IPOs- An Issuer's Perspective

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There has been a considerable increase in the number and size of public issues during last few years. For example in the year 2001-2002 there were 19 issues with the total issue size of Rs.6423 crore where as the total number of issues in 2005-06 was 102 with the total issue size of Rs.23, 676 crore. The Third Annual Global IPO Trends Report of Ernst Young pointed out that IPO activity continues to reflect the shifting landscape of the world economy. While a key trend in 2005 was an increase in IPOs in China, Israel, Russia and Poland, the outlook for 2006 showed an increased interest in markets including the Middle East, South Korea, India and Brazil. The report further highlights that many Indian IPOs have been oversubscribed 20 to 30 times in markets that have been scaling record levels.

Public issue of equity shares is thus an important segment of securities market as it enables the Corporate Sector, both public and private, to raise resources required for business and related purposes. One of the major advantages of raising money through issue of shares is its nature of being a permanent source of capital without providing a security. Money can be raised through offering of shares to public or to existing shareholders or by issuing the shares on private placement basis. Though offering of shares to public involves higher cost and higher level of compliance, it is considered a better source of finance as it helps in accessing not only domestic market, but also the international capital market.

An IPO is the first sale of a company's shares to investors through a listing of the shares on the stock exchange. The purpose is to raise capital for the company. It is an opportunity for the company to open a window to raise further capital through issue of rights shares. It may allow the company to tap a wide pool of investors on the stock market from the domestic and foreign sources. A follow-on offering can be completed in a significantly shorter time frame than an IPO. This is because a company that is already public has relationships with underwriters who are familiar with its business; has an established valuation, and a following among analysts and investors who understand the company's business and market.

Further, going public may have a positive impact on the company's stature, perceived stability and competitive position. A private company may face sales resistance from prospective customers who may entertain doubts about the company's staying power. Suppliers and lenders may perceive a company to be a better credit risk after its IPO. The company may obtain more favourable terms from them. Financial newspapers and magazines as also general media are more inclined to cover public companies than private ones. This may enable the company to attract better management talent.

A successful public offering may remove the illiquidity discount the company has in its market valuation. A wider investor base that includes a variety of investors may increase the demand for the company's stock.

The limitation is that the listing of the shares on stock exchange invites regulatory compliance and reporting requirements, which may make a heavy cost.

An IPO is the first public issuance of the company shares. The existing shareholders have their shareholdings diluted as the proportion of the company capital. They may also gain by their shareholdings becoming far more valuable in absolute terms.

The company is then able to raise large amount of capital from the market without having to seek and negotiate with individual investor.

After the IPO the company gets a liquid market for its shares and the shares become as much valuable as cash for acquiring other businesses. Tax experts point out that there are tax shelters for a stock-for-stock acquisition which is not available for a cash acquisition.

The investor approach to IPOs has changed dramatically since the times in 1990s when Internet companies were booming. They are no longer impressed by mere "concept" stories, unproven business models, growth and market share gains at any expense. They are now looking for companies that are profitable, driven by experienced managers having proven track record, having proven business models and differentiated products or technologies and rapidly growing market opportunities. The Guidebook on IPO published by Browne & Co, Inc points out that the criteria used by various merchant bankers may differ; larger merchant bankers may require stronger financial profile. The criteria may also differ based on the industry sector of the candidate company. Individual exceptions of candidate company having an unusually innovative product or exceptionally accomplished management team may be able to attract merchant bankers and investors even if it falls short on other criteria.

What is however imperative for a company considering a public issue of equity shares is to take an objective view, after examining all aspects on the purpose of the issue, including evolving state of investment climate, performance of the industry and its prospects, investors appetite for equity shares, (both retail and institutional) as well as the state of primary and secondary market of the stock exchanges.

Dr. J. J. Irani Expert Committee on Company Law while examining the issue of access to capital by the corporate sector deliberated on the need for streamlining the regulatory framework being administered by multiple authorities under several statutes including simplification of approval requirements. The Expert Committee in its recommendations highlighted the need for effective interaction and coordination between Ministry of Corporate Affairs and SEBI in various aspects of public issue of equity shares and other securities.

The Expert Committee has recommended that, the Companies Act should deal with basic framework and provisions relating to issue and management of capital, rights flowing from ownership of capital and regulation of various stakeholders with regard to capital, while the capital market regulator should work out the details through regulations governing the operation of the capital market. The Committee also recommended the rationalization and reduction of timeframe prescribed under the law for the process of issue of capital to bring it at par with international practices. The Committee further suggested the introduction of concept of Deemed Approval with time bound processes and favoured allowing corporate issuers of capital to use electronic media in the process of issue of capital as well as reducing the cost of raising capital through a system of shelf prospectus. Non-compliance with disclosure norms relating to access to capital market or raising money fraudulently has been recommended by the Committee to be subject to strict penalty regime.

