropriate and unbiased information, at this stage, is quite limited. Once the Issue is listed, there are not only regulatory requirements of disclosure of certain critical information consistently and timely, but also the entity attracts the attention of all the organized players in the stock market which results into adequate research coverage. Though, the unbiased and dispassionate research based opinion of a Rating Agency at the subsequent stage could be of help, it may not be so critical for the purpose of secondary market operations where things are changing constantly and timeliness of information is much more critical.

There is a view that the Grading Opinion is based more on subjective issues and subjective issues are matters of opinion and opinions are prone to differences. The service that a Rating Agency provides – be it Credit Rating or IPO Grading, at the end of the day, it is the 'opinion' of the concerned Rating Agency. Therefore, the end product is the opinion and the differences among the Rating Agencies, with reference to opinion is not ruled out. It is also a fact that the opinion of a Rating Agency is built around both objective and subjective issues. However, the process through which that opinion is arrived at is an interactive process and goes through considerable amount of verification, validation and cross-checking. The combination of objective and subjective analysis ultimately ends up in an objective opinion, unconditional and precise.

Also, there is always an anxiety of conflict of interest inherent in the business model of Rating Agencies. The fees are paid by the Issuer and, therefore, there is a possibility that the Rating Agency may like to be 'soft' towards the Issuer. Also, this may lead to Grading shopping. At the same time, there is another view that the Rating Agencies would tend to 'play safe' and, therefore, the opinion could be unduly harsh so as to protect them from embarrassments in future. There is some element of contradiction in these two statements. If we assume, for the sake of argument, that both these statements are correct, then they should neutralize each other. The most valuable asset of a Rating Agency is its credibility and the most critical risk to which such Agencies are always exposed to is the reputation risk.

A Rating Agency is quite vulnerable and any compromise in its standards, due to commercial reasons would severely impact its credibility, which in turn, would erode its acceptability in the market. Therefore, this would be a process of self-destruction. On the other hand being unduly harsh on its judgment could lead to missed opportunity on the part of the investors. This, in turn would also impact the acceptability of the Agency. An Agency, worth its name, has no choice but to take a fair and balanced view.

In conclusion, it is important to clarify that the submission, as above, is in no way an attempt to claim perfection. This is just to place the things in its right perspective. The analytical skills, techniques and tools are always subject to improvement. The feedback from the users of the services, professionals and academicians are of great help towards achieving perfection, even though perfection remains a moving target.