What Goes into Pricing of IPOs?

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Abstract

Of late, there has been considerable debate in the media about pricing of Equity Issues in the capital market, especially Initial Public Offers (IPOs). A lot of attention has been drawn to the fact that investors have not been able to make good returns on their investments in IPOs - right from 2006. In this article, an attempt has been made to throw some light on the processes and the factors that go into pricing of Equity Issues - with focus on IPOs.

Introduction

Pricing of Equity Issues is a complex process, involving a large number of factors, many of which require a subjective judgement on the part of the Issuer Company and the investment banks handling the issue. Only a few of the decisive factors are included in the prospectus for the issue, as per SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2009, that govern such issuances of capital.[1]

IPOs: Toughest nut to crack

IPOs are unquestionably the most difficult to price among all equity issuances, since these stocks have never been listed before[2]. In the absence of any history of stock performance, and hence any clear benchmark for pricing of such shares, subjective elements tend to overshadow the decision - notwithstanding any number of scientific peer comparisons of various multiples, etc. The process of pricing other equity offerings, such as FPOs or Rights Issues, where the stock is already listed, is relatively easier; in Qualified Institutional Placements and Preferential Allotments, there are well defined regulations by SEBI on computation of floor price.

Step 1: Prepare the Basis for Pricing

Faced with this situation, investment banks typically look for **listed companies in comparable lines of businesses**. Their price multiples are studied and compared with the possible price multiples of the Issuer Company. The data used in this decision-making process is disclosed in the prospectus for the issue, but only in respect of historical numbers, whereas, in reality, the ultimate pricing decision is generally based on the comparative forward numbers, which are not allowed to be published. It is instructive to look at the historical data (Table 1 below) furnished in the Red Herring Prospectus of one of the hugely successful IPOs viz. Punjab & Sind Bank, which was lead managed by SBICAP (acting as the left lead):

Table 1: Comparison of Ratios * *(As per Red Herring Prospectus for the IPO of Punjab & Sind Bank)*

Name of Bank	EPS (Rs.)	Price-to-Earnings Ratio (P/E)	Price-to-Book Value (P/BV)	Face Value per Equity Share (Rs.)	Return on Net Worth (%)	Book Value/ Share (Rs.)
Punjab & Sind Bank	26.70	-	-	10	23.76%	104.15
Peers						
Andhra Bank	21.60	8.0	1.9	10	23.70%	90.90
Bank of Maharashtra	10.20	7.1	1.3	10	18.30%	55.80
Corporation Bank	81.60	8.7	1.8	10	12.30%	402.70
Dena Bank	17.80	7.3	1.4	10	19.70%	90.70
United Bank of India	2.50	47.3	1.0	10	8.30%	123.40
Vijaya Bank	11.70	8.7	1.5	10	16.00%	73.00
Average of Peers	**24.20**	**14.5**	**1.5**	**10**	**16.40%**	**139.40**

* All figures for FY 2009-10

From the above table, the price per share of Punjab & Sind Bank could be approximated as under:

a. Based on the average P/E Ratio: 14.50 * 26.70 = Rs. 387.15[3]
b. Based on the average P/BV Ratio: 1.50 * 104.15 = Rs. 156.23

This approach is the most preferred one, since it is based on market benchmarks, and hence takes into consideration the vagaries of stock markets that would have affected the peers (companies of similar size in the same sector) uniformly. Pricing derived through any other method of valuation, such as discounted free cash-flow method, would need to be further adjusted for various market-specific factors.

It is important to understand what the average numbers signify. The averages of various parameters of peer companies would provide an indication of the ideal market price of the Issuer Company's stock, since the external macro-economic factors would generally be constant for all players in that industry. However, more often than not, the Issuer Company cannot be considered as the perfect average of the sample set of peers under consideration, and hence these results need to be further adjusted - either upwards or downwards.