Over the years, Securities and Exchange Board of India (SEBI) has done a commendable job in issuing and wherever required modifying guidelines from time to time with an aim to protect the investors' interest as well as to enhance transparency and fairness, relating to disclosure and eligibility norms. Operational procedures have also been simplified to facilitate mobilization of resources. In terms of eligibility norms, SEBI allows making of an IPO of equity shares, by an unlisted company with a track record of profitability including conditions of net worth, net tangible assets etc. An unlisted company not complying with any of the above conditions is also allowed to make an IPO, provided the issue is made through the book building process, with at least 50% of the issue size being allotted to the Qualified Institutional Buyers (QIBs), failing which the full subscription money have to be refunded, or the project has at least 15% participation by Financial Institutions/Scheduled Commercial Banks, of which at least 10% comes from the appraisers. In addition, at least 10% of the issue size is to be allotted to QIBs, otherwise the full subscription money is to be refunded. Also, the minimum post issue face value capital of the company has to be Rs. 10 Crore or, there should be a compulsory market making for at least 2 years from the date of listing of the shares subject to certain conditions stipulated in the guidelines.

New trends are emerging as shown by issuance of novel categories of capital in the form of Tracking Shares and Treasury Stock in the overseas markets. The issuer may have to tackle these in not too distant a future.

A listed company is eligible to make a public offer of equity shares, provided the aggregate issue size of the proposed issue alongwith all the previous issues made during the same financial year should not exceed 5 times its pre issue net worth as per the audited balance sheet of the last financial year. In case the name of the company has been changed in the last one year, then the revenue accounted in the new name should not be less than 50% of the total revenue in the preceding one full year period. SEBI has also issued guidelines relating to promoters contribution and lock-in period and regulations relating to substantial acquisition of shares and takeover, in fact, the regulatory framework prescribed by SEBI for initial public offering is at par with global standards and continues to evolve.

The book building in public issue of equity shares has been a significant innovation in the sphere of price discovery of an issue. Based on the bids received at various prices from the investors, demand is assessed and thereafter the price of the equity shares is discovered. In this process the issuer has to enter into an agreement with one or more stock exchange(s), which have the appropriate system to offer on-line securities.

In case the offer is through 100% book building process, then the guidelines require not less than 35% of the net offer to be made to retail individual investors; not less than 15% to non-institutional investors, i.e. other than retail individual investors and QIBs, and not more than 50% of the net offer to QIBs. Specific conditions have also been stipulated in respect of offering through book building in other situations. Book building system requires that the issuer to provide indicative floor price and no ceiling price bid to remain open for at least 5 days. Only electronic bidding is permitted and bids are submitted through syndicate members, while investors can bid at any price, retail investors have option to bid at cut-off price. Bidding demand is displayed at the end of every day. The lead merchant banker analyses the demand and determines the issue price in consultation with issuer and other entities.

Another important aspect of public issue of equity shares is the publication of offer document or prospectus. Both the draft offer document and the final offer document should be approved by the Board of Directors and signed by all the Directors including the Chief Executive Officer (CEO), the Company Secretary who is the Compliance Officer and Chief Financial Officer (CFO). They should also certify that all the disclosures made in the offer document are true and correct. The draft offer document has to be duly approved by SEBI. Also the offer document is required to be filed with the Registrar of Companies (ROC) and the designated stock exchange(s). The contents of the offer document, duly prescribed by SEBI, normally relate to information relating to issue, purpose of the issue, risks envisaged by the management and how those risks are proposed to be addressed. Industry environment, detailed information on the issuer, full disclosure of financial information, management discussion and analysis of financial statements, accounting standards, financial ratios, accounting policies and related matters should also form part of the offer document. The offer document should reveal all outstanding litigations being faced by the issuer and its promoters as well as directors, compliances of all laws, regulations and guidelines of the Government and the concerned regulatory authorities.

Road Shows

The success of an IPO crucially depends upon effective marketing of the issue to the different investor groups. Once, all the pre-issue process of an IPO, including all regulatory approvals and compliances are complete, the management together with the lead merchant bankers and other intermediaries should draw up a comprehensive plan for 'Road Shows' as it is customarily termed to market the issue. If global investors are also targeted, the 'Road Shows' should also be organized at important investor centres both within the country and abroad. The involvement of top management in the process is very crucial in making presentations as well as in replying to the queries, which may be posed by the prospective investors.

Abroad, the practice of making the road show presentation after filing the offer document with the authorities is widespread. The merchant bankers have every incentive in ensuring a successful road show. Prior to the road show presentations are made to the merchant bankers' sales forces. The prior presentations educate the sales forces about the company and enable them to call on their retail accounts to solicit interest in the IPO.

Road show presentations provide large amount of high-level information in a very short period of time. Herein a representative from the lead underwriter introduces the management team. He also makes initial remarks about the company and the industry. The CEO then speaks to investors giving an overview of the company, its history, business, products and services, sales and marketing, customers, competitive situation, etc.

