IPO Grading – Demystified!

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After the Securities and Exchange Board of India (SEBI) made the grading of initial public offerings (IPOs) mandatory for all issuers, many questions have been asked about the significance of the move and its effect on the Indian equity markets. This commentary explains the utility of IPO grading for the investment process, and its benefits to both the issuer and investor. It also seeks to clarify some misconceptions about IPO grading.

Background

For several years, SEBI has mandated increasing disclosure levels by companies seeking to access the capital markets for funding. However, these disclosures sometimes demand fairly high levels of analytical sophistication for a complete understanding; investors, particularly small ones, may not always possess such skills.

Also, in the interest of investor protection, regulators the world over have been seeking to improve the functioning of equity markets by introducing independent views and research into the equity market. Initiatives in this direction include the Spitzer settlement, and exchange-funded research. However, independent research that is structured as an investment recommendation (of the 'buy/sell/hold' variety) has struggled for business viability in the presence of free research from brokers and investment banks.

Considering this scenario, SEBI in January 2006 introduced a grading system for Indian equity IPOs. The objective was to encourage independent research into the equity market, capitalising on the high disclosure levels already prevalent. The grading was to be done by rating agencies, since rating agencies are independent of the issue-selling process, and their proficiency in analysis would give investors an expert opinion. To better understand the mechanics and utility of the IPO rating process, IPO gradings were assigned to 20 equity issues by three rating agencies in a pilot project in the second half of 2006. Taking on board the learnings from this pilot exercise, SEBI made IPO grading mandatory in April 2007 for all issues where offer documents were filed with SEBI after April 2007.

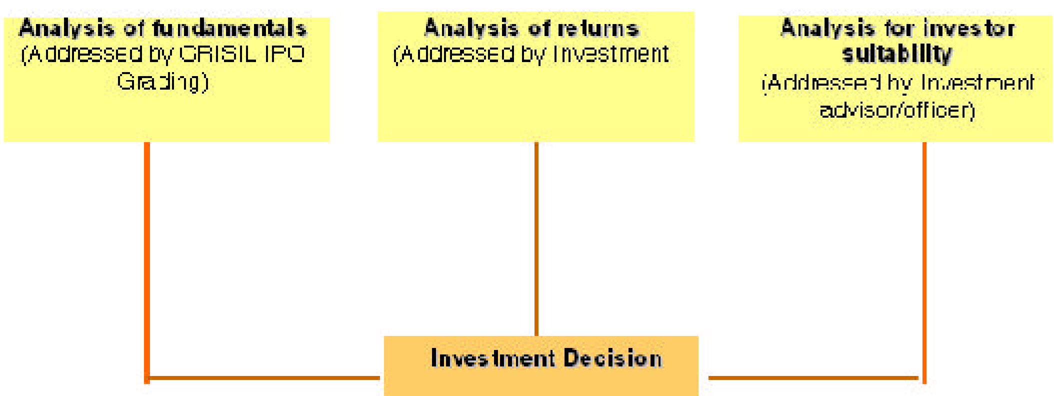
Definition of IPO grading

IPO grading represents an overall assessment of the fundamentals of the issue, graded in relation to other listed equity securities in India. The grade is assigned on a five-point scale, with 1/5 representing poor fundamentals, and 5/5 representing strong fundamentals. The grade facilitates comparison of fundamentals between companies, irrespective of size or industry. Each IPO grading is accompanied by a short rationale detailing the reasons behind the grade assigned.