Step 2: Consider the Issuer-specific Factors
After arriving at the broad numbers based on average multiples, these have to be fine-tuned - coloured - with **various factors that are specific to the Issuer Company** - encompassing areas like operational efficiencies or inefficiencies, future business initiatives, track record in implementation and execution - as also various other qualitative and quantitative factors. These factors are covered in the prospectus in the section "*Basis of Issue Price*", and are generally explained in great detail in the chapter "*Our Business*".

The quantitative and qualitative factors used in the pricing process of Punjab & Sind Bank IPO have been reproduced in Table 2 below, from the "*Basis of Issue Price*" section in the Red Herring Prospectus:

Table 2: Quantitative and Qualitative Factors extracted from the "Basis of Issue Price" section in the Red Herring Prospectus for the Initial Public Offering of Punjab & Sind Bank (except "Comparison of Accounting Ratios" - reproduced in Table 1)

Qualitative Factors
We believe the following business strengths allow us to successfully compete in the industry:

- High asset-quality and robust financial growth;
- Wide distribution network and infrastructure;
- Over 100 years of banking experience and established relationships with customers, including Central & State Governments and public sector enterprises;
- Streamlined risk management controls, policies and procedures;
- Stringent provisioning coverage ratio for advances;
- Presence predominantly in Punjab and other North Indian states.

For further details, see "***Our Business - Competitive Strengths***" on page 62 of RHP.

Quantitative Factors
The information presented below relating to the Bank is based on the restated financial information for the fiscals 2006, 2007, 2008, 2009 and 2010 and the half-year ended September 30, 2010, prepared in accordance with Indian GAAP and restated in accordance with SEBI ICDR Regulations. For details, see "***Financial Information* - *Report by the Auditors***" on page 163 of RHP.

Some of the quantitative factors which may form the basis for computing the Issue Price are as follows:
*1.**Basic and Diluted Earnings Per Share ("EPS")***

Period	Basic & Diluted EPS (Rs.)	Weightage
Year ended March 31, 2010	26.70	3
Year ended March 31, 2009	7.15	2
Year ended March 31, 2008	5.24	1
Weighted Average	**16.61**	

Note: The profit available for equity shareholders is calculated as - Net Profit less Preference Share Dividend and Tax thereon. The weighted average number of Equity Shares has been considered for calculation of Basic & Diluted EPS.

The basic and diluted EPS for the half-year ended September 30, 2010 is Rs. 15.10 (not annualized).
Note: As on September 30, 2010, the number of outstanding Equity Shares of the Bank stands at 18,03,56,000.

*2.**Price to Earnings ("P/E") ratio in relation to Issue Price of Rs. [●]:***

a. Based on the EPS of Rs.26.70 for the year ended March 31, 2010, the P/E ratio is [?] at the lower end of the price band and [●] at the higher end of the price band.
b. Based on the weighted EPS of Rs.16.61, the P/E ratio is [●] at the lower end of the price band and [●] at the higher end of the price band.
c. Industry P/E[4]
   i. Highest: 21.3
   ii. Lowest: 6.3
   iii. Average: 11.8

*3.**Return on Net Worth ("RoNW")***

Period	Return on Net Worth (%)	Weightage
Year ended March 31, 2010	23.76	3
Year ended March 31, 2009	26.86	2
Year ended March 31, 2008	25.20	1
Weighted Average	**25.03**	

Note: Net Worth has been computed by aggregating Share Capital and Reserves & Surplus, and after adjusting for Revaluation Reserves, Intangible Assets and Deferred Tax Assets, as per the audited restated financial statements.

RoNW for the half-year ended September 30, 2010 is 11.60% (not annualized).

*4.**Minimum return on increased Net Worth required to maintain pre-Issue EPS***
The minimum return on increased net worth required to maintain pre-Issue EPS of Rs.26.70 is [●]% at the lower end of the price-band and [●]% at the higher end of the price band.

