

**“AN ANALYTICAL STUDY ON INITIAL PUBLIC OFFER (IPO) –  
SUCCESS AND FAILURE”**

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**ABSTRACT**

*Going public is, in many cases, a step towards the eventual separation of ownership and control. Ownership matters for the effects it can have on management's incentives to make optimal operating and investment decisions. In particular, where the separation of ownership and control is incomplete, an agency problem between non-managing and managing shareholders can arise rather than maximizing expected shareholder value, managers may maximize the expected private utility of their control benefits (say, perquisite consumption) at the expense of outside shareholders. Most companies that go public do so via an initial public offering of shares (IPO) to investors. New issues of existing companies are, by and large, very good investments. They provide an opportunity for acquiring shares in ongoing profit-making companies at relatively low prices. On the other hand, all new issues of newly formed companies are not good investments. One good thing about the IPO market vis-à-vis the earlier times has been that most of them have been from good companies and at reasonable prices. This trend, however, seems to be narrowing off and we are increasingly seeing public issues from the relatively not-so-good or known companies and at fairly stretched prices. Therefore, it becomes necessary for the investors to become cautious and be more selective about their investments in IPOs. The present paper examines the issues and challenges confronted the IPO. It tries to find out the strategies to IPO for investors and companies. The paper assesses the success and failure of IPO and takes into account the assessment of IPO norms and IPO grading*

**KEYWORDS:** *Initial Public Offering, IPO Grading, Primary Capital Market, Investors.*

## **INTRODUCTION**

Small companies are becoming big. They have devised novel ways to raise funds, fast, to realize inspirational growth. From the various options available, IPOs remain the hot favourite for Indian companies. The first public offer of securities by a company after its inception is known as Initial Public Offer (IPO). Going public (or participating in an “initial public offer” or IPO) is a process by which a business owned by one or several individuals is converted in to a business owned by many. It involves the offer of part ownership of the company to the public through the sale of equity securities (stock). [1]

IPO dilutes the ownership stake and diffuses corporate control as it provides ownership to investors in the form of equity shares. It can be used as exit strategy and finance strategy. As a financing strategy, its main purpose is to raise funds for the company. When used as an exit strategy, existing investors can offload equity holdings to the public. Apparently, for Indian companies, IPOs remain a hot favourite to raise funds. The model of IPOs is tried and tested by companies in various sectors. IPOs can be a risky investment. For the individual investor, it is tough to predict what the stock will do on its initial day of trading and in the near future because there is often little historical data with which to analyze the company. Also, most IPOs are of companies going through a transitory growth period, which are subject to additional uncertainty regarding their future values.

IPOs are the first offer of shares to the public. The emphasis is on

- shares,
- an offer to the wide public (otherwise it would be a private placement) and
- the first time that shares would be offered

## **REVIEW OF THE LITERATURE**

Going public is, in many cases, a step towards the eventual separation of ownership and control. Ownership matters for the effects it can have on management’s incentives to make optimal operating and investment decisions. In particular, where the separation of ownership and control is incomplete, an agency problem between non-managing and managing shareholders can arise (Jensen and Meckling (1976) [2]): rather than maximizing expected shareholder value, managers may maximize the expected private utility of their control benefits (say, perquisite consumption) at the expense of outside shareholders. Most companies that go public do so via an initial public offering of shares to investors. IPOs have interested financial economists for many decades. Early writers, notably Ibbotson (1975) [3], documented that when companies go public, the shares they sell tend to be under priced, in that the share price jumps substantially on the first day of trading. Since the 1960s, this ‘under pricing discount’ has averaged around 19% in the United States, suggesting that firms leave considerable amounts of money on the table. Under pricing has tended to fluctuate a great deal, averaging 21% in the 1960s, 12% in the 1970s, 16% in the 1980s, 21% in the 1990s, and 40% in the four years since 2000 (reflecting mostly the tail-end of the late 1990s internet boom). Clearly, under pricing is costly to a firm’s owners: shares sold for personal account are sold at too low a price, while the value of shares retained after the IPO is diluted. In dollar terms, IPO firms appear to leave many billions ‘on the table’ every year in the U.S. IPO market alone. Levis (1990) [4] conducts a similar analysis for the U.K. Though now no

longer in regular use, the preferred IPO method in the U.K. until the early 1990s was the ‘offer for sale’, which required that allocations be pro-rated in the event of over-subscription. The unconditional average degree of under pricing for the 123 IPOs in Levis’ sample is 8.6%, but this declines to 5.14% or less for medium-sized and small applications conditional on being allocated stock. Thus while rationing reduces the initial returns among small investors, it does not drive them down to zero. Keloharju (1993) [5] provides similar evidence for Finland, though he also shows that investors placing large orders lose money on an allocation-weighted basis. In Israel, this latter finding seems to hold true more generally: uninformed IPO investors do not appear to break even at all. Amihud, Hauser, and Kirsh (2003) [6] find that uninformed investors earned a negative allocation-weighted initial return in Israel in the early 1990s, of -1.2% on average.

