Decoding IPOs through Gradings

D.R.Dogra
Managing Director & CEO
Credit Analysis & Research Ltd.

The growth and development of the capital market is an essential objective of any financial eco system as it reinforces the investment process that is so essential for the growth process to take off given the potential that has to be leveraged. The symbiotic relation between the primary and secondary markets may be debated, but ultimately the trigger point is the raising of equity for investment purposes which in turn also spurs the debt market. This is where IPOs are important as they add strength and confidence to the system.

However, an issue that arises is as to how does one judge an IPO. Large and well known companies are studied by all analysts and taking a decision is easier. But what about companies that is relatively less known? Is there a way in which potential investors could take an informed decision considering that the plethora of data provided as per the rules and regulation may not be easy to decipher? Within the world of credit rating, there is one such product which bridges this information asymmetry and is called IPO grading.

An initial public offering (IPO) grading is an independent and unbiased opinion of a rating agency on the fundamentals of the company that has filed or is expected to file a draft offer document for its IPO with SEBI. The grade represents a relative assessment of the fundamentals of that issue in relation to the other listed equity securities in India. It provides the investor with an informed and objective opinion expressed after analyzing factors like business and financial prospects, management quality and corporate governance practices etc.

IPO grading was introduced by Securities and Exchange Board of India (SEBI) as an endeavor to make additional information available for the investors in order to facilitate their assessment of equity issues offered through an IPO. Any company which has filed the draft offer document for its IPO with SEBI, on or after May 1, 2007, is required to obtain a grade for the IPO from at least one rating agency.

Process

IPO grading can be done either before filing the draft offer documents with SEBI or thereafter. Typically, a company which has filed or is expected to file the draft offer document for its IPO with SEBI can approach CARE (or any other rating agency) for a grading. CARE will assign a grading team, which will then interact with the company to obtain the offer document and other information, analyze the data and information so obtained, undertake the site visits, clarify doubts if any on the information obtained and request for any additional information required for the analysis. This analysis is then presented to the Internal Review Committee and subsequently to the Grading Committee to assign a grading to the IPO. The grading assigned by the Grading Committee is then communicated to the company for acceptance.

As per the SEBI guidelines, IPO grade/s cannot be rejected. Irrespective of whether the issuer finds the grade given by the rating agency acceptable or not, the grade has to be disclosed. Although, the issuer has the option of opting for another grading by a different agency, in such an event, the issuer shall have to disclose in the prospectus/red herring prospectus, advertisements, etc. all the grade/s given to the IPO by all rating agencies approached by the company for grading such IPO.

However, CARE permits the company to represent its case by furnishing any additional information/documents. The Grading Committee reviews such additional information/ documents as provided by the company and may decide to either revise or reaffirm the grading assigned. Such revised/reaffirmed grading is then communicated to the company and also made public through a notification in the press. A grading letter with a detailed rationale of the grade assigned is provided to the company, which gets included in the final prospectus among the material documents available for inspection by the investor.

Criteria and scale

A time horizon of around 3 years is considered for the assessment. IPO grading is a one-time assessment and is valid for a period of not extending three months from the date of release of the grading.

Following are the key factors on which the assessment of the fundamentals and the grade of the issue are based:

<u>Business Prospects and Competitive Position</u>

- <u>Industry Prospects</u>

The issuer's position in an industry and the nature of the industry itself has a strong bearing on the fundamentals of the issuer. Industry analysis involves a review of the characteristics and structure of the industry along with an assessment of past trends and future prospects. Some of the important aspects analyzed are:

- o Establishment of the concept (stage of industry/ product life cycle)
- o Industry prospects for growth (demand & supply position)
- o Level of competition
- o Entry & exit barriers
- o Government policies (regulatory framework)

● Firm's ability to generate suitable business

The business model is examined to understand the company's ability to generate suitable business.

