Issue Size: Is there any difference based on IPO Grade

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Indian capital market regulator Security Exchange Board of India (SEBI), pioneered the concept of equity instrument rating. IPO Grading (the rating of IPOs), is supposed to be based on the fundamental quality of an IPO bound company. In this research paper, it is explored whether issue size differs, on the basis of IPO Grade. Non parametric statistical analysis, shows that, issue size differs significantly, on the basis of IPO Grade. This is a significant contribution to existing literature on IPO Grading.

1. Introduction

Indian equity market, caught the attention of the world, after 1991, the year on which, opening up of the economy, marked a watershed event for the nation. In 2001,top notch Wall Street investment bank Goldman Sachs clubbed India along with three other emerging market economies(Brazil, Russia and China) and famously termed it as “BRIC” nations, and predicted that these countries will be leading economic powers in the world, in the days to come. This further increased India’s profile among the foreign institutional investors(FIIs).

India’s equity culture is quite old, the first stock exchange in Asia, was set up in India, in the form of 'The Native Share & Stock Brokers Association' in 1875, later it came to be known as BSE(Bombay Stock Exchange). Among the emerging market economies, equity market in India has an unique place, as the performance of the equity market is often taken as the proxy for the performance of the overall economy. Also India is among the few emerging countries with well developed financial markets. Initial Public Offering (IPO) by companies and their performance post listing takes considerable media space in this nation.

Indian equity market has seen complete transformation from the days of Controller of Capital Issues (CCI) to setting up of the SEBI (Securities Exchange Board of India) in 1988, to abolition of CCI in the post reform years of early 1990s.

In the reforms initiated under SEBI, centralised power to determine pricing of equity issues gave way to information dissemination in the public domain. These led to stricter information disclosure norms, Book Building (BB) of Issues, IPO Grading, Applications Supported by Blocked Amount (ASBA), SME platform in the stock exchanges etc.

In the Indian equity market now most of the issues are done through the Book Building measure, according to the website of the BSE (Bombay Stock Exchange), some of the salient features of this approach are as follows:

- A 20% price band is offered by the issuer, signifying upper limit and lower limit, within which the prospective investors have to bid; The issue price is determined by the company, post closure of the bidding.
- Demand for the securities offered, is updated in the BSE(Bombay Stock Exchange) and the NSE(National Stock Exchange) websites (quantity and price wise) on a real time basis.
- 50% of shares offered are reserved for QIBS(Qualified Institutional Bidders) or institutional investors, 35% for small investors or retail investors and the balance for all other investors, including HNIs (High Net worth Individuals). According to the latest SEBI guidelines, any investor, who puts less than Rs.200,000 in an IPO is considered as a retail investor.

Till 2006, the Indian book building process resembled the book building process as seen in the developed western markets, especially the American market. Post that period, the discretionary allotment as seen in the US market is dispensed with (Neupane et al.,2012).

Financial performance of the company preceding the issue (IPO) plays an important role, to signal investors regarding the quality of the issue. The track record and expertise of the promoters and the management team are also important signals from the prospective investors point of view. There are other formal and informal certification processes available to investors, to enable them to take an informed decision.

Some of these are reputation of the underwriter of the issue, venture capital firm affiliation, shareholding pattern of decision makers (board of directors), reputation and track record of the lead manager of the issue, promoter group affiliations, analyst recommendations etc.

Lack of Penetration of Indian Equity Market

Number of investors in the equity market, compared to the total population is minuscule in India (about 1%). There is a significant mistrust among the risk averse investors as far as the equity market is concerned. The reasons for this trust deficit are manifold. Securities Exchange Board of India (SEBI), the statutory body that governs the stock exchanges in India, has taken several initiatives to bridge this deficit. Initial Public offer (IPO) grading is one such initiative.