Behavioral finance is interested in the effect on stock prices of ‘irrational’ or ‘sentiment’ investors. The potential for such an effect would seem particularly large in the case of IPOs, since IPO firms are young, immature, and relatively informational opaque and hence hard to value. The first paper to model an IPO company’s optimal response to the presence of sentiment investors is Ljungqvist, Nanda, and Singh (2004) [7]. They assume some sentiment investors hold optimistic beliefs about the future prospects for the IPO issue company. The issuer’s objective is to capture as much of the ‘surplus’ under the sentiment investors’ downward-sloping demand curve as possible, that is, to maximize the excess valuation over the fundamental value of the stock. Flooding the market with stock will depress the price, so the optimal strategy involves holding back stock in inventory to keep the price from falling. Eventually, nature reveals the true value of the stock and the price reverts to fundamental value. That is, in the long-run IPO returns are negative, consistent with the empirical evidence in Ritter (1991) [8] and others. This assumes the existence of short sale constraints, or else arbitrageurs would trade in such a way that prices reflected fundamental value even in the short term. Aggarwal (2008) [9] analyze the Indian IPO issue and their pricing mechanism with empirical studies on the valuation of IPOs and both theoretical and empirical work on the determinants of short-run under pricing. Aggarwal, Krigman and Womack (2002) [10], Madhusoodanan, and Thiripalraju (1997) [11] and Rock (1986) [12] and Jegadeesh, Weinstein, and Welch (1993) [13], amongst others have reviewed the problem of underpricing. Lowry and Schwert (2000) [14] analyzed the aggregate IPO market activity and also have examined the initial returns at the firm level. The research also studies strong cycles in the number of IPOs by calculating the average initial returns realized by investors from 1960 to 1997. The statistical measures being used in the study are mean, median, standard deviation and auto-correlations. The results show that IPOs cycles occurs and has subsequent effect on returns and underperformance. The study also shows that clustering of IPOs happens in the market and is also associated with predictably different initial returns. And also the information about the value of an IPO which is being available during registration period has an effect on the prices and offering decisions of other firms.

## **RESEARCH METHODOLOGY**

Research in common parlance refers to a search for knowledge. One can also define research as a scientific and systematic search for pertinent information on a specific topic. The present study has been undertaken to examine the issues and challenges to be addressed by means of initial public offer.

*The present paper aims to achieve the following objectives:*

- To examine the issues and challenges confronted the IPO;
- To find out the strategies to IPO for investors and companies
- To assess the success or failure of IPO
- To assess IPO norms and IPO grading.

**Area of Study**

The paper is not confined to any particular area; on the other hand it is applicable to whole India. However, opinion of officers/managers of various share broking companies in Jaipur and Moradabad district of Rajasthan and Uttar Pradesh respectively has been taken about the growth, roadblocks and benefits of IPO. Their views have been incorporated in this paper. The paper also takes the references of various articles written by various experts on IPO.

We have used qualitative research techniques as focus group discussion with respect to IPO in various share broking companies. Our focus group discussion was based on some share broking companies in region of Jaipur and Moradabad district. The discussions were based on key analysis of primary market with emphasis on IPO.

**GROWTH OF IPO MARKET IN INDIA**

Year	No of IPOs	Amount (Rs. In Crore)
1991-1992	158	724
1992-1993	467	3673
1993-1994	693	7650
1994-1995	1231	9919
1995-1996	1357	10924.11
1996-1997	717	5958.60
1997-1998	52	1047.52
1998-1999	18	404.21
1999-2000	51	2719.04
2000-2001	114	2722.38
2001-2002	7	1201.8
2002-2003	6	1038.68
2003-2004	14	1412
2004-2005	23	12382
2005-2006	79	10936
2006-2007	77	28504
2007-2008	85	42595
2008	37	18393
2009	20	19266
2010	67	38000

*Source: SEBI Annual Reports and Economic Survey Report*

**MAIN HIGHLIGHTS OF IPO MARKET IN 2009**

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The main highlights of IPO market in the year 2009 are mentioned herein below:

- NHPC, Adani Power and Cox & Kings waited for more than a year to get listed on stock exchange in 2009, though they received SEBI approval in 2007 or 2008
- Despite a surge in the secondary market, the IPO market witnessed just 20 issues in 2009 compared to 37 and 103 public issues got listed in 2008 and 2007 respectively.
- In terms of the proceeds, 2009 raised Rs. 157B from the market as compared to Rs. 185B in 2008 and Rs. 342B in 2007
- Most of the IPO activities witnessed in 2<sup>nd</sup> half of 2009. 15 out of the 17 IPOs came in the 2<sup>nd</sup> half which garnered Rs. 156.5B out of the total 2009 proceeds of Rs. 157B
- In June 2009, SEBI introduced the concept of anchor investors to help the priced discovery process, and lower listing day volatility by bringing in a class of investors with a slightly longer term view
  - An anchor investor (who cannot be a promoter of the company) can subscribe up to half of the 60% portion reserved for qualified institutional buyers in an IPO, but have to stay invested in the issue for a month after listing
  - Also, unlike other QIBs who need to pay only 10% as margin money, an anchor investor has to cough up 25% and follow it up with the remaining 75% within two days of the closure of the issue
- An anchor investor gets firm allotment of shares, as opposed to the proportionate allotment that other QIB constituents would
- SEBI also extended the ASBA (application supported blocked amount) facility to corporate investors and high net worth individuals (HNIs) to enable them to apply for IPOs or rights issue by keeping the application money in their bank accounts till allotment with effect from Jan 01, 2010
- Only 1 IPO was withdrawn in 2009 as compared to 3 in 2008
- IPO market got active in 3<sup>rd</sup> and 4<sup>th</sup> quarter of 2009
- Energy & Power, the hottest sector among the investors. All the 3 IPOs within this sector got subscribed by more than 21 times
- OIL India IPO witnessed an overwhelming response from the investors followed by NHPC, Adani Power and Indiabulls Power IPOs
- 30% of the top 10 IPOs of 2009 actually were the IPOs of 2008 or 2007, which could not hit market earlier when markets were going south

## **IPO MARKET IN 2010**

The higher valuations in the secondary market during 2010 have boosted the primary market sentiment. The number of FPOs has been declining over the years probably because they involve a further reduction in the government's stake in public sector enterprises. Besides, most of the successful public offers in recent times have been by cash-rich government companies that are

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under fewer compulsions to tap the capital market at frequent intervals. Another interesting feature is the preponderance of large-sized public issues. There were as many as 13 issues of over Rs.1,000 crore and only nine issues of less than Rs.50 crore. The large average size of the public offer reinforces the point that the new issues market has not been able to accommodate small and medium enterprises. Hence the quest for a separate, dedicated exchange for them will continue.