This is followed by a presentation by the CFO who reviews the financial and accounting matters. The entire road show presentation should not give any information that is not contained in the prospectus. Otherwise the extraneous information may serve as the basis for a claim against the company for publishing misleading prospectus.

Any company issuing equity shares to the public has to enter into a Memorandum of Understanding (MOU) with lead merchant bankers, specifying rights, liabilities and obligations of parties. The lead merchant banker should exercise due diligence and satisfy itself of the all aspects of offering, veracity and adequacy of disclosures in the offer document. All the other formalities like allotment, refund, and dispatch of certificates are also taken care of by the lead merchant banker. The lead manager should also ensure that the issuer company has entered into agreements with all the depositories for dematerialization of equity shares and that the investors have been given an option to receive equity shares in dematerialized form through any of the depositories.

In case of an under subscription, the lead merchant banker is authorized to invoke underwriting obligations and ensure that the merchant bankers pay the amount devolved. The merchant banker has to appoint a compliance officer to directly liaise between the regulatory authorities and the issuer company with regard to compliances of various laws, rules, regulations and other directives issued by SEBI.

After the issue, the lead merchant banker should ensure that post issue monitoring reports are submitted irrespective of the level of subscriptions. The merchant banker should also monitor the redressal of investor grievances. In a public issue, the Managing Director of a Designated Stock Exchange alongwith the post issue lead merchant banker and the Registrars to the Issue should be responsible for the finalization of allotment in a fair and proper manner. Under e-IPOs, a company proposing to issue capital to public through the online system is required to enter into an agreement with the stock exchange (s).

SEBI has recently made IPO grading mandatory. Though there have been different views for and against IPO grading, considering the retail investors, it is a positive move on the part of SEBI to make the same mandatory. The primary reason being, it helps the small investor to take informed decision, with confidence. Further, many investors will not be in a position to read and understand the descriptive and technical aspects of abridged prospectus. Through IPO grading, aspects such as risks involved in business, promoters' track record forward looking statements, litigation status etc are being analysed by a recognized credit rating agency.

Though some analysts may feel differently who feel that IPO grading would increase cost of compliance and may constrain fund managers who may not be able to invest in low graded IPOs for fear of being reprimanded later even if they make a positive assessment of their value. Also at present there is no uniform methodology and the weightages assigned to various parameters may be questionable but which I am sure would evolve with time. Most importantly they feel that IPOs are all about the future generation of value, while IPO grading may substantially be based on the past performance.

Having regard to the stringent legal and regulatory framework of public issue of shares, the role of Company Secretaries, may be considered quite vital at several stages in the whole process. The compliance officer, normally a Company Secretary, is key personnel in whole process. Company secretaries in practice may be involved at many stages by the external agencies such as lead merchant bankers and others to certify the veracity of compliances with laws, regulations, rules etc. required by the regulatory authorities. Company Secretary is a specialist in corporate governance and contributes to improvement of corporate governance, which role assumes great significance for the company in the context of IPO. Company Secretary entails, through her/his persistent work, a culture of corporate governance consciousness in the company. This betters the prospects of successful listing of the company's shares.

I am of the firm belief that once listed it forces the company to perform better, have better governance practices as all companies naturally want to meet the expectations of various stakeholders and I think corporates realize today that investors always pay a premium to those corporates who not only perform better but follow good practices too.

Pricing

A proper balance must be struck while pricing an IPO. There is an alignment of interests between the company and the merchant banker when it comes to pricing the IPO. A higher price raises more money for the company with less dilution and higher fees for the merchant banker. The company and the merchant banker have an incentive to establish as high a price as possible while ensuring good after-market demand that will support the trading price in the days following the IPO. They must however remember that an unsustainably high price can harm both. Disappointing aftermarket performance may make investors and analysts lose interest making a follow-on offering more difficult. The company may even face securities litigation. There is also a threat to the merchant banker' credibility with their institutional accounts.

The merchant banker access different financial models to determine company valuations. During the underwriter selection process the company will become familiar with the valuation approach of the underwriter. When there are comparable companies in the same industry, which are publicly traded, the merchant banker generally will use a similar multiple of earnings, revenue or cash flow while valuing the company. Otherwise, a discounted cash flow or net present value method will be used discounting the projected cash flow or earnings to a current valuation.

A discount will be applied on this valuation for ensuring after-market demand. Such a discount is also called for to reflect the relatively higher risk of investing in a new, unproven company as compared to more established companies with greater resources.

The merchant banker will have a good feel for the demand for the company shares as they near the end of the road show and encounter the levels of potential orders. During the road show merchant banker tabulates the indications of interest and provide the company with visibility as the "book" is built during the progress of the road show.

Thus an IPO process comprises of a series of events, some of which are sequential while others could be simultaneous. The objective would be to complete the process within agiven time frame. The process involves a large number of intermediaries, advisors, beside the full commitment of the management in the entire chain of events.