

# IPO Pricing - The Eternal Debate



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The entire IPO pricing theory is well encapsulated by Roger G. Ibbotson Jeffrey & F. Jaffe in their famous paper in 1975 "HOT ISSUE" MARKETS where they postulated that the desire to leave a "good taste in investor's mouths" as a potential explanation of under-pricing by intermediaries. An IPO may be under-priced deliberately in order to boost demand and encourage investors to take a risk on a new company. An IPO is considered under-priced by the difference between its first-day closing price and its set IPO price. The endeavour constantly has been to achieve the right initial under-pricing, i.e. the positive first-day returns.

Under-pricing is market independent and a global phenomenon and in India its evolution can be traced very distinctly. When the Initial Public Offering (IPO) market started in India, after the formation of Securities and Exchange Board of India (SEBI) new companies with a limited track record were allowed to issue their shares at their face value only whereas companies with a good track record were allowed to freely choose the price of their shares. Hence the pricing decision making was extremely limited and consequently under-pricing opportunities were huge.

SEBI issued the Disclosure and Investor Protection guidelines first in the year 1992 for free pricing in the IPOs. However, it was only fixed price issues which were allowed by the then applicable laws in force and the investors were not given an opportunity to discover the pricing. Subsequently, SEBI allowed pricing to be determined either through fixed price process or book building process pursuant to Securities and Exchange Board of India (Disclosure and Investor Protection) Guidelines, 2000. In the fixed price regime one could actually create a perception of under-pricing by generating a scarcity value hence there was an emergence of the "grey" market which became a barometer of the under-pricing.

While "grey market" continue to thrive; book-building mechanism introduced in 1999 (*the year represents a natural structural breakpoint in issuance mechanism & to an extent the level of under-pricing*) has gained immense popularity to an extent that by the year 2005 over 72% of the IPOs brought to the market were book built. See Table 1

Another important phenomenon which drove the under-pricing was the emergence of Qualified Institutional Investors (QIBs) as the dominant investor class and both issuer & intermediaries set about meeting their requirements for participation.

Allowing this class of investors to feel privileged & important through the discretionary allocation process was critical in the extent of under-pricing. Creating demand-supply mismatches amongst this class overshadowed all other classes of investors in determining the extent of under-pricing.

Qualified Institutional Buyers (QIBs) were allotted the shares in the IPO on a discretionary basis, whereas Non-institutional Bidders (NIB) and Retail Individual Bidders (Retail) were allotted the shares on a proportionate basis. This gave an opportunity to the QIBs to determine the pricing the IPO as major portion i.e. typically around 50% of the offer could be allocated to QIBs. SEBI vide its circular in the year 2005 extended provisions of allotment through proportionate basis as applicable to Retail & NIB to the QIB category.

From 2000 till 2005 i.e. when QIBs were allotted equity shares on discretionary basis approx. 78% of total no. of IPOs saw under-pricing of approx. 138%. Whereas, from 2006 till 2009 i.e. when QIBs were allotted equity shares on proportionate basis there was a drastic drop with approx. 62% of total no. of IPOs having an under-pricing of approx. 136%.

Most market participants & issuers realised this anomaly and through various dialogues petitioned the regulator to bring back discretionary allocation in a different form and SEBI brought in regulations for allocation to anchor investors on a discretionary basis, out of QIB portion. The portion so reserved for Anchor Investor has been increased from 30% to 60% of the QIB Portion over the years through amendments.

The biggest variable in issue under-pricing has been the sectorial affinities of investors depending on their perception of sectorial growth and risk appetite in the visible time frame. At the turn of the decade in the year 2000, IT which was deemed as the sunrise industry took a major fancy with investors and that trend has continued till around 2004. Various sectors like realty fancied towards the peak of the bull markets in 2007 whereas in the crisis years of 2008 & 2009 it was the more steady power generation & distribution. In the last decade the sectorial choices have moved from traditional industries to more new-age industries like BFSI & Asset management, renewable energy and internet based search / services. See Table 2.

Hence under-pricing as phenomenon is set to continue however, the determinants of under-pricing will continue to change with time.

**Table 1**

Analysis of IPO's from 2000 to 2020 - (Source: Prime Database, BSE,NSE)

Year	No. of Issues				No. of Issues				Average (%) Over / Under Pricing	
	Fixed Price	Book Building	Total	% of Book Build Issues	Under Priced	Over Priced	Total	% of Issues Under Priced	Under Pricing	Over Pricing
2000	6	4	10	40%	6	4	10	60%	43%	-16%
2001	3	0	3	0%	2	1	3	67%	594%	-7%
2002	5	1	6	17%	4	2	6	67%	16%	-4%
2003	2	3	5	60%	5	0	5	100%	58%	NA
2004	7	15	22	68%	19	3	22	86%	60%	-4%
2005	14	33	47	70%	41	6	47	87%	53%	-6%
2006	16	59	75	79%	54	21	75	72%	40%	-12%
2007	14	87	101	86%	65	36	101	64%	156%	NA
2008	5	35	40	88%	21	19	40	53%	323%	NA
2009	0	17	17	100%	10	7	17	59%	24%	-15%
2010	1	65	66	98%	44	22	66	67%	28%	-13%
2011	2	37	39	95%	19	20	39	49%	49%	-38%
2012	0	11	11	100%	6	5	11	55%	13%	-7%
2013	0	3	3	100%	1	2	3	33%	15%	-4%
2014	0	5	5	100%	4	1	5	80%	36%	-12%
2015	0	20	20	100%	12	8	20	60%	19%	-7%
2016	0	27	27	100%	21	6	27	78%	21%	-11%
2017	1	33	34	97%	24	10	34	71%	34%	-6%
2018	0	24	24	100%	13	11	24	54%	21%	-9%
2019	0	16	16	100%	11	5	16	69%	31%	-6%

**Table 2***Sectorial Choices and under-pricing based on expectations change with time*

Year	Sector	Total Amount Raised (INR Crore)	Average under-pricing (%)
2000	IT – Software	788	195%
2001	Media - Print/Television/Radio	45	-7%
2002	Banks	937	64%
2003	Auto Ancillaries	993	31%
2004	IT – Software	5,984	72%
2005	Airlines	1,899	19%
2006	Refineries	2,700	42%
2007	Realty	14,669	125%
2008	Power Generation & Distribution	10,954	-38%
2009	Power Generation & Distribution	10,813	-11%
2010	Mining & Mineral products	16,437	64%
2011	Finance	2,945	7%
2012	Telecomm Equipment & Infra Services	4,173	-13%
2013	E-Commerce/App based Aggregator	919	15%
2015	Air Transport Service	3,017	15%
2016	NBFC/ SFC etc	6,059	48%
2017	Insurance	34,932	-10%
2018	BFSI & Asset management	10,896	47%
2019	Renewable Energy	2,850	-7%

With inputs from Hitesh Kothawale &amp; Chandresh Sharma