**IPOs IN 2009 and 2010**

S. No	Company Name	Offer Price (Rs.)	Current Price (Rs) as on 25.03.2011	% Change (+/-)	Issue Dates	Closing Date
1	Adani Power Ltd.	100	112.95	+12.95	28.07.09	31.07.09
2	Aqua Logistics	220	17.20	-92.18	25.01.10	28.01.10
3	ARSS Infrastructure Projects	450	516.70	+14.82	08.02.10	11.02.10
4	Ashoka Buildcon Ltd.	324	303.15	-06.44	24.09.10	28.09.10
5	Astec Lifesciences	82	46.05	-43.84	29.10.10	04.11.09
6	Aster Silicates Ltd.	118	25.05	-78.77	24.06.10	28.06.10
7	A2Z Maintenance and Engineering Services Ltd.	400	278.75	-30.31	08.12.10	10.12.10
8	Bajaj Corp	660	464.10	-29.68	02.08.10	05.08.10
9	Bedmutha Industries Ltd.	102	110.30	+08.14	28.09.10	01.10.10
10	Birla Shloka Edutech	50	16.55 (B)	-66.90	11.01.10	13.01.10
11	BS Transcomm Ltd.	248	92.10	-62.86	06.01.11	08.10.10
12	C Mahindra Exports Ltd.	110	249.85	+127.14	31.12.10	06.01.11
13	Cantabil Retail India Ltd	135	40.40	-70.07	22.09.10	27.09.10
14	Career Point Info systems Ltd.	310	356.25	+14.92	16.09.10	21.09.10
15	Claris Life sciences Limited	228	640.95	+181.12	24.11.10	02.12.10
16	Coal India Ltd.	245	358.10	+46.16	18.10.10	21.10.10
17	Commercial Engineers & Body Builders Co.Ltd.	127	40.80	-67.87	30.09.10	05.10.10
18	Cox and Kings (India)	330	427.75	+29.62	18.11.09	20.11.09
19	DB Reality Ltd	468	96.75	-79.33	29.01.10	02.02.10
20	DB Corp Ltd	212	247.85	+16.91	11.12.09	15.12.09
21	Den Networks Ltd	195	93.55	-52.03	28.10.09	30.10.09
22	DQ Entertainment International	80	59.90 (B)	-25.13	08.03.10	10.03.10
23	Electrosteel Integrated Ltd.	11	8.10	-26.36	21.09.10	24.09.10
24	Emmbi Polyarns	45	12.85	-71.44	01.02.10	03.02.10
25	Eros International Media	175	132.60	-24.23	17.09.10	21.09.10

	Ltd.					
26	Euro Multivision	75	14.15	-81.13	22.09.09	24.09.09
27	Excel Infoways	85	28.70	-66.24	14.07.09	17.07.09
28	Gallantt Ispat Ltd.	50	74.25	+48.50	22.09.10	24.09.10
29	Globus Spirits	100	139.40	+39.40	31.08.09	02.09.09
30	Godrej Properties	490	680.35	+38.85	09.12.09	11.12.09
31	Goenka Diamond & Jewels	135	57.60	-57.33	23.03.10	26.03.10
32	Gujarat Pipavav Port Ltd.	46	63	+36.96	23.08.10	26.08.10
33	Gravita India Ltd.	125	322.05	+157.64	01.11.10	03.11.10
34	Gyscoal Alloys Ltd	71	16.65	-76.55	13.10.10	15.10.10
35	Hathway Cable & Datacom	240	96.15	-59.94	09.02.10	11.02.10
36	Hindustan Media Ventures	166	131.55	-20.75	05.07.10	07.07.10
37	IL & FS Transport Networks	258	206.25	-20.06	11.03.10	15.03.10
38	Indiabulls Power	45	22.10	-50.89	12.10.09	15.10.09
39	Indosolar Ltd.	29	18	-37.93	13.09.10	15.09.10
40	Infinite Computer Solution India	165	162.25	-01.67	11.01.10	13.01.10
41	Intrasoft Technologies	145	67.30	-53.59	23.03.10	26.03.10
42	Jaypee Infratech Ltd.	102	56.05	-45.05	29.04.10	04.05.10
43	Jindal Cotex Ltd	75	103.10	+37.47	27.08.09	01.09.09
44	JSW Energy Ltd	100	72.80	-27.20	07.12.09	09.12.09
45	Jubilant Foodworks	145	547.85	+277.83	18.01.10	20.01.10
46	Mahindra Holidays & Resorts	300	372.10	+24.03	23.06.09	26.06.09
47	Man Infraconstruction	252	139.65	-44.58	18.02.10	22.02.10
48	Mandhana Industries	130	61.75	-52.50	27.04.10	29.04.10
49	Manganese Ore India Ltd	375	408.10	+08.83	26.11.10	01.12.10
50	MBL Infrastructures	180	176.10	-02.17	27.11.09	01.12.09
51	Microsec Financial Services Ltd.	118	39.05	-66.91	21.09.10	21.09.10
52	Midfield Industries Ltd.	133	54.15	-59.29	21.07.10	21.07.10
53	NHPC Ltd	36	23.40	-35.00	12.08.09	12.08.09
54	Nitesh Estates Ltd.	54	24.55	-54.54	27.04.10	27.04.10
55	NMDC Ltd	300	279.20	-06.93	10.03.10	12.03.10
56	NTPC Ltd.	201	182.90	-09.00	03.02.10	05.02.10
57	Oberoi Realty	260	234.80	-09.69	06.10.10	08.10.10
58	Oil India Ltd	1050	1303.25	+24.12	07.09.09	10.09.09
59	Orient Green Power Company Ltd.	47	23.65	-49.68	21.09.10	24.09.10
60	Punjab & Sind Bank	120	101.25	-15.63	13.12.10	16.12.10
61	Parabolic Drugs Ltd.	75	40.95	-45.40	14.06.10	17.06.10

