Revisiting Price Discovery in Bookbuilding IPOs

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Corporates may raise capital in the primary market by way of an initial public offer, follow-on public offer, rights issue or private placement. An Initial Public Offer (IPO) is the selling of securities to the public in the primary market. This Initial Public Offering can be made through the fixed price method, book building method or a combination of both.

There are two types of Public Issues:

ISSUE TYPE	OFFER PRICE	DEMAND	PAYMENT	RESERVATIONS
Fixed Price Issues	Price at which the securities are offered and would be allotted is made known in advance to the investors	Demand for the securities offered is known only after the closure of the issue	100 % advance payment is required to be made by the investors at the time of application	50 % of the shares offered are reserved for applications below Rs. 1 lakh and the balance for higher amount applications
Book Building Issues	A 20% price band is offered by the issuer within which investors are allowed to bid and the final price is determined by the issuer only after closure of the bidding	Demand for the securities offered, and at various prices, is available on a real time basis on the stock exchanges' websites during the bidding period	10% advance payment payment is required to be made by the QIBs along with the application, while other categories of investors have to pay 100% advance along with the application	50 % of shares offered are reserved for QIBS, 35 % for small investors and the balance for all other investors

About Book Building

Book Building is essentially a process used by companies raising capital through Public Offerings-both Initial Public Offers (IPOs) or Follow-on Public Offers (FPOs) to aid price and demand discovery. It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices, which are within the price band specified by the issuer. The process is directed towards both the institutional as well as the retail investors. The issue price is determined after the bid closure based on the demand generated in the process.

Book building definition

SEBI Guidelines define Book Building as a process undertaken by which a demand for the securities proposed to be issued by a corporate body is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document

History of Book building Process

The introduction of book-building in India in 1995 followed the recommendation of an expert committee appointed by SEBI under Mr. Y. H. Malegam "to review the (then) existing disclosure requirements in offer documents,'' two of the terms of reference being "the basis of pricing the issue'' and "whether substantial reduction was possible in the time taken for processing applications by SEBI.'' The committee recommended and SEBI accepted in November 1995 that the book-building route should be open to issuer companies, subject to certain terms and conditions.

The concept

Book building is a comparatively new concept for the Indian investors as compared to their peers in the US or the UK, where it is a very common practice. It is a process wherein various bids are collected from investors and the entries made in a book. It must be noted here that book building is just another form of an IPO wherein investors, retail and institutional, can participate in the process and acquire shares of the company up for divestment or whose equity is at sale.

Book Building – A price discovery mechanism

The most apparent reason for choosing the book-building route over the conventional method of fixed price is the price discovery. Since the investors – both institutional and retail - have the option to bid for the equity, at or above a particular floor price, decided by the company in consultation with the merchant bankers, it helps the company realise the true value for its equity, or simply put, what the investors perceive the value (or rather intrinsic value) of the company to be. It also gives the company an insight into its credibility factor amongst the investors, which could be gauged by the demand generated for the purchase of equity up for sale. Also for the company, this route saves on cost and time required to complete the issue.

The Process

- The Issuer who is planning an offer nominates lead merchant banker(s) as 'book runners'.
- The Issuer specifies the number of securities to be issued and the price band for the bids.
- The Issuer also appoints syndicate members with whom orders are to be placed by the investors.
- The syndicate members input the orders into an 'electronic book'. This process is called 'bidding' and is similar to open auction.
- The book normally remains open for a period of 3 working days.
- Bids have to be entered within the specified price band.
- Bids can be revised by the bidders before the book closes.
- On the close of the book building period, the book runners evaluate the bids on the basis of the demand at various price levels.
- The book runners and the Issuer decide the final price at which the securities shall be issued.
- Generally, the number of shares are fixed, the issue size gets frozen based on the final price per share.
- Allocation of securities is made to the successful bidders. The rest get refund orders.

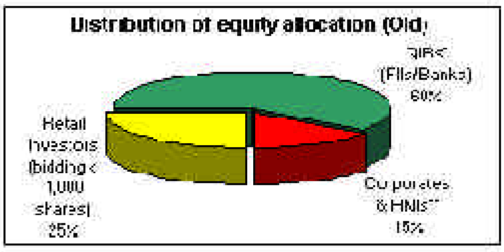
Price discovery is basically a function of the demand for the stock at various prices. A weighted average of all the bids received is calculated to arrive at the final price. Sometimes, the pricing and allocation also takes into consideration the fact that the allotment should be made in such a way so as to leave some craving for the stock post its listing on the bourses, which would provide the support needed for the stock in its early days of trading.

