IPO Grading-An Update

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It has been about a year since Grading of Initial Public Offerings (IPOs) was made mandatory via an amendment in the SEBI (Disclosure and Investor Protection) Guidelines, 2000. And during this one year, IPOs seem to have lost some of their shine, prompting a revival of the old debate on the relevance of IPO Gradings. Besides, some other questions too have cropped up in the interregnum, such as: Is there room for any IPO reform in India? Is it possible for Rating Agencies to assign the Grading after the IPO price has been finalised? That is, is it possible to factor in the IPO price in the Grading decision, given the experience that the Rating Agencies have gained in Grading IPOs for about a year now? Are investors now able to make a better choice while selecting IPOs?

In this write-up I make an attempt to answer these questions and address some related issues as well, but first a few words on the old debate that refuses to die down.

Relevance of IPO Gradings

It is true that during the past one year IPOs have found the market turn from euphoric to tepid. In fact, there have been reports of scrip prices going below the IPO price, of IPOs Graded low preferring not to proceed with the issue, of highly Graded IPOs not doing well on the bourses, and so on. These are facts, and being so, cannot be contested. But do they make IPO Gradings irrelevant? Certainly not.

If the market price of a scrip has gone below the IPO price, it is purely a market function. IPO Grades very specifically declare that they are not a comment on the issue price, valuation, or possible gains. Also, the exercise of IPO Grading does not take price into account at any stage. Price being a market function, it is entirely possible for highly Graded IPOs to do badly on the bourses post-listing, especially if the market is on a downward slide, and also vice versa. That is, IPOs Graded low may well perform smartly on stock markets when the going is good. The question that may follow from this is: What then does an IPO Grade convey to the prospective investor? The answer: The strength of the business fundamentals of the company making the IPO, in relation to the universe of similar issuers.

Next, to turn to the subject of prospective IPO issuers turning away from the market after having been Graded low by a Rating Agency. True, this would rob investors of an investment opportunity. But that is the way it should be. If IPO Gradings are a way of filtering out "weak" issuers from the market, that should be only desirable; in fact, that is a Regulatory goal. I would say, instances of weak prospective issuers deciding not to come out with their IPO on getting poor Grades only reinforces the relevance of IPO Gradings.

Now, to take up the other questions.

Is there room for any IPO reform in India?

This question, I suppose, accepts the relevance of IPO Gradings, and that is welcome. By now, I think the Regulators and the Rating Agencies have been able to convey the basic idea that the IPO Grading system is designed to provide investors with an opinion on the **fundamentals** of the company making the IPO. That is, an IPO Grading, specifically, is not a comment on the issue price, the valuation and possible gains, post-listing. The value of an IPO Grade lies in the fact that it is arrived at through an analytically rigorous process, one that involves evaluation of the candidate company's competitive position, its execution capabilities, its management depth, and the prospects of the relevant industry or industries. An IPO Grade thus can only serve as an additional input in the investor's decision-making process, the others inputs being individual risk appetite, investment horizon, investment purpose, and so on. This much, I think, the Rating Agencies and the Regulators have been largely able to get across.

Nevertheless, the concept of IPO Grading remains new and it would take some time for the implications to sink in. To that extent, it is perhaps slightly premature to be thinking on the lines of an IPO reform in India, at least in terms of Grading methodology. However, some regulatory streamlining may still be possible. In fact, that may even be desirable. For instance, the process of allotment to Qualified Institutional Investors (QIBs) could be made less discretionary. That is, the QIBs could be required to put in the full money on application, just as retail investors do. That would not only level the playing field between QIBs and retail investors, but also shorten the "waiting time" between application and allotment.

Is it possible for Rating Agencies to assign the Grading after the IPO price has been finalised? That is, is it possible to factor in the IPO price in the Grading decision, given the experience that the Rating Agencies have gained in Grading IPOs for about a year now?

