Role of Institutional Investors in IPOs

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With most capital issues in India relying heavily on a robust demand from institutional investors, the importance of this class of investors cannot go without an underline.

This includes an important role in the process of demand and price discovery. Institutional investors enjoy minimum allocations of 50% (60% in case of Rule 19(2b) issues) of the net offer in book built issues. The Institutional demand for the equity offered in an IPO is ascertained upfront and facilitates price band fixation and appetite for the offering. Book Building is essentially a process used by companies raising capital through Public Offerings for both Initial Public Offers (IPOs) and Follow-on Public Offers (FPOs) to aid price and demand discovery. It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices, which are within the price band specified by the issuer.

The price band adopted is based on the valuation of the company and the market appetite for the stock. The process is directed towards the institutional, non-institutional as well as the retail investors. The issue price is determined after the bid closure based on the demand generated in the process. The flip side of the whole process is that investors bid in the 'Guided Price Band' and are not free to quote a price.

Historically, IPOs which have received robust demand from Institutions have received tremendous response from retail and non-institutional investors.

Institutional investors, in India, face fewer protective regulations since its assumed that this category of investors are more sophisticated and have the wherewithal to judge valuations and fundamentals. Institutions maintain huge corpus of funds which has to be deployed in various asset categories including equity. They have the expertise and resource pool & leverage their understanding of the market, sector, previous investments etc. to convert their investments into profitable ventures. It is well perceived that if an institution is ready to put its money, the issuer company will be a long term counter for other investors too and their presence in a company boosts the confidence of retail and non-institutional investors in the equity offering. Furthermore, the participation of institutional investors in the IPO ensures post-listing liquidity which facilitates fresh buying and selling.

Institutional investors have played an important role in the mop-up of funds from the capital markets for Indian companies. This year in the fist six months, Indian companies raised $38.33 billion (Rs1.66 trillion today) from loans and initial public offerings, or IPOs, both in the domestic market and overseas, according to 'Bloomberg'. Of this, around $9.8 billion was raised from syndicated loans in foreign currencies. Domestic bonds contributed $9.4 billion. In terms of IPOs, Deutsche Bank AG topped the underwriter league tables. And in terms of local loans, State Bank of India topped the league tables.

A look at the QIB investments vis-à-vis subscription in IPOs in some of the recent issues reflects the importance of institutional investors. In January 2008, for Reliance Power's issue of Rs.9234 - 10260 crores, QIB subscription was 82 times against the overall subscription of 73 times; for an issue size of Rs.491 crores of Future Capital, QIB subscription was nearly 181 times against the overall subscription of 131 times. On Mobile Global's issue of Rs.480 crores, QIB subscription was about 17.16 times against the overall subscription of 10.85 times. In March 2008, Titagarh Wagons' issue of Rs.130 crores saw QIB subscription of about 11 times against the overall subscription of 6.6 times.

Currently, Institutions are required to pay 10% of the funds at the time of application and the balance, if any, after closure of the IPO. However, proposal on the regulator's anvil for introducing 100% margin at the time of application if adopted , can further boost confidence amongst small investors as this will be treated as a measure of parity and higher commitment from the Institutions.

The regulator with its intention to facilitate greater participation by Institutions has allowed pre-IPO placements. Pre-IPO investment is a display of confidence by the Institution in the fundamentals of the company. The credibility of the Institution and the amount of equity commitment helps small investors in taking their investment judgment.

To further increase direct participation by Institution investors, SEBI has enacted guidelines for Qualified Institutional Placements (QIP). In a QIP only Qualified Institutional Buyers are allowed to invest in the equity of a listed Company and the Issuer Company should be in compliance of the minimum public shareholding requirements of the Stock Exchange. Salient features of a QIP are as under:-

- Only QIBs are eligible for allotment of specified securities issued through the QIP route.
- Minimum of 10 per cent of specified securities issued shall be allotted to mutual funds. Provided, if no

mutual fund is agreeable to take up the minimum portion or any part thereof, such minimum portion or part thereof may be allotted to other QIBs.

- No allotment to be made to any QIB being a promoter or any person related to Promoter.
- Minimum number of allottees to be two, where the issue size is less than or equal to Rs. 250 crores and five, where the issue size is greater than Rs. 250 crores. However no single allottee shall be allotted more than 50% of the issue size.

In the first half of 2008, the top 11 domestic equity qualified institutional placements totaled Rs 2800 crore and this trend is only expected to increase.

QIBs have a major portion of IPO quota of 50% as against retail investors who have a quota of 35%.The response of these large investors is now considered as a guide by the lay investors for subscribing to book built IPOs. This can prove to be misleading if the QIBs enter the issue for listing gains. In the case of Reliance Power IPO listing, 7 Mauritius based FIIs sold in falling markets on the date of listing at Rs 370 against the allotment price of Rs 450. Such huge selling made the shares listed on NSE for 530 and BSE for 547, fall within 4 minutes by 26% in NSE and 28% in BSE sucking nearly Rs30,000 crores from the investors . This clearly is an indication that large investors are also in the game for short term gains and lay investors can burn their fingers by considering FIIs response before rushing for an IPO. Blind response to an IPO for short term gains makes the stocks overpriced with the investors ending up paying more than the value for companies which have yet to prove its credentials.