

Relating IPO Gradings to markets and corporate governance



Roopa Kudva
Managing Director & CEO
CRISIL Ltd.

In 2008, the Indian equity markets witnessed an unprecedented meltdown, the worst in its history and reflected in a decline of over 50% in key indices. The fraud at Satyam Computers which came to light in early 2009 brought the role corporate governance into critical focus, raising several troublesome questions. In this backdrop of market upheaval, underscored by a sluggish economic outlook in general, heightened concerns on some sectors in particular, Initial Public Offers (IPOs) of equities virtually dried up, especially after the third quarter of 2008.

While the concept and practice of IPO gradings is still very much at a nascent stage, CRISIL Research carried out a comprehensive exercise comparing IPO gradings to the performance of such companies on various parameters in an effort to explore potentially strong correlations, and over time can serve as metrics for IPO gradings. Another perspective that the CRISIL's study explored was the relationship between IPO gradings and management quality/corporate governance.

Notwithstanding the limitations of small sample size, the results of the study suggests strongly that CRISIL IPO Gradings are measuring what they were expected to measure, namely fundamentals and growth prospects. It also brings out that the high emphasis laid on corporate governance and management in IPO

gradings.

CRISIL Research's key findings are presented in this commentary.

CRISIL IPO Gradings: Status

Since the time IPO gradings grading became mandatory in July 2007, CRISIL has graded 29 companies. Out of the gradings assigned so far, 14 companies have tapped the primary market for fund raising and hence subsequently got listed. The remaining 15 companies are understood to have postponed or dropped their IPO plans for the present; probably due to weak equity market sentiments.

Table: 1: CRISIL IPO gradings outstanding as of May 31, 2009

Grades	No of Companies	No of Listed Cos.
1	3	3
2	6	1
3	11	6
4	7	4
5	2	0
Total	29	14

CRISIL IPO Grading Methodology: A recap

For any analysis involving IPO gradings it would be pertinent to relate it to the objective and framework of analysis followed for the gradings.

CRISIL IPO gradings are aimed at providing guidance to investors on the fundamentals of companies approaching the primary market and are of added significance in the case of relatively less-known companies. The grades are meant to be used by investors in conjunction with their personal risk appetites, price and return considerations

The CRISIL IPO grading assessment combines quantitative analysis as well as qualitative judgement covering the following parameters:

1. Business Prospects, including an assessment of industry and company's prospects
2. Management track record and competence
3. Financial performance – past and expected
4. Corporate Governance

The methodology is holistic and does not assign any pre-defined weights for any of the above parameters. This is to ensure that adequate weightage is given the most relevant factor in our judgment, rather than follow a stereotyped analysis, which might be irrelevant to circumstances. For example: if a company enjoys good business prospects but has very poor corporate governance mechanisms, then factoring in the importance of the latter, the overall grade assigned to the company is likely to be on a lower side.

Comparing IPO gradings to performance on financial parameters

CRISIL carried out an extensive review exercise on the 14 companies that it has graded and which were subsequently listed. Only the listed companies were selected for the analysis, as otherwise there would be no or limited access to performance details pertaining to the company. The broad approach adopted was to look for logical linkages or correlation between IPO gradings at a particular level, and performance of the companies. Although the lack of adequate time-series data posed a challenge, the following conclusions could be drawn from the study

● Market valuations exhibit a fair degree of correlation with CRISIL IPO Gradings

Of the various parameters tested for correlation, it was observed that market valuations, as reflected in the trailing P/E multiples exhibited strong correlation with CRISIL IPO gradings. (See Table 2 below)

It was observed that companies with higher gradings enjoyed, on an average, higher PE multiples (based on their FY08 EPS) six months post listing. CRISIL Research observed that P/E multiples for companies with Grade of 1/5 on an average were 5.22 while that for Grade 4/5 were around 21. CRISIL IPO Grade 2/5 and 3/5 had on an average P/E multiple of 6.15 and 14 respectively. None of the companies with CRISIL IPO Grade 5/5 have been listed and therefore could not be tested for correlations. The above linkages are in line with the CRISIL Research opinion's that it takes around six months post listing for a fair price discovery of any stock in the market. Listing price and subsequent movement in the stock price post IPO Listing is normally very volatile due to position taken in the stock by investors with varying objectives.

Table 2: IPO grade correlation with market valuations

CRISIL IPO Grade	Avg. P/E Ratio
1/5	5.22
2/5	6.15
3/5	14
4/5	21

The Price to Earnings multiple is an indicator of how much an investor is willing to pay for company's stock, keeping in mind its earnings and growth potential and fundamentals. Investors tend to be willing to pay premium for a company that is expected to hold superior growth opportunities, which is often the case with leading companies in a "sunrise" sector. Given that in CRISIL IPO Grading, assessment of industry prospects and company prospects are key factors considered while arriving at the overall grading, the above correlation is significant, and suggests that trailing P/E multiple could be a good market metric for evaluating effectiveness of IPO gradings

While the current sample size is limited, CRISIL expects that with the number of IPO gradings increasing over a period of time, it would be possible to explore and further establish this correlation. It is also expected to get more robust studies conducted, in different market circumstances, keeping in mind that the period of study has coincided with the worst equity market conditions in several decades, due to the global financial market crisis.

● More robust correlations likely once market stabilises post impact of global meltdown

The global meltdown seen in 2008-09 has been unprecedented in terms of scale and impact, and while relatively less affected, India and Indian business have witnessed a degree of impact significantly belying assumptions and prior expectations. As a consequence, given that most of the IPO gradings were completed before mid-2008, much of the economic and business assumptions underlying the evaluation have turned out to be anachronistic, in view of the altered macroeconomic environment. It is also relevant to note that the Indian equity market had risen to levels hitherto unprecedented, before the market crash.