Several factors determine a company's ability to withstand competitive pressures, including its share in key markets, product dominance and the ability to influence price. Relevant factors influencing the relative competitive position of the issuer are examined. The issuer's ability to maintain/improve its market share and pricing power is examined. Key factors which are examined include:

- o Market position/competitive advantage of the issuer
- o Exhibited growth in sales
- o Diversification and volatility of revenue

● Operating efficiency

Operational efficiency is analyzed in terms of a company's ability to control costs and maintain margins. Operating efficiency to a large extent is influenced by the following factors:

- o Marketing and distribution arrangements
- o Location of the production unit(s)
- o Access to raw materials
- o Scale of operations
- o Quality of technology
- o Level of integration
- o Working Capital management and turnover ratios
- o Efficient utilization of resources
- o Cost structure

● Trend in operating margins

Operating margins provide a useful measure of a company's profitability and competitive position.

Financial Position

The impact of the various parameters (considered above) is also reflected in the actual as well as prospective financial position of an issuer. Trend as well as inter-firm analysis is done for determining the relative ranking of the issuer. The projected financials for the next three years are also examined.

● Financial Flexibility

The capital structure of an enterprise is looked in conjunction with its business risk. A highly leveraged entity would be constrained to make additional borrowings for further growth. Ability of an enterprise to raise fresh capital at competitive terms is considered a favorable factor.

● Profitability

Past trend in issuer's profitability along with the industry wise profitability is examined to assess the relative standing of the issuer. The primary indicators looked at are:

- o PBILDT margin
- o PAT margin
- o Return on Equity
- o Return on Capital Employed

In case of companies in the financial sector, profitability indicators include gross and net spreads earned and operating expenses to capital employed.

● Debt Service Coverage Ratio

Adequate level of cash generating ability is essential for an issuer for sustainability of its business.

● Liquidity

For assessing the liquidity position of a company, CARE would analyse liquidity ratios such as current ratio and quick ratio of the entity. In case of finance companies, stress would be laid on asset liability management. While the primary source for servicing obligations is the cash generated from operations, an assessment is also made of the ability of the issuer to draw from other sources (like liquid investments, unutilised lines of credit, financial strength of group companies, etc).

● Off Balance Sheet Liabilities

Off-balance sheet items such as operating leases, contingent liabilities, exposure to subsidiaries/group companies, nature of related party exposures and its impact on the company's fundamentals are analyzed.

Management Quality

A company's business and financial position is greatly influenced by the quality of its management and promoters' track record. When the business conditions are adverse, it is the strength of management that provides resilience. Following areas are analyzed to ascertain the quality of the management:

- Experience/competency of the promoters
- Performance of other ventures of the promoters
- Cohesiveness among the promoters
- Debt servicing track record
- Organization structure and delegation of powers
- Succession policy

Corporate Governance Practices

The corporate governance practices of the company are reviewed in terms of transparent ownership, cross holdings, size, composition & independence of the Board, compliance with regulatory requirements, audit function etc.

Compliance and Litigation History

History of legal compliance of the firm with respect to various statutory dues and the status of tax returns is assessed. Any adverse and prolonged litigation history and present status of pending legal issues in the company can adversely affect the future growth of the firm.

New Projects—Risks and Prospects

The scale and nature of new projects or expansion can significantly influence the risk profile of any issuer. Project assessment in terms of viability is examined using the return on investment (RoI) expected from the project. Risks from the new projects expansion like time and cost overruns, diversification of the project, non-completion of the project, gaps in financing tie-ups, operational risks, etc are also analyzed. Other factors that are assessed include: track record of the management in project implementation, experience and quality of the project implementation team, implementation schedule, status of necessary approvals from regulatory authorities, project cost comparisons, financing arrangements, tieup of raw material sources, etc. Besides assessment of various project risks, assumptions about completion and contribution to/from these projects are incorporated in the issuer's overall financial projections.