62	Persistent Systems Ltd.	310	360.15	+16.18	17.03.10	19.03.10
63	Pipavav Shipyard	58	79.30	+36.72	16.09.09	18.09.09
64	Pradip Overseas	110	81.85	-25.59	11.03.10	15.03.10
65	Prakash Steelage Ltd.	110	147.90	+34.45	05.08.10	10.08.10
66	Prestige Estates Projects Ltd.	183	134.75	-26.37	12.10.10	14.10.10
67	Ramky Infrastructure Ltd.	450	282.20	-37.29	21.09.10	23.09.10
68	Ravikumar Distilleries Ltd	64	38.60	-39.69	08.12.10	10.12.10
69	Rishabhdev Technocable	33	3.83 (B)	-88.39	04.06.09	09.06.09
70	RPP Infra Projects Ltd.	75	67.05	-10.60	18.11.10	22.11.10
71	Rural Electrification Corporation	203	245.85	+21.11	19.02.08	22.02.08
72	Sea TV Network Ltd.	100	22.20 (B)	-77.80	27.09.10	29.09.10
73	Shekhawati Poly-Yarn Ltd.	30	32.70	+09.00	27.12.10	29.12.10
74	Shree Ganesh Jewellery House Ltd.	260	161.75	-37.79	19.03.10	23.03.10
75	SJVN Ltd.	26	20.15	-22.50	29.04.10	03.05.10
76	SKS Microfinance Ltd.	985	550.50	-44.11	28.07.10	02.08.10
77	Syncom Healthcare	75	33.05	-55.93	27.01.10	29.01.10
78	Talwalkars Better Value Fitness Ltd.	128	219.95	+71.84	21.04.10	23.04.10
79	Tarapur Transformers	75	23.85	-68.20	26.04.10	28.04.10
80	Technofab Engineering	240	154.10	-35.79	29.06.10	02.07.10
81	Techpro Systems Ltd.	355	258.05	-27.31	23.09.10	28.09.10
82	Texmo Pipes and Products	90	32.15	-64.28	16.02.10	19.02.10
83	Thangamayil Jewellery	75	159.70	+112.93	27.01.10	29.01.10
84	Thinksoft Global Services	125	58.30	-53.36	22.09.09	01.10.09
85	United Bank of India	66	104.10	+57.73	23.02.10	25.02.10
86	VA Tech Wabag Ltd.	1310	1289.25	-01.58	22.09.10	27.09.10
87	Vascon Engineers	165	89.90	-45.52	27.01.10	29.01.10

Source: Various sites of share broking companies

From the above table it is clear that out of 87 IPOs under study which came in the year 2009 and the year 2010, 60 IPOs are trading below their offer price as on 25.03.2011 which is indicated by negative signs in the table. By analyzing the above data we come to the conclusion that the offer price fixed by the companies is generally high. The above prices of stocks are taken as on week ending 24<sup>th</sup> March, 2011 when index was very high, SENSEX closes above 18800. When the SENSEX was below 18000 and NIFTY was below 5400, many more stocks were traded below their offer price.

### **WHO DECIDES THE PRICE BAND FOR IPO**

Company with help of lead managers (merchant bankers or syndicate members) decides the price or price band of an IPO. SEBI, the regulatory authority in India or Stock Exchanges do not play any role in fixing the price of a public issue. SEBI just validate the content of the IPO



prospectus. Companies and lead managers do lots of market research and road shows before they decide the appropriate price for the IPO. Companies carry a high risk of IPO failure if they ask for higher premium. Many a time investors do not like the company or the issue price and doesn't apply for it, resulting unsubscribe or undersubscribed issue. In this case companies' either revises the issue price or suspends the IPO.

## **WHY IPOs ARE PROFITABLE?**

Public issues provide you with an opportunity for picking up shares at relatively low prices. Newly formed companies usually offer their shares for subscription at par values, whereas existing companies price their new issues at levels which are sometimes as much as 20 to 30 per cent lower than the market price of their existing shares. For example, new issues priced at Rs. 12 to Rs. 15 per share may be quoted as high as Rs. 20 to Rs. 25 per share in the secondary market soon after their listing on the bourses. Similarly, shares issued at par by new companies also quote at high premiums soon after they get listed on the stock exchange. For example, in early 2004 public issues of Maruti Udyog, Indraprastha Gas and Divi's Labs listed at high premiums. Equally, most companies, which went in for IPOs in 2005 and 2006 did well. In most cases, the initial days after listing saw the stock prices moving well above the listing prices before settling down in a price range. Many companies, which listed during this period gave double digit returns, some companies like Indiabulls, Bharati Shipyard, India Infoline, PTC India Limited, Shoppers Stop, Sun TV Limited, Suzlon Energy and Tulip IT Services even gave triple digit returns. This is the main reason why public issues are so popular with investors; they offer opportunities for making quick money which few other forms of investment can hope to match, match particularly during the market's bull phase.