In CRISIL Research's opinion, the market discontinuity introduces significant "noise" in the data used as input during this period, and creates potential for misinterpreting the relationship between performance and IPO gradings. However, once the market stabilises, and the impact of extreme volatility can be isolated, more robust metrics are likely to evolve.

The importance of qualitative judgement in IPO gradings

As indicated earlier, parameters used in the grading methodology are both qualitative and quantitative. While quantitative analysis in IPO gradings, such as on financial parameters lend a degree of objectivity to benchmarking and performance analysis, some of the qualitative aspects such as corporate governance and management quality are equally integral to fundamental strength of a company. Especially in an environment where business uncertainties and volatility tend to be high, these governance attributes are what invariably determine the relative success or failure of corporations. However the assessments of these attributes necessarily involve a degree of judgement – and more often than not, the impact of these attributes will be evident in a company's performance only over the medium to long term. Over a long enough period of time, it is however reasonable expect that good quality management and good governance has also to reflect in sustained financial performance and shareholder wealth creation.

In relating this perspective to IPO gradings, it needs to be noted that many companies doing IPO's are small and mid cap, with their track record and corporate governance architecture not widely known to the market. In such a situation, even if corporate governance is inherently and relatively strong, the market may accord a premium for the valuation multiples only after these companies have established best practices over a period of time, when sustained shareholder wealth creation is proven. Similarly, the absence of good corporate governance may not reflect in the valuations and market behaviour pertaining to a company, till such time as impact starts showing in performance. CRISIL's assessment of corporate governance and management tries to take a forward looking view at the time of IPO grading assessment itself, which may fully reflect in market parameters only over a period of time.

In this context, it is pertinent to note that the CRISIL IPO Grading methodology includes both qualitative and quantitative measures and the weights assigned to each factor is judgmental. Hence, any study trying to correlate first level financial parameters or numeric indicators will have limitations and are unlikely to be effective measures of the efficacy of the gradings.

Relating corporate governance to CRISIL IPO gradings

As indicated earlier, CRISIL's IPO grading methodology include a broad assessment of corporate governance and management quality, apart from other key factors such as industry and business prospects, and financial performance..

For the purpose of studying the impact of corporate governance on IPO gradings, the study considered all the 29 IPOs graded by CRISIL since May 2007.

● Corporate government assessment in CRISIL IPO Gradings

In assessing corporate governance standards, CRISIL Research makes a broad-brush assessment of the shareholding structure, board composition, typical board processes, disclosure standards and related party transactions of the company. Qualifications by regulators or auditors also serve as useful inputs.

● Corporate Governance issues in 50% of IPO gradings

The look-back analysis by CRISIL Research revealed that corporate governance structures were found to be 'weak' in close to 50 per cent of the companies. Only about 10 per cent of these 29 companies were assessed to have robust corporate governance structures, whereas 25 per cent of them were 'average' and 15 per cent were 'above average'. Specifically, the quality of the Board and their independence and propensity for related party transactions emerged as key differentiators between well governed and weakly governed IPO graded companies.

● Limited independence and understanding of the Board

CRISIL Research observed that in contrast to well-governed companies, weakly governed IPO graded companies displayed limited independence of the Board from promoters, limited understanding of the independent directors about the business of the company, and a higher propensity for related-party transactions. In over 45 per cent companies with relatively weak governance scores, independent directors exhibited less than expected awareness about the company's businesses or other businesses of the promoter group, or even IPO related plans and strategies of the company. Moreover, in 15 per cent of the cases, the quality of independence of the Board from promoters or management was itself an area of concern, as it could impact the extent of balance and quality of oversight that independent directors are expected to bring to bear on board decisions.

● High propensity for related party transactions

In about 55 per cent of the companies assessed to have governance issues, related party transactions or presence of group companies in similar lines of business emerged as key issues, as these could potentially affect minority shareholder interests.

Summary and Conclusions

CRISIL's analysis reveals that CRISIL IPO Gradings seem to have a fairly strong correlation with trailing P/E multiples. This is significant given that the P/E multiple generally reflects the market's assessment of a company's growth potential and fundamentals. Similarly an IPO grading reflects a relative position of a company based on the industry and company growth prospects, as well as structural fundamentals such as management quality and corporate governance quality which have a bearing on future wealth management. The correlation between the two therefore suggests strongly that CRISIL IPO Gradings are measuring what they were expected to measure, namely fundamentals and growth prospects.

For further correlations to be established, data is required to be captured and synthesized on a systematic basis over time. CRISIL's experience while developing metrics for credit ratings is instructive in this regard, where robust measures such as default statistics and financial medians for the Indian market were tested and established over a period of over 10 years. Such a systematic approach not only helps in the development and refinement of good metrics, but will also serve as a good feedback mechanism for the analytics, and assist in making refinements to the grading methodology.

The importance of assessment of qualitative parameters in CRISIL IPO gradings is at least as important as that of the assessment on quantitative parameters. Corporate governance in particular has a critical bearing, and this is borne out by the fact that CRISIL IPO grading reveal that nearly 50% of the IPO gradings have corporate governance related issues. While not the sole determining factor, the quality of corporate governance as assessed by CRISIL may significantly influence the CRISIL IPO grade, beyond what the company's business prospects and financials may suggest. A view on the company's corporate governance is particularly relevant for IPOs, since investors may have only limited information on the company's or promoter's track record. Nevertheless, since CRISIL IPO grading is a one-time assessment, investors need to monitor subsequent developments in the company, post-grading.
