A Blue Print For Buoyancy in the Primary Market

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The primary market in India has been in a way in doldrums ever since the beginning of 1990s when the process of liberalization and globalization was ushered in.

Amount of Capital Raised

It is true that the amount of capital raised in the primary market shot up sharply from an annual average of Rs.500 crore in 1980s to Rs.27,633 crore in 1994-95, mainly due to repeal of the Capital Issues (Control) Act, 1951 with effect from May 27,1992. Valuation guidelines issued under the said Act provided for strict norms for fixation of premium by linking it to the net asset value and price-earning capacity value discounted at 8% - 15%. Guidelines issued by the Securities and Exchange Board of India (SEBI) in this behalf are relatively lax. The various parameters stipulated by SEBI in 1996 for justification of issue price, viz, earnings per share for the last three years, comparison of the price earning ratio pre-issue in relation to the issue price with industry P/E, average return on net worth in the last three years, net asset value per share, etc. provided ample leeway for issuers and merchant bankers to fix the premium at arbitrary levels. On the basis of same parameters, issuers and merchant bankers can justify premia in a wide range of say Rs.100/- to Rs. 200/- per share for the same company.

There were quite a few other factors which affected adversely the working of the primary market. SEBI's decision to dispense with the vetting of prospectus further emboldened the issuers to be lax, particularly in fixation of premium. Book-building process introduced by SEBI permitting companies initially to have the book-building up to 50% and subsequently up to 100% coupled with the facility to move the price bands worsened the situation. Permitting the issuers to announce the price band just a day prior to the opening of the subscription list in the case of listed companies has created confusion in the minds of investors, particularly those located in semi-urban and rural areas.

Erosion in Prices

As a result of the above factors, prices of new issues eroded sharply after listing. For example, out of 3,872 new issues listed during the period of four years from April 1, 1992 to March 31, 1996, 2987 issues were traded below offer price with 205 issues not being traded and 118 issues belonging to "vanishing companies" as on January 14, 1997 according to the Prime Database. Only 562 issues were traded above the offer price. There has not been any significant improvement thereafter.

Even in the case of IPOs through book-building listed on the National Stock Exchange during the period April 2000 to June 2001, out of 25 issues, 21 issues lost more than 50% of the value initially with only four issues registering net gains.

Performance in last Two Years

As a result of the above factors, there was a sharp decline progressively in the quantum of capital raised which dipped to a low of Rs. 4,070 crore in 2002-03. It is true that in the next two years, the amount of capital raised shot up to Rs. 23,272 crore and Rs.28,256 crore respectively mainly due to disinvestment by profitable public sector undertakings and buoyancy in the secondary market.

The capital of Rs.28,256 crore raised in 2004-05 accounted for a meagre 3.3% of the gross domestic savings, while the amount of Rs.27,633 crore raised in 1994-95 accounted for 11.0% of the gross domestic savings.

It is imperative that the process of disintermediation needs to be encouraged as it leads to a more competitive system which is needed, particularly in the context of globalization. In most of the advanced countries, the amount of capital raised from the primary market accounts for 20%-30% of gross domestic savings. India has a long way to go to reach anywhere this level.

Export of Capital Market

A major factor hindering the growth of the primary market is the export of the capital market by floatation of GDRs and ADRs by several Indian companies. Over $500 million are being raised every year through this route.

A recent disturbing development has been the floatation of ADS wherein the domestic shares are exported and listed on foreign stock exchanges. This is affecting in turn the market capitalization of the country.

Buybacks and de-listing of shares following buybacks also effect the market capitalization of the country.

Decline in Shareholding Population

Disappointing performance in the primary market coupled with scams in the secondary market resulted in a sharp decline in the shareholding population of the country. Accordingly to the Survey of Indian Investors by SEBI – NCAER, the number of equity investor households was almost halved from 12.1 million in 1998-99 to 6.5 million in 2000-01, representing a meagre 3.7% of Indian households. The growth of equity shareholders after 2000-01 has been meagre, estimated at about 1% to 2%, as the public offer of shares has been just a little over Rs.1,000 in the two years after 2000-01. In 2003-04 and 2004-05, however, due to a spurt in public issues, there was an estimated increase in shareholding population by about 5%.

The low level of shareholding population is duly reflected in the number of clients' accounts in NSDL and CDSL, both of which had a total of 7.31 million accounts at the end of March 2005. The actual number of demat account holders will be much lower as most of the accounts are in joint names, and quite a few of the accounts would be duplicate ones. With over 75 of the market capitalization having already been demated, the residual number of individual shareholders may be another about two million.

The low level of shareholding population in India is sharp contrast with a high level of 15% - 30% of the population in almost all the developed markets of the world. Fruits of growth, as reflected in the rising market capitalization, need to be shared with the lower segments of society.