*5.**Net Asset Value per Equity Share***
As of March 31, 2010: Rs.104.15
As of September 30, 2010: Rs.119.20
After the Issue: Rs. [●] at the lower end of the price band and Rs. [●] at the higher end of the price band. Issue Price per Equity Share will be determined on conclusion of the Book-Building Process.

Note: Net Asset Value per Equity Share has been computed by dividing the Net Worth, as restated, by the number of Equity Shares outstanding at the end of the year / period.

Based on the analysis of various qualitative and quantitative factors, the investment banks are in a position to conclude whether the basic pricing (based on peer group multiples) needs upward or downward adjustment. Examples of business-specific factors that will push the price up are - market leadership position of the Issuer Company, high corporate governance standards and brand recognition / recall. Factors that can push the pricing down include any negative news or market rumours about the Company executives or the Company, poor efficiency of operations as compared to peers, stagnant or de-growing cash-flows and heavy dilution in the Company.

Who is running the Issue?
At this stage, it is essential to understand that the Red Herring Prospectus is the document which contains "approved information", which can be used to sell the offering. Each fact in this document is carefully checked and vetted by the investment banks managing the issue, and while obtaining the regulator's approval, the investment banks provide a certificate stating that every fact / material statement appearing in the document has been backed by their due-diligence.

It is obvious that issues backed by **reputed investment banks -** with a long and successful track-record and a deep understanding of the regulatory processes - would have a greater investor acceptability, especially in terms of the proposed pricing. This is clearly reflected in the market's response to the issue, i.e. the investor demand for shares and the subscription numbers.

Step 3: Decide on the Optimum Liquidity Discount
Generally, in an IPO, investors expect around 15-20% discount to the peers trading in the market. The logic for **such discount is that these shares would trade for the first time after the IPO**. Since there is no past trading history and it is difficult to predict whether there would be enough liquidity in the counter to facilitate exit, the investors would generally seek a suitable discount.

The discount becomes lower, as the size of the issue goes up, leading to increasing liquidity. Also, in a large size issue, more investors become eligible to participate in the issue, such as Insurance Companies, which cannot invest in issues of less than Rs.200 crores, as well as some large long-only FII funds that have internal investment guidelines on the size of primary market issues. The fact that more investors can participate in the IPO boosts the expected liquidity that will be available in the stock post listing, and hence a lesser discount is expected by investors.

Step 4: Take into account Demand and Supply
Apart from the business-specific factors, there are many other factors relating to the market that investment banks take into account for arriving at an optimum pricing. One of the most important factors is the **demand-supply of similar instruments in the market**. A good case in point is the LinkedIn Initial Public Offering that closed recently in the United States: The Offering was initially priced at $32-$35. After seeing the investor demand building up rapidly, the investment banks priced the offer at $42-$45, valuing the firm at a whopping $9 billion or roughly 17.50 times LinkedIn's revenue in 2010.[5,6] In comparison, Google, arguably the world's most valuable Internet brand, is valued only at a little under 6 times its 2010 revenues.

The main reason cited for LinkedIn receiving such a huge valuation, bordering on the irrational, is that it was the only opportunity that was available to the investor community at large to invest in a social networking website company. Such valuations drive the after-market performance of the stock as well, which was seen in LinkedIn's case. While its valuation was pegged at $45 a share in the IPO, the stock closed at $94.25, i.e. more than 109% above the IPO price.

An Indian case in point was the IPO of DQ Entertainment (International) Limited. DQ Entertainment was a unique story that SBICAP brought to the market in FY 2010. By all accounts, the IPO pricing was considered to be appropriate at Rs.80. Yet, the post-listing demand in this counter was so robust that the stock price touched Rs.140 during the first day of trading - almost double the IPO price.[7]

The opposite can also occur in an IPO, when there are too many companies in the market with similar business plans.

Step 5: Assess the Markets
Last but not the least, one of the major driving forces for determination of IPO pricing is the **state of the markets**. We have observed that whenever the stock markets are not doing well, investors prefer to stay away from IPOs. It is well established that IPOs are a successful product in buoyant market conditions. Whenever the markets are volatile or the sentiments are weak, as is the case at present, or are actually falling, very few issues can be launched successfully, even if priced attractively.