## **REASONS FOR GOING PUBLIC**

The company goes for initial public offer keeping the following objectives in mind:

- To raise funds for financing capital expenditure needs like expansion, diversification etc.
- To finance increased working capital requirement
- As an exit route for existing investors
- For debt financing
- To provide a venue for trading the company's shares
- Increase brand name
- To finance possible acquisitions
- To take up new projects
- To execute long-range business models
- To enable its existing shareholders to diversify their investments and to crystallize their capital gains from backing the company – an important consideration for venture capitalists
- By converting to corporate status, a company can always dip back into the market and offer additional shares through a rights issue

### **IPO NORMS**

A number of initiatives were taken to further rationalize the Initial Public Offer (IPO) norms:

- SEBI (Disclosure and Investor Protection) Guidelines require a minimum offering of 25 percent of post issue capital to public. This requirement was relaxed to 10 percent, first for companies in the Information Technology sector, and then in the entertainment, media and telecom sectors.
- In December 2000, this relaxation was extended to companies in all sectors. SEBI also kept the minimum offering size at Rs.100 crore and retained the existing limit of minimum public offer of 20 lakh shares. Companies not meeting the prescribed conditions need to make a minimum public offering of 25 percent.
- With a view to enhancing the quality of issues in the primary market, SEBI tightened the entry norms for IPOs. Accordingly, IPOs of issue size upto 5 times the pre-issue net worth shall be allowed only if the company has track record of profitability and net worth as specified in the Guidelines.
- The book building route has been made compulsory for companies, which do not have such track record. Further, 60 percent of the offer made by them should be allotted to Qualified Institutional Buyers (QIBs) comprising financial institutions, banks, mutual funds, FIIs and VCFs registered with SEBI. Inability to meet this condition would mean failure of the issue.
- The book- building route has also been made compulsory for IPOs with issue size more than 5 times the pre-issue net worth and for public issues by listed companies worth more than 5 times the pre-issue net worth. In these cases also, success of the issue requires allocation of 60 percent of the offer to QIBs.
- The lock-in provisions applicable to IPOs have been rationalised. While the lock-in period for minimum promoters' contribution of 20 percent shall continue to be 3 years, the balance of the entire pre- IPO capital held by promoters or others shall be locked in for 1 year from the date of allotment of the IPO.
- It has also been decided to lock in the shares issued on preferential basis by a listed company to any person for one year from the date of their allotment except in respect of issues involving share swap for acquisition.
- The procedures for allotment of shares and refunds were streamlined. The time for finalizing the allotment has been reduced from 30 to 15 days in book-built issues so as to minimize the risk arising from volatility.

### **IPO GRADING**

IPO Grades are assigned for instance ICRA grading, on a five-point point scale, where IPO Grade 5 indicates the highest grading and IPO Grade 1 indicates the lowest grading, i.e. a higher score indicates stronger fundamentals. An IPO Grade is not an opinion on the price of the issue, pre- or post-listing. An investor in a hitherto unlisted company may either have limited access to information on it, or may find it challenging to appropriately assess, on the basis of the information available, its business prospects and risks. An IPO Grade provides an additional input to investors, in arriving at an investment decision based on independent and objective

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analysis. In recent times, with the stock market participation of new and foreign investors increasing, there is need for greater value-added information on companies tapping the capital market and their intrinsic quality. In this context, IPO Grades, being simple, objective indicators of the relative fundamental positions of the issuers concerned, could help in both widening and deepening the market.

The highlights of IPO grading are:

- IPO grading is a service aimed at facilitating the assessment of equity issues offered to public and is mandatory as per SEBI guidelines
- Aimed at providing an independent assessment of fundamentals to aid comparative assessment
- Intended to serve as an Information and Investment tool for investors
- IPO grading does not take cognizance of the price of the security. It is not an investment recommendation.
- IPO Grading is required prior to marketing of the IPO and needs to be disclosed in the Red Herring Prospectus and Prospectus
- IPO Grading process involves a review of the company background, corporate governance, business, financial performance and SEBI observations

Perceived as the quality gauge for public issues, grading of initial public offers (IPOs) has failed to make a major impact either on the investment rationale of retail investors, or the wealth created by the underlying companies post-listing. In fact, the higher the grade of an IPO, the poorer has been its performance in the market. Companies such as Reliance Power, Edelweiss Capital and Gammon Infrastructure, which were rated four out of five (meaning above average fundamentals), have posted losses in the range of 46 to 56 per cent. And, nine out of 10 which were similarly graded lost more than 40 per cent, according to a report from SMC Capitals.

During 2007 and 2008, the boom years for IPOs, investors hardly took cognizance of ratings assigned to a particular company. And that was the reason why some of the companies with even absolutely low ratings managed to gather stellar subscription figures. Despite opposition from several quarters, the Securities and Exchange Board of India (SEBI) had made it mandatory for all IPOs to be graded by rating agencies from April 2007 onwards. After a company gets SEBI approval for an IPO, it has to rope in rating agencies such as ICRA, CRISIL, FITCH and CARE to get the issue graded

## **ADVANTAGES OF GOING PUBLIC**

The going public offers lots of advantages to the company as well as to the investors. The important ones are:

- **Stock holder Diversification:** As a company grows and becomes more valuable, its founders often have most of its wealth tied up in the company. By selling some of their stock in a public offer, the founders can diversify their holdings and thereby reduce somewhat the risk of their personal portfolios.
- **Easier to raise new capital:** If a privately held company wants to raise capital a sale of a

new stock, it must either go to its existing shareholders or shop around for other investors. This can often be a difficult and sometimes impossible process. By going public it becomes easier to find new investors for the business.