Measures to Foster Primary Market

A multi-pronged approach is necessary to foster the growth of the primary market. Investor awareness programmes alone will not produce the desired results.

Percentage of Public offer

Till September 20, 1993, the percentage of capital that was required to be offered to the public through prospectus for being entitled to be listed on a stock exchange was 60% of each class or of kind of securities. This was reduced to 25% by amending rule 19 (2) (b) of the Securities Contracts (Regulation) Rules, 1957. This was further reduced to 10% of the issued capital of the company in case of large public flotations of at least Rs.100 crore. The modification effected by SEBI is so much against investor interest that even a member of SEBI was constrained to observe that "the rule is serving the purpose of promoter-protection rather than investor-protection. The rule is also harmful to market liquidity and is partly responsible for the upsurge in price-rigging".

The percentage of equity capital of a company required to be offered to the public through prospectus should be raised from 25% to at least 40% so that not only are the investing public given greater opportunity to participate in the equity stakes of companies but also the scope for manipulation of prices due to lack of adequate holdings by the public is reduced.

Disinvestment by PSUs

In case of disinvestment by Public Sector Undertakings (PSUs), the entire offer can be earmarked to only Retail Individual Investors (RIIs) and in the case of heavy subscription not more than 100 - 200 shares be allotted to any single individual, as was done by some of the developed countries while privatising their PSUs. In case PSUs choose to follow the normal route, RIIs may be allotted shares at a discount of 5% of the issue price as was done by quite a few PSUs in 2003-04.

Allocation to RIIs

The trifurcation of the public offer into three categories, viz, Qualified Institutional Buyers (QIBs), High Networth Individuals (HNIs) and RIIs and allocation of 60% (recently reduced to 50%) 15% and 25% (recently raised 35%) respectively to these three categories has not been in to the interest of RIIs. The share of RIIs needs to be raised to 50% of the public offer and those of QIBs and HNIs may be fixed at 35% and 15% respectively.

It is doubtful whether the decision of SEBI to hike the investment limit for RIIs from Rs.50,000 to Rs. 1 lakh would at all be in the interest of small investors. Small investors are really those who apply for shares worth say Rs.20,000 to Rs.25,000. At least 50% of the allocation to RIIs may be earmarked to the applicants up to Rs.50,000, with the balance 50% being earmarked to those who apply for shares worth Rs.50,001 to Rs.1,00,000. Alternatively, those who apply for shares with upto say Rs.25,000 may be granted weightage in allotment of say 1.5.

Justification of the Issue Price

SEBI guidelines relating to justification of the issue price needs to be tightened. It is relevant to note in this connection that in the US, issue of securities is also governed by separate securities laws of individual states in addition to the Federal Securities Act, 1933. The common denomination of all these state-level legislations specify minimum promoter's contribution, maximum expenses of public offerings, the price that insiders must pay for their stock related to the proposed price for public investors, securities offer prices to be related to earnings ratios or other benchmarks, interest and dividend coverage with respect to senior securities, minimal shareholder voting rights, etc. In order to harmonise state securities regulations, the US Congress enacted the Uniform Securities Act in 1985 which has been adapted by almost all the states.

While it would not be desirable to go back to the valuation guidelines under the CCI Act, it is necessary to ensure that greater exactitude is injected in the fixation of premium amount. This can be done by specifying that the justification for the premium amount be vetted by a Chartered Accountant drawn from a panel of Chartered Accountants, specially approved by SEBI in this behalf.

Prefer Fixed Price Route

An ordinary investor is not adequately informed about the intricacies of nuances like cut-off price, options I, II & III, etc, of the book-building process. This apart, experience has indicated that fixed price issues give better returns as compared to book built issues. For example, in the first half of 2005, the three fixed price issues have generated returns (as on June 11, 2005) from 75% to 370%, while eight out of the ten book-built issues gave returns varying from 12% to 109% with two of them giving negative returns of 4% to 6%. PSUs at least should follow the fixed price route while disinvesting.

Scatter the Public Offers

Public offers should be scatted and not bunched, as was the case in respect of public offers in February / March 2004 so that small investors can recycle their funds. Issuers, particularly PSUs, and merchant bankers should take care of this.

Abridged Prospectus

Abridged prospectus should be printed in a booklet form, as is being done in respect of IPOs of mutual funds, with a proper index page, so as to facilitate perusal of the same.

Remove MAPIN - UIN

MAPIN – UIN is a bugbear for investors. This should not be made applicable to individual investors, while there need be no objection to make the same applicable to all registered intermediaries.

Rejection of Applications

While rejecting applications, companies do not give any reasons. It should be made mandatory on the part of companies to spell out the reasons for rejection of applications so that investors not only get better educated but will not commit the same mistakes again.