Bottom-line: IPOs are a price-sensitive product
It is essential to understand that the pricing strategies that may have succeeded in earlier issues, may not necessarily work in different market conditions. Pricing depends on many other factors that are completely unrelated or external to the Issuer Company, as discussed above.

It is for the investment banks to judge how the various factors will affect the pricing and to guide the Issuer Company suitably. Their advice may not always be appreciated by the promoters, who expect that investment banks should be able to replicate the success of earlier issues in the same sector for their offerings also. While the promoters are also justified in expecting the highest possible price for their equity dilution, in the process, at times, the pricing can be quite off-track, and this may lead to the investors getting hit on the first day of trading itself.

In the last year's AMBI Summit in October 2010, SEBI Chairman had also expressed concern on this matter and exhorted the investment banks to ensure that IPOs are not overpriced. There is also a feeling that investment banks tend to overprice the IPOs, because their fees may be linked to the total issue size. However, in reality, in most cases, the fees are not linked to the issue size. Secondly, the overall issue size may go up by only 5-10 percent because of the perceived higher pricing and the issue management fees could be only 1-2 percent of that figure. It is quite unlikely that this aspect would have any major bearing on the pricing guidance by the investment banks. Thirdly, the investment banks have to go back again to their key institutional investors - as well as to the retail and HNI

investors - for future offerings managed by them. If these investors are disappointed repeatedly, then the investment banks would face difficulty in their future capital raising mandates. In fact, this last point must weigh heavily with the investment banks for resisting any unrealistic expectations of the promoters.

Conclusion

The ongoing debate in the media about pricing of Equity Issues in the capital market, especially Initial Public Offers (IPOs), needs to be understood in the context of what is summarized above.

Price band for any IPO is arrived at as a consensus between the Issuer Company and the investment banks. It is the duty of the investment banks to analyse the market conditions and all other relevant parameters fully - apart from the pre-issue investor feedback - while arriving at the most appropriate pricing guidance, which takes care of both promoter expectations and investor acceptability of the offering.

However, it is pertinent to note that the ideal or fair price can differ in different market conditions. For example, what was fair price in October last year may no longer be so today, when the markets are down. In other words, the various peer multiples, whether trailing or forward, used for deciding the price band could have been higher at the time of issue - as compared to the multiples later prevailing in weaker market conditions.

Public issues are generally launched in a buoyant market, and promoters also look to pricing the offerings aggressively, when the sentiments are positive. If the issue was launched at - what is later perceived to be - a higher price, and was very well subscribed, it may not perhaps be fair to blame either the Issuer Company or the investment banks, in case the stock is quoting at below the offer price at a later date, when the markets are doing badly.

In the calendar year 2010, there were about 70 odd public issues of equity, and very few of these are currently quoting above the offer price, because the markets were doing well then and are now down - especially in respect of mid cap / small cap stocks and some sectors - like infrastructure. It can be surmised that many of the recent issues may appear to be faring poorly – primarily because the markets are currently not doing well, although in the long term, companies with good fundamentals should deliver decent returns to its shareholders in a rapidly growing economy like India.

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1 SEBI (ICDR) Regulations, 2009 do not permit forward looking numbers to be included in the prospectus.

2 In some cases, the counter may have been listed earlier, and later de-listed, and subsequently proposed to be listed once again. Also, the holding company or a subsidiary company, which may be a good proxy for the issuer company, may already have been listed on some other exchange abroad - like the Alternative Investment Market (AIM), London. In such cases too, the issue would be termed as Initial Public Offering.

3 If one considers the United Bank of India P/E ratio as an outlier, then the average P/E ratio of the remaining banks works out to 7.96, based on which, the price per share of Punjab & Sind Bank could have been approximated at Rs.212.53.