While growth prospects of the industry, financial strength and operating performance of the issuer are the quantitative parameters, qualitative parameters such as management capability, promoter evaluation, accounting policies, corporate governance practices although subjective provide critical inputs in determining issuer's fundamentals.

IPO grading is assigned on a five-point point scale with a higher score indicating stronger fundamentals and vice versa as below:

IPO grade **1**: *Poor fundamentals*
IPO grade **2**: *Below-average fundamentals*
IPO grade **3**: *Average fundamentals*
IPO grade **4**: *Above-average fundamentals*
IPO grade **5**: *Strong fundamentals*

These numbers are what can really be looked at by potential investors as the rating agency's summary view of the company and its IPO.

How IPO grading assists

- The grade represents a relative assessment of the fundamentals of that issue in relation to the other listed equity securities in India. This is particularly useful to the issuer since the issuer is accessing the equity markets for the first time and has no track record of market performance.
- While, SEBI requires high levels of disclosure to be made by the issuer in the issue document before listing, interpreting and analyzing the same however requires a fair amount of analytical sophistication. An IPO grade would help investors, particularly the retail investor in being able to better appreciate the meaning of the disclosures made in the issue document
- It provides the investor with an informed and objective opinion expressed after analyzing both quantitative factors like business and financial prospects and qualitative factors such as management quality and corporate governance practices etc.
- IPO grading is one of the inputs to the investor's decision making process. It provides additional information to the investors in order to facilitate their assessment of equity issues offered through an IPO.

Story so far …

Since August 17, 2006 when CARE assigned the first IPO grade, so far CARE has assigned IPO grades to over 125 companies that filed or expected to file draft offer documents with SEBI, and of that around 73 companies have successfully listed themselves with the exchanges. A study was carried out to check the relevance of IPO grading exercise on these 73 listed companies, results of which present an interesting conclusion and reinforce our belief in IPO grading being a relevant tool for an issuer in benchmarking themselves in the market place.

Volatility in the share price is considered to be one of the important indicators of risk for an investor in the security. Share price of companies with sound fundamentals should show relatively lower volatility when compared with that of not so fundamentally sound companies. The study considered the volatility in the share price of the 73 listed companies since their listing, till date. Below are the key takeaways of this study:

Grade assigned by CARE	No.of Companies	Average Grade assigned by CARE
CARE IPO Grade 1	8	120.0%
CARE IPO Grade 2	23	109.5%
CARE IPO Grade 3	23	89.8%
CARE IPO Grade 4	16	79.2%
CARE IPO Grade 5	3	32.8%

Average volatility in share price of companies which were assigned (by CARE) an IPO grade of 5 and 4 have been much lower, when compared with companies which were assigned an IPO grade of 1 or 2.

The benchmark index during the period starting May 1, 2007 till date exhibited a volatility of around 66.5%.

What IPO grading does not connote

While the IPO grade has gained acceptance from investors as an additional piece of information that can be used while taking a decision, care must be taken in terms of its interpretation.

- The analysis draws heavily from the information disclosed in the draft prospectus filed with SEBI. A rating agency generally does not undertake a forensic exercise or perform any audit function to detect any fraud. The grade does not indicate compliance/ violation of various statutory requirements.

- IPO grading does not take cognizance of the price of the security, so should not be taken as a comment on the offer price or listed price of the scrip.
- It is not a recommendation to buy, sell or hold shares/ securities.
- It is also not a forecast of the future market performance and the earnings prospects of the issuer.

This said, irrespective of the grade obtained by the issuer, it is recommended that the investor should make his/her own independent decision regarding investing in any issue after studying the contents of the prospectus including risk factors carefully.

The IPO grading is a unique concept that has been introduced to help investors take an informed decision. This will help in the growth of the IPO market to begin with which in turn can set in motion the virtuous circle in the secondary market too. This major step in the market will help particularly when the overall sentiment improves in the market and there are a stream of such issuances when investors could tend to get a bit lost, in the absence of such a grading provided by an independent and unbiased agency.