The place of IPO grading in the investment process

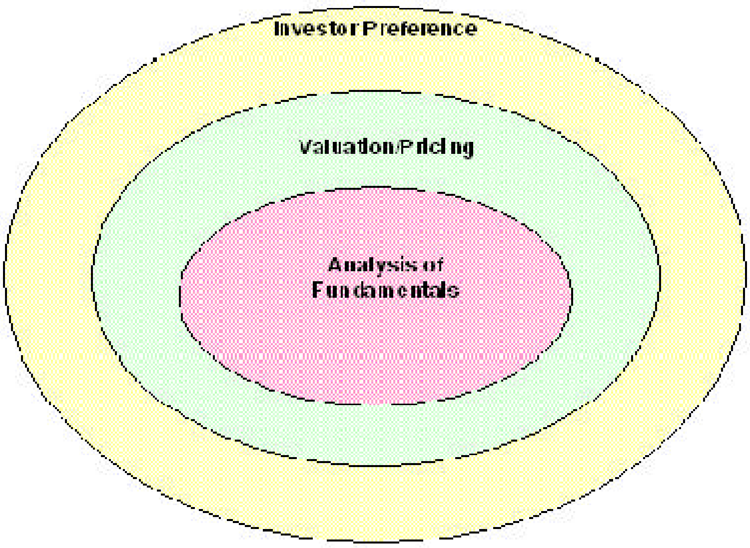
The generic components of any investment decision consist of an analysis of fundamentals, an analysis of returns/ pricing, and an opinion on suitability for the investor (see Chart 1).

Chart 1: Components of an investment decision



Since these components follow each other chronologically, it is useful if fundamentals are analysed in a manner that facilitates the pricing decision; this analysis also needs to enable investors to clearly understand if the investments fit their investment objectives and needs. Chart 2 below gives a schematic representation of this concept.

Chart 2: Order of analysis of components of the investment decision



The bond market uses an analysis of fundamentals in a comparative framework (credit rating) that easily dovetails into the pricing decision (where a clear relationship between credit rating and pricing emerges). These components together present a clear choice to the investor across, say, 'speculative' bonds and 'high safety' bonds.

IPO grading seeks to learn from rating practices in the bond market that have worked well for close to 50 years. It disaggregates the equity investment decision into its components, each of which are analysed separately.

Fundamentals defined: CRISIL's IPO Grading framework

An IPO grading requires a fairly clear delineation of that frequently talked about but often amorphous concept called 'fundamentals', in the context of equity investment. CRISIL has arrived at the constituents of fundamentals, based on extensive interactions with participants in the equity markets – such as corporates, merchant bankers, and banks – and its understanding of the Indian market. CRISIL's IPO Grading is a relative assessment on these constituents of equity fundamentals, which include:

- **Management capabilities**
  - *Experience, consistency of performance, success of past strategies*
- **Business prospects**
  - *Industry: growth prospects, degree of competition, regulatory environment*
  - *Company: revenue growth, market position, operational efficiency/cost control*
- **Corporate governance**
  - *Board functioning and composition, governance processes, transparency and disclosure levels, to ensure that all benefits and risks of the business are equally shared by all categories of shareholders*
- **Financial performance**
  - *Accounting quality: bringing disparate treatment of items to a common level*
  - *Profit levels and growth, return on equity, financial flexibility*
- **Other factors**
  - *Track record on compliance and litigation, capital history*
  - *Other details: Stature of auditor, lead manager, listing arrangements*

Benefits of IPO grading

An IPO grading offers the following benefits to investors:

1. Disaggregated analysis of the components of the investment decision and the introduction of fundamental analysis for its own sake will improve the efficacy of the equity investment process.
2. Presenting the analysis of fundamentals in a framework that is comparable across companies and industries facilitates the emergence of a clearer relationship between fundamentals and pricing than is currently possible.
3. An independent opinion on fundamentals from an informed and independent agency that is not linked to the placement of the equity issue will enhance the quality of information available to investors.
4. The grading rationale succinctly presents all the information that is relevant for an investor.

CRISIL believes that IPO grading adds value for issuers too, as it prepares them for investor scrutiny by asking questions that investors typically ask of a public company. In the pilot exercise, the seven issuers that CRISIL graded were unanimous in their opinion that they found the experience of undergoing an IPO grading value–adding, and 'a good learning experience'.