- **Enhance liquidity:** The stock of a closely held firm has no liquidity. If one of the holders wants to sell some of his shares, it is hard to find potential buyers-especially if the sum involved is large. Even if a buyer is located there is no established price at which to complete the transaction. These problems are easily overcome in a publicly owned company.
- **Establishes value for the firm:** This can be very useful in attracting key employees with stock options because the underlying stock has a market value and a market for them to be traded that allows for liquidity for them.
- **Image:** The reputation and visibility of the company increases. It helps to increase company and personal prestige.
- **No cost of capital:** The Company will not pay any interest on the capital raised from public in the form of an IPO. Even it doesn't need to repay the capital. Only in case of liquidation/bankruptcy it needs to pay the residual amount after paying bank loans, debentures, preferential shares etc.
- **Huge amounts can be raised:** It can raise huge amount of capital by going to public which may not be possible otherwise.
- **Debt swap:** IPOs are one of the ways to rotate debt, which means a company can use funds generated through an IPO to pay off expensive loans. By doing this, companies can reduce the debt burden, thereby, bringing about a balance in the debt-equity ratio.
- **Driving professionalism:** An IPO mandates certain standards of performance and compliance. This strengthens professionalism and regulatory awareness among companies. IPOs are a better route to raise funds, especially for SMEs and new entrants
- **Correct Valuation:** Since the share price reflects the company's financial healthiness it would become easy to arrive at a price in case of mergers and acquisitions

## **DISADVANTAGES OF GOING PUBLIC**

Going public also offers certain disadvantages such as:

- **Cost of Reporting:** A publicly owned company must file quarterly reports with the Securities and Exchange Board of India. These reports can be costly especially for small firms.
  - **Disclosure of information:** Once a company becomes public it has to disclose so much information to public on regular intervals. This includes share holding pattern, quarterly and annual financial statements, profiles of directors etc. Because of this restriction companies will always be under pressure to perform and show profits in every quarter. This, some times, doesn't allow the management to take bold steps which may yield long term benefits but less profits in short term.
  - **Self dealings:** The owner's managers of closely held companies have many opportunities for self-transactions, although legal they may not want to disclose to the public.
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- **Inactive market low price:** If a firm is very small and its shares are not traded frequently, then its stock will not really be liquid and the market price may not be truly representative of the stocks value.
- **Control:** Owning less than 50% of the shares could lead to a loss of control in the management.
- **Profit is distributed:** The profit earned by the company should be shared with its investors in the form of dividend
- **Costly affair:** An IPO is a costly affair. Around 15-20% of the amount realized is spent on raising the same. Also, a substantial amount of time and effort has to be invest

### **PRECAUTIONS TO BE TAKEN WHILE INVESTING IN NEW ISSUES (IPO)**

New issues (IPO) can be divided into two broad groups:

- New issues of newly formed companies, and
- New issues of existing companies.

New issues of existing companies are, by and large, very good investments. They provide an opportunity for acquiring shares in ongoing profit-making companies at relatively low prices. On the other hand, all new issues of newly formed companies are not good investments.

Some of the important precautions which should be taken while selecting the right new issues for investment are mentioned herein below:

- **Don't invest blindly in a company having unknown and untried promoters:** First study the performance of other companies set up by the same promoters. If these have done well, then chances of the new one doing well are also high.
- **Check the reputation and market standing of the foreign collaborator, if there is one:** For instance, new issues of Vesuvius India and Birla Ericsson evoked a very good response from investors because of the excellent international reputation of their parent companies.
- **Companies where the foreign collaborator has an equity stake are often good investments:** Foreign collaborators do not readily opt for an equity stake in any company unless they are confident of its bright future prospects.
- **Don't invest in a company, which is not ready to start business operations:** This will help in avoiding investment in companies, which may have long gestation periods before business operation can commence.
- **Invest in companies that have something new to offer:** Companies introducing a new product or industrial process for the first time, companies proposing to manufacture a product which is currently being imported, companies introducing a technologically advanced or better quality product, or companies venturing into new areas are likely to be better and more remunerative investments.
- **Invest in companies that operate in high-growth sectors of the economy.** The incidence of failure is likely to be lower for such companies.

- **Do apply for the mega issues of well-known profit-earning companies.** The sheer size of such issues ensures better chances of getting a firm allotment. This is what happened in the public issue of the State Bank of India. The bigger the size of the issue, the better will be your chances of getting a firm allotment.

## **TIPS FOR INVESTORS TO GAIN MAXIMUM FROM IPO**

One good thing about the IPO market vis-à-vis the earlier times has been that most of them have been from good companies and at reasonable prices. This trend, however, seems to be narrowing off and we are increasingly seeing public issues from the relatively not-so-good or known companies and at fairly stretched prices. Therefore, it becomes necessary for the investors to become cautious and be more selective about their investments in IPOs. The critical factors which need to be studied in an offer document when making an investment are: [15]