An IPO Grade, by design, is an input for investors seeking to decide whether they should invest in an IPO at the given price, or price band. A *post facto* Grading, if I may put it that way, in an extreme case, could even amount to closing the stable door after the horse has bolted. Besides, the price at which an IPO gets subscribed is a function of various factors such as market sentiment, investor willingness, investor risk appetite, and so on, many of which are highly dynamic. In fact, the very concept of a "market" is based on the fact that different investors have different views on what constitutes the "fair value" for a scrip; there are thus both buyers and sellers for a scrip for the same price at any given point in time.

The other point is, if Rating Agencies were to factor in the IPO price in their Grading decisions, such Gradings would run the risk of being considered biased. Here, one must emphasise that a Grading or Rating should not only be unbiased, but must also appear to be so.

While on the issue of price and IPO Grading, it is perhaps appropriate that I dwell on the talk of Grading-Price correlations that one gets to hear nowadays. While correlation statistics have enormous utility otherwise, in this context correlating IPO Grades to IPO Prices would at best indicate the extent to which an IPO Grade has been factored in by investors while making their choice. Moreover, if Rating Agencies were to put out such statistics more harm may be done than good. Invariably, there would be many who would interpret such statistics as a validation or otherwise of an IPO Grade, and by extension, of the competence of the Rating Agency concerned. Correlation statistics may however have use for the Rating Agencies themselves, economists, academicians and such other interest groups studying market behaviour.

It is possible that the talk of correlation statistics in some sections arises from a woolly mental association with the Rating Migration Studies that the leading Rating Agencies periodically come out with, in which they declare how their Ratings have behaved in the real world of shifting business dynamics. Replication of this practice for IPO Gradings however does not make sense. In fact, it is not possible. One simple reason for that is, being a one-time exercise, an IPO Grade cannot migrate.

Are investors now able to make a better choice while selecting IPOs?

I wish I had investors tell me that. The basic purpose of an IPO Grade is to serve as an additional input in the investor's decision-making process. Now, what weight an investor assigns to an IPO Grade is a matter of individual judgement. A Rating Agency can only hope that the Grades it assigns are taken seriously.

Before I wind up the discussion, I would like to touch upon a subject that is central to the concept of Grading. I had discussed this issue at some length in my article for The Prime Directory last year, but a bit of repetition would do no harm, given its importance.

Opinion: Subjective or Objective?

It is often remarked that a Grading opinion is based more on subjective issues, and subjective issues, being matters of opinion, are prone to differences, since opinions can themselves differ. True, the service that a Rating Agency provides, bet it Credit Rating or IPO Grading, is after all the opinion of the Agency concerned. And the end-product being an opinion, differences among Rating Agencies cannot ruled out. It is also a fact that a Rating Agency's opinion is built on both objective and subjective issues. However, the process through which that opinion is arrived at is an interactive one and goes through considerable verification, validation, and cross-checking. The combination of objective and subjective analysis, I would say, ultimately leads to objective opinion, one that is unconditional and precise.

Conflict of Interest

Besides the issue of subjectivity versus objectivity, concerns are also expressed often over the conflict of interest that appears to be inherent in the business model of a Rating Agency. It is argued that since the Rating or Grading fee is paid by the Issuer, it is possible that the Rating Agency would be inclined to be "soft" towards the Issuer. Besides, there is also the possibility of "Grading shopping". Interestingly, the "opposite view" is also to be found in equal abundance. This one suggests that Rating Agencies, to save themselves for future embarrassments, would tend to play safe and therefore their opinion could be unduly harsh. But for argument's sake, if we assume that both the statements are correct, they should neutralise one another. The most valuable asset that a Rating Agency has is its credibility, and the most critical risk to which it is always exposed is the reputation risk. Any compromise in its standards by a Rating Agency because of commercial reasons would severely impact its credibility, which in turn, would erode its acceptability in the market. It would simply amount to self destruction. On the other hand, being unduly harsh could lead to missed opportunity for investors, which again would impact the acceptability of the Agency concerned. Ergo, an Agency worth its name has no choice but to be fair and balanced.

I should hasten to add that I make no attempt to claim perfection on behalf of Rating Agencies. My purpose here has been merely to place things in the right perspective. The analytical skills, techniques and tools that Rating Agencies employ are always subject to improvement. And such improvement is often achieved at the prompt of the feedback received from users of Gradings/Ratings, professionals, and academicians.