

IPO Grading: CRISIL's experience



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It is now one year since SEBI made the grading of initial public offers (IPOs) mandatory. Given the uniqueness of the product, several questions have been asked about the utility of the grading and whether grading has served the purpose for which it was introduced. This commentary puts forth CRISIL's experience with the IPO gradings we have assigned to date. It goes on to detail how IPO grading can be used by investors to make more informed investment decisions.

Belief in utility of the tool validated

CRISIL's experience, while grading over 20 IPOs in the past one year, has validated our belief in the utility of IPO grading. On a fundamental basis, clear distinctions are emerging amongst IPOs. Investors are receiving the benefit of an informed opinion on the fundamentals of a company as an additional input into their decision making process. The purpose of making IPO grading mandatory is therefore being served, with gradings having been assigned across the scale. Upto May 22, 2008, 65 gradings have been assigned by the four credit rating agencies (CRAs) together.

IPO Gradings outstanding as of May 22,2008

IPO Grade	CRISIL	Others	Total
5/5	2		2
4/5	6	10	16
3/5	9	16	25
2/5	3	11	14
1/5	3	5	8
Total Graded	23	42	65

CRISIL has witnessed a fair degree of dispersion in the quality of companies coming to the market to raise funds through an IPO. As part of the IPO Grading process over the last one year, we have come across many interesting observations and we have highlighted these observations in individual IPO Grading rationales that are available for investors for free on CRISIL's website. A few such observations are summarized below and CRISIL believes that insights and observations of this nature benefits the investing community significantly.

- The solidity of business plan of the companies graded has been fairly dispersed. For example, while some companies wanted to use the IPO proceeds to make further investments to further strengthen their competitive position in areas where they were already strong, some others proposed to make use of the funds collected for venturing into new business areas or for general corporate purposes/meeting working capital requirements.
- Management clarity on the business plan outlined and their readiness to execute the plan was differing. Certain managements had a strong understanding of market dynamics, which served to enhance our confidence in the ability of the management to execute their business plan. On the other hand, in some cases, we observed that key management personnel had limited understanding of business strategies and plans.
- In some cases, the publicly disclosed information was inconsistent with business operations and/or business plans.
- Our comfort with the financial accounting practices was also varied. For example, in one particular case, we found that the financial numbers disclosed in the draft red herring prospectus were not consistent with each other. In some cases, we observed frequent change in auditors.
- The understanding of the role of the independent directors on the board, from a corporate governance point of view, has been found to be inadequate in several cases. However, in the case of a few companies, independent directors were complying not only with the letter but also the spirit of Clause 49, and provided effective oversight of the management.
- CRISIL's experience clearly has been that the size of a particular company has not been a constraint at all in obtaining high grades. For example, Company A with a turnover of around Rs 110 crore and net worth of Rs 42 crore was assigned a CRISIL IPO Grade 4/5. On the other hand, Company B with a turnover of around Rs 750 crore got a CRISIL IPO Grade 1/5.

- Many issuers have revised the size/terms of their proposed issue or deferred their issue based on CRISIL's comments during the IPO grading process. Some issuers and their merchant bankers, in fact, talked of addressing the issues raised by CRISIL before accessing the market.

CRISIL believes that an independent objective opinion on the fundamentals of the company significantly benefits the investing community. As part of the IPO Grading process, CRISIL's analysts interact extensively with company managements and board members. CRISIL's opinion on the quality of the business plan, our opinion on the levels of corporate governance in the company etc are value adds that investors would not have access to if not for IPO Gradings.

Market warming up to the IPO Grading concept

CRISIL has received positive feedback on the IPO grading initiative from most stakeholders. While most reputed merchant bankers have welcomed the fresh information and the independent unbiased view that IPO grading brings to the market, some small merchant bankers have expressed reservations on IPO grading playing a 'supervisory' role on their actions.

Many issuers have remarked that they appreciate the different perspective from which CRISIL is looking at them as this makes them better prepared to face future questions from investors. In fact, some issuers called the exercise a good learning experience that will help them better prepare to become shareholder-oriented from being only business-oriented.

While all market participants have been unanimous in saying the market needed a tool such as IPO grading, many have said that there must be more investor education about how to make best use of it.

CRISIL, on its part, has made extensive efforts to spread investor awareness on the IPO grading concept and its utility to investors. CRISIL has made available free of charge to all investors a press release and a detailed grading rationale on all IPOs graded by us on our website (*Please refer to <http://www.crisil.com/research/research-ipo-grading.htm>*). In addition, we have participated in a number of workshops and seminars, and have published FAQs in regional languages as well as regular articles showcasing the utility of IPO grading.

The role of IPO grading in the investment decision framework

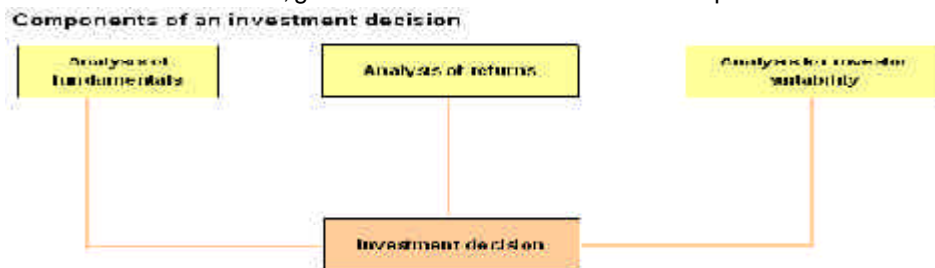
However, many investors are still unsure how to make use of IPO gradings in their investment decision. CRISIL believes that, over time, as more gradings are assigned, IPO grading will emerge as a useful input for the valuation of shares, just as credit ratings are used for valuing bonds today.

Here it is important to understand what IPO grading is and what it is not. An IPO grade reflects CRISIL's opinion on how strong the company making the IPO is on fundamental parameters—business prospects, financial performance, management capability, and corporate governance—compared with other listed Indian companies. To an investor, it offers expert unbiased opinion on the quality of the company in terms of business fundamentals.

An IPO grading is, however, not an opinion on whether the graded instrument's issue price is appropriate in relation to the issue fundamentals or its suitability for a particular investor. In other words, investors should not use an IPO grade to assess the "attractiveness" of an issue for them. For this, they should use widely used valuation tools such as comparison of the price-earnings (P-E) ratio with that of other companies in the peer group in conjunction with the fundamentals assessed during the IPO grading process and/or consult a competent financial advisor.

CRISIL believes that there are three components of an investment decision:

- Fundamental analysis of the company, which is addressed by CRISIL IPO grading
- Valuation of the issue, which involves assessing whether the pricing of the issue is in line with its fundamentals
- Suitability of the issue for the investor, given his/her asset allocation and risk profile



Conclusion

CRISIL's belief in the utility of IPO grading has been validated over the past one year. We believe that as more gradings come out in the market, there can be more research on the specific relationships between grading and investment analysis. Investors too would stand to benefit immensely from the comparative framework of assessment of companies across industries and sizes that an IPO grading offers.