Caveat emptor

While discussing the benefits of IPO grading, it is also useful to understand that it is *not*:

1. A recommendation to invest or not invest in the graded security
2. A valuation of the equity offering – present or future
3. An audit of the issuer
4. A forensic exercise that can detect fraud

Myths regarding IPO grading

CRISIL believes that some of the criticism of the concept of IPO grading and its utility arises out of incomplete or erroneous understanding of the methodology. A few of these issues are discussed below:

1. **IPO grading is based on past performance.**
   CRISIL's IPO Grading is based entirely on the assessment of expected future performance, taking into account the business plan of the company's management as CRISIL understands it. CRISIL subjects the business plan to extensive reality checks based on its understanding of industry and market dynamics, management capability, and the management's track record of translating intentions into action. Past performance will be studied only to the extent it acts as an indicator of future performance.

2. **The size of the issuer is a constraint in getting a high grade.**
   The size of the issuer is taken into consideration only to the extent that it has a direct influence on the competitiveness of the company or impacts its future growth. Therefore, a high grading could be assigned to a small company in a rapidly-growing business area.

3. **IPO grading is an investment recommendation.**
   No. Investment recommendations are expressed as 'buy', 'hold', or 'sell', and are based on a composite comparative assessment of '**fundamental factors**' (such as business prospects and financial position), '**market factors**' (such as liquidity and demand/supply), and current **price**.

   IPO grading addresses only one of the above three: fundamentals. Investors have to use this as an input in relation to price, keeping in mind the question of suitability to their needs. Only then should an investment decision be made. To illustrate, an IPO graded 5/5 would not be an attractive investment opportunity if the valuation was very high.

4. **Is IPO grading the same as issuer credit rating?**
   Though the basic elements of the analysis that goes into issuer credit rating and IPO grading are the same, the orientation of the analysis and, therefore, the outcomes, are very different as the assessment is done for different objectives.

   Credit rating assesses fundamental factors from a debt-holders' perspective, which is distinct from – and sometimes opposite to – an equity-holders' perspective. For instance, some companies raise far more equity through IPOs than they need, and hence suffer depressed return on equity (RoE); such companies are likely to be assessed unfavourably in the IPO grading exercise. However, they are likely to be assessed more favourably in a credit rating exercise, as equity cushions debt repayment. Likewise, a financially aggressive, risk-taking management style could be a negative in a credit rating assessment: debt investors do not get to participate in the higher returns arising out of risk-taking by the management, but are exposed to the downsides of any high-risk ventures.

This distinction of objectives also means that the relative emphasis on the elements is very different in IPO grading and credit rating. For instance, the assessment of corporate governance while evaluating an IPO grading would tend to assume a much more pervasive character than in credit rating, as it affects the ability company to deal with all its stakeholders in a sustainably value accretive manner.

Given these differences in analytical approach, CRISIL does not carry out IPO grading in its credit rating division.

5. **The grading agency's opinion is not independent because the issuer pays for the grading.**
Experience from the bond market, where issuers pay for credit ratings, indicates that the existence of this conflict does not by itself lead to lax standards. This is because the reputation of the grading agency would play a crucial role in the perceived value of the grading. Although the company pays for the grading, it is the investor who will use it. Like any other product or service, the value of the grade would depend entirely on the perceptions of the investor. Consequently, people would invest only in IPOs carrying gradings that they find objective, independent, and analytically rigorous. Thus, grading agencies would have a strong incentive to maintain their independence due to the reputation risk arising out of lax standards. CRISIL also ensures that the grading is free from any individual bias by using a multi-layered process for assigning the grading, where the facts underlying every grading are deliberated in a grading committee. In addition, the team that works on assigning the grading is completely separate from the business development team that originates the assignment.

6. **Comparing companies making an IPO to all other listed companies in India is 'unfair'.**
IPO grading is aimed to aid the investor. The investible rupee is fungible across both companies making an IPO and secondary market companies. Therefore, if IPO grading is to meet investors' needs, companies making IPOs would need to be compared with all companies that are potential investment equity options for the investor, including companies whose shares are already traded.

The way forward

CRISIL believes that, over time, CRISIL IPO Grading will emerge as a useful valuation tool for equity shares just as credit ratings are used for the valuation of bonds. Once a sufficient number of gradings are assigned, the market will develop robust ways of linking the grades to the price of the equity issue just as the market has developed a robust relationship between credit ratings and bond prices.