SEBI introduced IPO grading on voluntary basis in April,2006. It was optional till 30th.April,2007.However, the experiment was not successful as borne out by the relevant data; although around 40 companies tapped the primary market in that time

frame, only 4 companies approached the Credit Rating Agencies(CRAs) for grading. These 4 companies also did not accept the grade assigned to them. This situation aroused because there were no incentives for the companies to opt for the rating/grading. On the one hand a fundamentally good company had an apprehension, that if they do not get a good rating, their plan to raise capital may get jeopardized, on the other hand fundamentally not so good companies had the fear that, their careful cover ups may get exposed(Poudyal,2008).

SEBI had made Initial Public Offer Grading mandatory with effect from May 1, 2007.Explaining the rationale behind making the IPO grading mandatory, the then SEBI chairman M. Damodaran explained, " When the market started going up suddenly a lot of people (companies) started coming to the market. It is not that only the best and the brightest continue to come to the market, there are a lot of other people (companies) who started entering the market. One of our concerns is whether we are going to have another round of 'vanishing companies' which will raise money and never spend it for the intended purpose. I firmly believe that (IPO) grading, if made mandatory, will prevent vanishing companies in future."

As India opened its economy in 1991, a new bull market started in India, based on the assumption that the Indian economy will now grow faster, leaving behind the history of 'Hindu Rate of Growth'. In particular, the initial years of liberalization, after 1990-91, witnessed a boom in the Indian IPO market. With fewer regulations during this period, many entrepreneurs used the primary market as the main vehicle to raise capital (Khanna and Palepu, 1997 and 2000). As equity market return zoomed , host of companies accessed the primary market to tap high investor appetite for the IPOs. However what followed from the mid 1990s onwards is a black spot till date, in the history of the equity market in India. Taking the advantage of the regulatory lacuna, hundreds of companies simply vanished. Indian authorities lacked the regulatory and the information gathering mechanism to trace these companies. At the last count as on 2009, Department of Company Affairs(DCA) identified 121 such companies(Source: Financial Times, London, Dated July 14,2009), who duped investors to the tune of thousand of crores of Indian Rupees(INR). According to some of the observers, in such instances, there is still some regulatory lacunae exists. For example liability of merchant bankers, auditors etc. is still not clear. So entities, which are supposed to do, due diligence professionally, there is no mechanism to hold them accountable, for their acts of omission and commission.

IPO Grading is important in this context. As this instrument is supposed to bridge the information asymmetry.
Credit rating agencies(CRAs) like CRISIL, CARE, ICRA, FITCH(now renamed India Ratings & Research) and Brickwork Rating are entrusted with the job of IPO grading.

Among these CRAs, CRISIL is an affiliate of Standard & Poor(S&P) a world renowned rating agency, international rating agency Moody's is the largest shareholder of ICRA, India Rating and Research(earlier Fitch India) is the Indian subsidiary of Fitch. S&P, Fitch,& Moody's are recognized as Nationally Renowned Statistical Rating Organizations(NRSRO) of the Securities and Exchange Commission (SEC) in the United States. Whereas CARE and Brick Work (BW) are India based domestic credit rating agencies.

The rating scale used is 1 to 5, with 1 being the worst, and 5 being the best.

The grading is done of the company and not of the issue. The basic difference between grading of a company and an issue is, a company may be good, but due to mispricing the IPO may not be attractive enough, for the investors.
The primary motivation of the regulator, regarding introduction of IPO Grading was quality information dissemination in the public domain, so that Indian equity market avoids, crisis of confidence as seen in various scams, especially the 'vanishing companies scam'.

However in December,2013, SEBI again made IPO Grading voluntary. This was done, to probably end the dry spell in the IPO market. Whether this initiative will bear fruit is yet to be seen.

According to SEBI guidelines, Credit Rating Agencies (CRAs) are supposed to analyze companies, for the purpose of grading on the following parameters:

a. Business Prospects and Competitive Position
   i Industry Prospects
   ii Company Prospects
b. Financial Position
c. Management Quality
d. Corporate Governance Practices
e. Compliance and Litigation History
f. New Projects—Risks and Prospects

With respect to financial position of a company, parameters like revenue, profit after tax (PAT), return on equity (ROE), earning per share (EPS) as well as their growth rate, capital structure are considered.