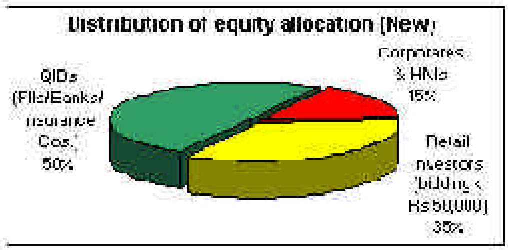
However, though India has adopted the US book building procedure, there is a difference in the process of the two countries. The difference lies, primarily, in the way the shares are acquired. In the US, the process is carried out at the institutional level, who in turn allots shares to their retail clients. But in India, direct retail participation is given importance. A good indication of this is the recent amendment in norms by Securities Exchange Board of India (SEBI) for equity allocation via the book building route.

The amendments:

- In its earlier amendments, SEBI has reduced the allocation of equity to Qualified Institutional Buyers (QIBs), which includes financial Institutions, banks and the newly added insurance companies, and increased the share of retail investors. Prior to the amendments, QIB's could be allotted 'upto 60%' shares, which now stands reduced to 'upto 50%'. Also, another change was the definition of retail investors, which previously meant those investors who bid for less than 1,000 shares. However, the definition now stands changed to an investor who bids for shares less than worth Rs 1,00,000.

Earlier norms... New norms...





- Another positive step taken by SEBI is the setting up of a price band, which will assist the retail participants in placing their bids. This would act as a good guidance for the retail investor in placing the bid, as the previous method had a flaw in the sense that a floor price was fixed below which the bidder was not allowed to bid while there was no upper limit to the bid price. This would often leave an investor guessing as to what should be the price at which he should be placing his bid so as to get a pie of the allotment. However, this shortcoming is taken care of. Now the investor knows the upper limit and can place the bid at the upper end of the price band if he finds the same as value for him. Therefore, the risk that he has overpriced his bid is reduced to some extent.
- Another change made by SEBI in the rules governing primary market issues is that institutional bidders cannot withdraw their bids after closure of the issue.

- A couple of other changes include the introduction of a 15% greenshoe option for IPOs adopting the book building route in case of an oversubscription of the issue. The greenshoe option, basically, gives the issuer company a right to allot an additional 15% of equity. This right will be exercised by the company, but naturally, in the case of extra demand due to oversubscription of the issue. This would, thus, help reduce price volatility post listing of the security. Moreover, the decision to reduce the listing period interval from 15 days to 6 days post the date of allotment ensures that the investor's finances do not remain locked in for a longer period of time. This move is more in line with the international practice.
- Another welcome change in order to safeguard investor interests includes making the board of the company more responsible towards what they state in the book building document. Also, the CFO of the company has to authenticate the financial statements stated with this document. Bottomline, the chief executive officer or the chief financial officer of a company will certify the disclosures in the offer document. Thus, the recent amendments announced by SEBI, aim at strengthening investor confidence.
- Going forward, since this is a relatively new concept for the Indian markets, it will take some time for an average investor to grasp all the nitty-gritty's involved in the book building process. But then, one must remember, that Indian investors tend to adapt themselves quickly to changing systems and scenarios. To cite a couple of examples, the change from the traditional Badla system to derivatives (futures & options) and the upgradation from the T+5 trading system to the current T+2 system (US and UK still follow the T+3 system of trading).

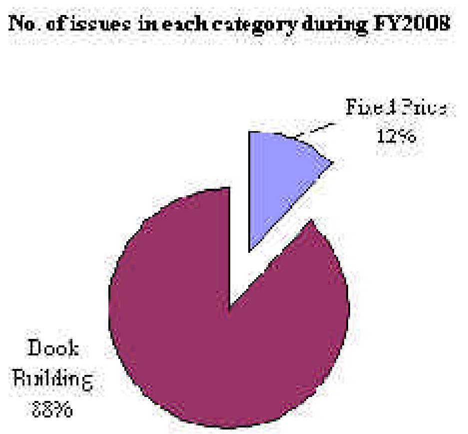
Recent Trends in Book-Building Issues in India