Safety Nets

A closely related issue is the prescription of safety nets for initial small investors say up to 200 shares for at least six months at a minimum buy back price of say 85 percent of the offer price. This by itself will act as a deterrent against fixation of unduly high premium.

Encourage Employee Stock Option Plans

Employee stock option plans (ESOPs) are popular instruments in advanced countries which not only help in retention of employees but also in widening the shareholding population. ESOPs were popular in India for some time in 1999 and 2000. The 2001 scam resulted in a set back to ESOPs. Now that the market has revived companies should be encouraged to offer ESOPs. In order to encourage companies to offer ESOPs, shares arising out of ESOPs up to say 5% may be considered as part of public shareholding for purposes like delising of shares in case of shrinkage in public shareholdings, etc.

Augment the Domestic Supply of Capital

A company raising capital abroad through GDRs and ADRs needs to be subjected to the condition that it can do so provided an equal amount of capital is raised by it from the domestic market.

It is high time issue of Indian Depository Receipts (IDRs) are permitted so that Indian investors get an opportunity to become shareholders of foreign companies, particularly of MNCs.

Buy back of shares leading to delisting of shares should be discouraged. A deterrent is to impose a higher rate of tax, say ten percentage points, on unlisted companies, as compared to listed companies. Such a distinction was there till 1993 with unlisted companies paying taxes at a rate higher by five percentage points.

Allotment Lots

There is no uniformity in allotment of minimum number of shares in respect of over subscribed issues. Minimum allotments should be such that applicants even in lower categories are assured of firm allotments. Allotments in case of over subscriptions may be made in lots of five shares, if not one share. There need be no objection to this, as trading lot in the demat mode is one share.

Denomination of Shares

There has been a school of thought advocating the removal of face value of shares with the object that the reserves and share capital be merged and all that the company would say is about the number of outstanding shares – a practice followed by some of the advanced countries. Although the Indian investors are still not sophisticated enough to appreciate this, this would have been a welcome step. Instead, SEBI's directive issued in 1999 permitting companies to have the shares in any denomination has created lot of confusion in the minds of investors, particularly when they deal in the secondary market. Either, status quoante i.e., having par values of Rs.100 or Rs.10 be restored or alternatively par value of shares be revived completely

Listing of Unlisted Companies by Merger

The surreptitious and unethical manner through which listing used to be obtained by merger of an unlisted company with a company already listed without a public offer was deplorable. It deprives the legitimate rights of the pubic to participate in the limited percentage of public offer of 25 percent of the capital of the merging unlisted company. For instance, Hinduja Finance Corporation Ltd., with an equity capital of Rs.7 crore, obtained listing in 1996 by merger with a small listed company, viz, Mitesh Mercantile and Finance Ltd., with a capital of just Rs.25 lakh. Rather belatedly SEBI came out with a guideline in January 2001 specifying that 25% of the paid up capital post scheme of the unlisted transferee company seeking listing comprises shares allotted to the public shareholders of the listed transferor company. In case, the public shareholding of the listed transferor company is less than 25% of the paid-up capital of the company prior to merger, as is likely in most cases, the residual percentage of shares should be offered to the public through prospectus.

Compensation to Investors of "Vanishing Companies"

"Vanishing companies" have seriously affected the morale of investors, who need to be compensated. The argument that investment in equities is always a matter of risk and reward cannot be extended to "vanishing companies" as the promoters and directors of these companies and other related entities like merchant bankers and auditors can rightly be accused of having defrauded the public. All possible efforts should, therefore, be made to recover the moneys involved from the personal assets of promoters and directors of these companies. Merchant bankers and auditors who are found guilty of having abetted in raising funds should be called upon to make good the shortfall in collection, besides being subjected to penal action such as fines, suspension, etc..

As the process of collection of the lost money will no doubt take time, investors should be re-imbursed immediately, at least to the extent of the principal amount of Rs.25,000, so as to cover the really small investors. Money for such re-imbursement can come from the Investor Protection Funds of the concerned stock exchanges and the Investor Education and Protection Fund (IEPF) established under Section 205C of the Companies Act, 1956. In case there is still some shortfall in the amounts to be re-imbursed to the investors, SEBI, which is statutorily mandated to "protect the interests of investors in securities", can bridge the gap from its own funds. As and when the efforts to collect money form the concerned promoters and directors, and merchant bankers and auditors succeed, the same can be returned to the funds in proportion to the amounts drawn from them.

Conclusion

Widening the shareholding population meets several objectives like fairer distribution of wealth, reducing the scope for manipulation of prices, disintermediation, injection of greater accountability on management due to wider focus of the company, etc. A target of at least 60 million shareholders by the end of say 2010 be fixed so that about 5 percent of the population of the country own equities in the country.