Under the management quality parameter, people who are associated with the company as key decision makers, their credentials and track records are being analyzed.

A company's corporate governance practice includes the checks and balances being in place in the top echelons of the organization structure. The credentials of the independent directors play a big role in this respect.

The costs of the Grading are to be borne by the IPO bound firm. Therefore there is likely to be conflict of interest between the rating agency(which is supposed to grade the IPO) and the equity issuing firm, which is bearing the costs of this grading process. However there is a reputational stake for the rating agencies in the longer term.

IPO Grading Initiative in Other Countries

India had become the first country to introduce IPO Grading, i.e. rating of equity instruments. The capital market regulator SEBI (Securities Exchange Board of India) is a pioneer in that sense. Following on the SEBI's footsteps countries like Sri Lanka also initiated discussion in the public domain in this direction. The capital market regulator in Sri Lanka, Securities and Exchange Commission of Sri Lanka, has published one discussion paper and sought opinion from various stake holders about the pros and cons of the method.

Literature Review

We did not find any direct linkage between the IPO Size (Issue Size) and the firm quality. However, there are some indirect correlation. For example Pecking-order theory (Myers and Majluff, 1984) predicts that firms prefer internal accruals to finance investments and that raising fresh equity capital will only be used as the last resort. Firms issuing equity will be undervalued. As a result only firms with low expected future performance may issue fresh equity. Similarly signaling theory (Leland & Pyle, 1977) suggests that debt issues can be used as a positive signal of firm's performance as opposite to equity issues, which is considered to be a negative signal. From both these theories, it can be inferred, that the firm quality and the issue size (the amount raised through the IPO) has inverse relationship.

2. Objective of the Research

IPO Grading indicates, the fundamental quality of a company. In this research paper, it is explored, whether amount of money raised through IPO differs for companies with different IPO Grade. The period chosen is, when IPO Grading was mandatory, in the Indian capital market.

3. Hypotheses of the Research

Null Hypothesis

There are no differences in the issue size (in terms of the amount of money raised), among the companies with different IPO Grades.

Alternative Hypothesis

There are differences in the issue size (in terms of the amount of money raised), among the companies with different IPO Grades.

4. Research Methodology

The data regarding the issue size is taken from the Capital Line data base. This data is not normally distributed, as borne out by Q-Q plot. As a result non-parametric analysis in the form of Kruskal-Wallis test is used. SPSS 16.0 version is used as the software for the analysis.

In total, 171 companies are considered which accessed market between 2007 and 2013, in the time period when IPO Grading was mandatory. All the companies, which accessed primary market at that time frame are taken into account.

5. Empirical Results and Analysis

From the test results, it is evident that, the companies with different IPO Grade, differ, in terms of amount of money raised through the IPO process. As the p-value is 0.000, it signifies, that the difference is statistically significant even at 1% level. So the null hypothesis is rejected. The Kruskal-Wallis Test result shows, that the Grade wise mean rank is higher, as the Grade increases, indicating as, the Grades increase, issue size also increases. For example, for IPO Grade 1 mean rank is 37.05, the same for IPO Grade 2,3,4 & 5 are 57.96, 97.62, 133.59 and 158.40 respectively.

6. Conclusions

This research proves that fundamentally stronger companies tend to raise more money through the IPO process. This conclusion is drawn, by analyzing IPO related data of 171 companies, spread over 6 years which is fairly a large number. The probable reason is that, the companies which are graded higher also tend to have bigger balance sheets(in terms of the amount of assets and liabilities). So they have bigger IPO size. However this contradicts, one of the fundamental premises of finance, as well as existing literature.This is a significant new addition to the existing literature.

7. References

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