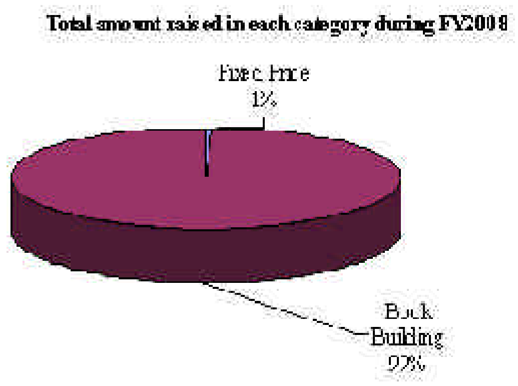
- The book-building process in India is very transparent. All investors (including small investors) can see on an hourly basis where the book is being built before applying. Therefore, no asymmetry as far as information dissemination is concerned.
- In November 1999 the HCL technologies had raised capital through IPO Book-building method and investors gave an enthusiastic response. It was the first Indian IPO in IT industry to adopt the "Book-Building" process and the issue was highly over subscribed. The issue got over subscribed by 27 times. This was despite the fact that the company revised its original price band of Rs. 450-540 to Rs. 500- 580. The final price offered was Rs. 580 for the shares.

Analysis of IPO's during FY2008

- From the period April 01, 2007 to March 31, 2008, the market saw 74 IPO's being concluded through the book-building route and 10 IPO's through the fixed price route.
- During this period the maximum size of an IPO done through the fixed price route was Rs. 39.46 crores of Glory Poly Films Limited, while total amount raised through this route was only Rs. 254.47 crores.
- While during the same period the maximum size of an IPO done through the book-building route was Rs. 10123 crores of Reliance Power Limited, while total amount raised through this route was Rs. 41068.98 crores.

Particulars of IPO's	Fixed Price	Book Building	Total
No. of issues	10	74	84
Total Amt raised (Rs. in crores)	254.47	41068.98	41323.45





As regards the number of issues only 12% chose the fixed price route with amount involved at abysmally low at 1% of the total amount raised. Clearly, book-building seems to be the most preferred route of raising money through an IPO process.

- Out of the 74 IPO's done through the book building route during FY 2008, 55 issuers finalized their issue price at the upper end of the price band, 10 issuers finalized their issue price at the lower end of the price band and 9 issuers finalized their issue price between the price band specified during the public issue process. Besides some companies had to revise their price band downward in view of the poor/lukewarm response from the investors.
- Hence, 74% of issues done through book building process were able to issue shares at the upper band of the price band, while 14% of the issues done through book building process had to issue shares at the lower band of the price band. This fact quite establishes the theory that the book building process is indeed a price discovery mechanism. Though the overall demand of an issue is effected partly by the secondary market sentiments, yet it is the credibility of the company and its intrinsic value of the security that gives the flexibility to the investors at large to discover the fair price of the issue.

Some of the benefits of a book-building system:

1. Demand for the securities offered, and at various prices, is available on a real time basis on the stock exchange website during the bidding period
2. QIBs have to pay only 10% margin money towards the total value of their application in the public issue
3. Book building ensures faster refunds and listing of the issuer company as compared to the fixed price process.
4. Book building also gives flexibility to the investors to invest at a price within the price band at which they feel comfortable in investing.
5. Flexibility to the company, in consultation with the BRLM, to fix a price at lower level than at the price where maximum demand is received, to factor the secondary market sentiments.

Limitations of Book-Building System

The book-building system has various limitations. Some of them are as are as follows:

- The issuer company should be fundamentally strong and well known to the investors;
- The book-building system works very efficiently in matured market conditions. In such circumstances, the investors are aware of the various parameters affecting the market price of the securities. But, such conditions are not commonly found in practice;
- The price is usually determined by the demand from institutions as most of the retail investors bid at the cut off price.
- Book building system is vulnerable to manipulative demand of shares by way of large bids which can be withdrawn before the public issue is closed.

Conclusion

In many ways the present form of the book building process is similar to the democratic election process. In a democracy one can choose the best candidate for a suitable post or not vote at all. Similarly the book building process allows the investors to invest at a price within the price band which they feel is fair, or not invest at all. Several book building issues in the recent past have revised their price bands in order to get favourable subscription. This is proof that the book building system has empowered the investors to a great extent as compared to yesteryears.

The evolution of the book building system has been very encouraging. The book building system in its current form is clearly the most acceptable format among issuers and lead managers. The same is evident from the analysis data that I have briefly discussed above. Like every system, book building may not be foolproof or completely accurate; however there is always scope of improvements based on the feedback/experience gained over a period of time.