- **Check promoter standing:** A good promoter or management team is important for any business success, especially over long periods. While businesses may have their ups and downs, a good management will take all necessary steps to ensure profitable performance. Secondly, they would be constantly looking at new business opportunities, thereby ensuring regular growth in the company. Thirdly, we are reasonably certain that the company money will not be deliberately misused or siphoned off to the detriment of the shareholders. Therefore, look at the promoter's background, the experience he has in the industry, the performance of the other companies promoted by him, his track record, investor complaints etc. Read the risk factors very carefully especially those pertaining to the promoter/management. Check for any serious litigation against the promoter or the company. See whether the company is a defaulter to the Banks/Financial Institutions and the reason thereof.
- **Study company performance:** The share price is the reflection of the operational performance of the company. Poor numbers say the sales, profit, EPS etc. would mean poor performance on the stock exchange. Therefore, it is important that the company has a track record of good operational performance. Look for any window dressing. Are the numbers in line with the similar companies in the industry? Is there any sudden improvement in the numbers just before the issue, without any justifiable reasons? Also look at the performance of the group companies and the inter-company transaction within the group. Ensure that there are no dubious transactions. Look at the loans given to group companies. Are they paying reasonable interest? Is the loan likely to be repaid?
- **Understand future prospects:** The future prospects of the Company and the industry would play an important role in the performance of the scrip on the stock exchange. Check the objects. How will they impact the future prospects? How will the funds raised be utilized? Will it additionally benefit the company? Is the money being raised for a new project, which will add to the bottom-line of the company? If it's an offer-for-sale, it means the existing shareholders are selling a part of their stake in the Company. The amounts raised from the issue will not go to the Company. Therefore, the Company will not benefit from an offer for sale. If the purpose of the issue is to list the company on the stock exchange and the 4 Ps are positive, then one can consider investing.
- **Look at the price:** Finally of course every product/scrip has a right price based on its'

fundamentals and industry prospects. Even if the above 3 Ps were favourable, a high price is likely to reduce the prospects of appreciation at the exchange, thereby defeating your purpose of investing. Look at the average industry P/E ratio and the company's EPS and tries and estimate the fair price. Compare this with the issue price to see if it is undervalued or overvalued. Buy value not price. Issues which are overvalued tend to quote below issue price over a period of time and it may be prudent to enter then, than at the IPO stage.

## **STEPS TO BE TAKEN BY COMPANIES WHILE GOING FOR AN IPO**

It is to be taken into account that going for an IPO is definitely not easy. The right recipe is to go step by step cautiously with each step dependent on the other. If the company misses out one step, the whole structure will crumble." [16]

Making an IPO involves immense research, planning and strategizing. So, an error even on a miniscule level can have drastic repercussions. The following steps are noteworthy:

- **Choosing the Perfect Time:** Choosing the ideal time to go public is of core importance. The timing of going public is very crucial in the pre-IPO process. One should look into many aspects before the plunge—like looking into the prevailing market sentiment. In the 1980's and early 1990's when branding and marketing were non-existent, liquidity in the market, behaviour of the secondary market and merchant bankers' advice were instrumental in deciding the right time for the IPO.
- **Choosing the Right Team:** Forming the right team is essential before going for an IPO. Apart from the Chief Executive Officer (CEO) or the Chairman, the main members are the Chief Financial Officer (CFO), Chief Operating Officer (COO), the Company Secretary, the auditors, professional merchant bankers, and the Chief Information Officer (CIO) in the current age of information and legal advisors. It is very important for the board of directors involved in the venture to have a progressive outlook. Only an intelligent team can contribute to the success of the venture. Team building and the professional team that a company brings in is very important. The company should be very careful not only about land and equipment but also while deploying money and manpower.
- **Definite Goals and Purposes:** A company should be focused and clear about the purpose of the IPO. Usually, the purpose behind companies making an IPO is to accumulate funds and finances for expansion and investments and above all woo the investors and consolidate as a brand. This requires a purely corporate structure. Currently, there are stringent SEBI guidelines to be followed before any company goes public. Keeping this in mind, the valuations which the company wishes to command will depend on the future goals and projects of the company, and the management team. Unless the management is fully sure of the ultimate goals, the company will not be able to come up with a high valuation for the proposed issue of shares.
- **Choosing the Right Merchant Bankers:** The primary role of a merchant banker should be to act as a bridge between the organization and the investors. Firstly, the merchant banker should have a brand image in the market. He should have sound knowledge of the capital market and about the industry in which the company operates. A merchant banker should have the capability and the experience to handle a large-scale IPO. And they should be able to reach a larger mass of people because investors today are just not located in the metros but

also in tier-II and tier-III cities. The merchant bankers will communicate the future projects and growth prospects of the organisation to the investors. Simultaneously, they also chalk out the risk management strategies for the company since risks and ventures are two sides of the same coin.

- **Capital Restructuring:** Companies should decide on the ways to deploy their capital, namely capital restructuring. Companies should be clear about the debt and equity ratio. This boils down to setting the ideal Debt-Equity Ratio (DER), which can vary from 1:1 to 2:1. The way companies are going to deploy their capital is also very important. Companies have to be very careful while deploying the resources and forecast the profit they will incur in three-four years' time. Also when it comes to capital restructuring, a company should be focused and clear about the proportion of the management and the stakes they are willing to dilute to the public.
- **Creating Investor Interest:** Confidence building and generating investor interest should be on the priority list for a company. A company must project an image of transparency and good governance to the investors. Infosys should be the role model for all companies going in for an IPO. Many of the experts agree that IT giant Infosys is a role model because their balance sheet is very clear, they value their managers as assets and year after year they expand rapidly. A company is accountable to its investors, which is why when they go public they have to disclose company projections—past, present and future prospects.
- **Media Campaigns:** A few years ago, marketing and media campaigns were considered a luxury, but today they are absolutely necessary. They contribute to the relative success of an IPO venture. The campaigns can be in the form of road shows and extensive investor meetings. They are required because the investors need to be made aware of the company and its past performances and any important projects undertaken/completed. During the campaigns, various facets related to company performance, the need to raise money and future plans are disclosed, information that investors seek. A successful media campaign ensures complete participation in the IPO by one and all.

## IPO FAILURE

The gross and continuous failure of issues to attract retail subscriptions has started ringing alarm bells among decision makers. If this continues, the government's disinvestment programme will be badly affected. Poor retail participation is the result of years of poor regulation and malpractices by market participants, which have caused equity products to perform very poorly.

The issuers (entities coming out with public offers) don't want to leave money on the table. They want to maximize the price. The companies need to have a heart to give money and let others make money. [17]

Every IPO appears to be over-priced against its listed peers. For IPO, there is no comparable track record on the return on capital. So a company currently serving 10 Crore capital could be having EPS of Rs 12. But the moment it launches public issue to raise the capital to 20 Crore, makes it's EPS to Rs 6. And we do not have data at the point of IPO on how they have served the 20Cr Capital. So these companies have benefit of data absence due to which SEBI may not be able to stop them from even asking for Price to current Earning ratio of 100, if they overstate their estimated earnings. There is another angle. Even the listed companies, e.g in Infrastructure



Development, have meagre EPS, but they are valued at 40++ times. But their assets real value could be very high, leading to higher stock pricing.

At any point of time PE ratio more than 10 times is absolute madness; but behind the India growth story everything is being over priced. Even now many of the IPOs and Shares are at about PE ratio of 18, it clearly shows that market is over priced and in long run there will be correction. Having high expectations is not regulated, therefore these IPOs are overpriced. Investor has to think what his expected return is and exit timing.

It is a fact that IPO's of recent times were & are overpriced. The economic advisors have gone wrong in reading the mood of the primary investors. The investors are now looking forward to secondary markets, due to the fact that they are now advised by Asset Managers-who are increasing their numbers.

**NHPC:** After Adani Power, NHPC proved to be yet another disappointing issue for those hopeful for quick gains. The company failed to deliver spectacular listing gains that many retail investors expected and closed with a gain of 2%.

**JSW Energy:** Retail investors stayed aloof from the JSW Energy initial public offering (IPO) despite the discount of Rs. 5 on the issue price. The issue has been fully subscribed. According to data available on the exchanges, the retail portion was subscribed only 0.4 times. The price band for the Rs. 2,700-crore issue was fixed at Rs. 100-115. Merchant bankers close to the issue said that retail investors are still apprehensive about IPOs, especially those from the power sector. The entire power sector IPOs of 2009 are trading at a discount to their issue prices. Due to this retail investors were wary of this issue too. Though the Reliance Power IPO witnessed huge investor interest and was fully subscribed within first few minutes of its book building process, it could not sustain the momentum in first day's listing and dipped below its issue price.

### **INSTITUTION OF VALUERS**

Amid allegations of over pricing of initial public offers, the Government of India is planning to make it mandatory for companies to get their shares priced (premium charged on face value) by authorized valuers before hitting the capital markets.

The institution of valuers, being set up by the Ministry, will be a statutory body on the lines of the Institute of Chartered Accountants of India (ICAI) and the entities engaged in valuation work will be required to be registered with the proposed body. [18]

There is no set procedure for valuation and no statutory body, which supervises or regulates this profession. So, the setting up of such institute will make accountability more effective. Currently, such valuations are done by merchant bankers, chartered accountants, company secretaries, cost and work accountants or any other professional possessing such qualification. There were allegations that various IPOs like that of Reliance Power was highly overpriced due to which investors got swayed and suffered huge losses, as the IPOs traded lower than the offer price at its close on the opening day.

### **SUGGESTIONS**

After going through the study we present the following suggestions:

- The IPO pricing exercise needs to strike a fine balance between the following conflicting objectives - optimally monetizing the issuer's holdings and achieving high valuations for the stock, making the attractive from the investor's standpoint and after-market performance because "Pricing is the key,". In order to provide good returns to the investors, companies should fix their prices fairly, neither under pricing nor over pricing.
- Reasonable premium should be charged on the shares otherwise prices will not represent the fair valuation.
- In many ways, marketing an IPO is akin to marketing a movie or an FMCG product, such as a cola or a pizza. These days, IPOs need a touch of brand marketing and management involving well-placed positioning and correct pricing. Following that, the company needs to wait for investors to bite the bait. Just as FMCG companies stimulate the customers to drink and consume their products, a company issuing an IPO should also excite the investors to 'consume' the IPO. If branding, timing, pricing and communication are not correct, the IPO will be lost.
- Full disclosures should be made by the company in the offer document so that investors may make proper analysis before investing.
- Companies should adhere to the IPO norms set up by various authorities such as SEBI.

## **CONCLUSION**

We know that Indian share market tops the hot list of all the investors whether domestic or global but the smartness of watchdog SEBI and fund raisers lies in passing on the premium benefit to retail domestic investors and increasing their involvement which at present is a meager 10%. With further liberalization and increased monitoring we can expect a better future for retailers in the market. Pulling down QIB on same platform as retailers is one of the major initiatives of the year which is proposed by SEBI. If all these proposals get through, there is no doubt that the participation of retail investors may see a rise in market.

The IPO market is a good setting in which to study the effect of 'irrational' investors on stock prices. IPO firms by definition have no prior share price history and tend to be young, immature, and relatively informational opaque. Not surprisingly, therefore, they are hard to value, and it seems reasonable to assume that investors will have a wide range of priors about their market values. There are some 45 public issues lined up for 2010 estimated to raise about Rs30,000 crore. However, analysts feel pricing will remain key for the IPO market as appetite is intact in the market for fresh issues. Some analysts say that the revival in the secondary market is also playing a key role in the heavy rush of IPOs. The Bombay Stock Exchange barometer Sensex has surged by over three-fourth in 2009 to end at 17,464.81 points.

Secondary markets out performed primary markets in 2009, but we expect 2010 will be exciting performance for both primary and secondary markets

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