SEBI's Initiative To Safeguard Investors' Interest Through IPO Grading

IPO grading is a service intended to facilitate the appraisal of equity issues offered by unlisted companies to public. The grade, assigned by some credit rating agencies, including ICRA, CRISIL, Fitch Ratings India and CARE, registered with SEBI to any individual issue, may represent a relative appraisal of the 'fundamentals' of that issue in relation to the universe of other listed equity securities in India. However, IPO grading may provide 'an independent assessment of fundamentals' to assist comparative assessment that would prove to be a useful investment tool for prospective investors. The methodology of such grading is to consider a five-point scale with a higher score indicating stronger fundamentals. In this perspective, this article provides an overview on IPO grading in India.

As part of a series of initiatives to protect investors' interest, the market regulator Securities and Exchange Board of India (SEBI) has granted in principle approval for introduction of 'optional grading' of public issues of those companies which are not listed with the stock exchanges [viz. Initial Public Offerings (IPOs)]. IPO grading service is provided by some credit rating agencies (CRAs), including ICRA, CRISIL, Fitch Ratings India and CARE, registered with SEBI. According to SEBI, IPO grading would not be mandatory and would be solely at the option of the issuer company. SEBI will not certify the assessment made by the grading agency.

The main objective of such IPO grading is to enable investors to have an independent opinion from credible entities about the equity issue of an unlisted company. Though it is optional for companies to seek an opinion, it would be mandatory for them to state the grading symbol on the offer document if they have opted to get themselves graded. However, SEBI has clearly said that the grading exercise would restrict itself to assessing the 'fundamental business strength' of the company (such as business prospects and financial position), and would not be an 'investment recommendation' as such. SEBI has also said: "As the IPO grading does not take cognizance of the price of the security, it is not an investment recommendation. Rather, it is one of the inputs for the investor to aid in the decision making process. All other things remaining equal, a security with stronger fundamentals would command a higher market price". SEBI will probably be the first regulator in the world to implement rating/grading of IPOs. Currently, only debt issues are rated ahead of offers. According to SEBI, "There are some variants of the product in other markets, for pre-sale equity reports done by equity broking houses. However, no regulator has initiated rating of IPOs in any part of the world."

- Dr. Siddhartha Sankar Saha

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IPO Grading: Conceptual Issues

IPO grading is a service intended to facilitate the assessment of equity issues offered by unlisted companies to public. The grade assigned to any individual issue may represent a relative appraisal of the 'fundamentals' of that issue in relation to the universe of other listed equity securities in India. In fact, IPO grading is positioned as a service that provides 'an independent assessment of fundamentals' to assist comparative assessment that would prove

useful as an information and investment tool for prospective investors. The methodology of such grading is to consider five-point scale with a higher score indicating stronger fundamentals. While investment recommendations are expressed as buy, hold or sell securities and are based on a security specific comparison of its assessed 'fundamental business strength' (such as business prospects, financial position etc.) and 'market factors' (liquidity, demand supply etc.) to its price, IPO grading is expressed on a five-point scale as stated earlier. In other words, it is a relative comparison of the assessed fundamentals of the graded issue to other listed equity securities in India. The cost of IPO grading shall be borne from investor protection funds administered by stock exchanges or from Investor Education and Protection Fund (IEPF) administered by the Ministry of Companies Affairs. SEBI would finalise necessary procedural aspects in consultation with Stock Exchanges.

IPO grading covers both internal and external aspects of a company seeking to make an IPO in general. The internal factors include competence and effectiveness of the management, profile of promoters, marketing strategies, size and growth of revenues, competitive edge, technology, operating efficiency, liquidity and financial flexibility, asset quality, accounting quality, profitability and hedging of risks. Among external factors, the key one is the industry and economic/business environment for the issuer. Here, it is important to note that internationally, the global rating agencies such as Standard & Poors and Moodys do not perform grading of IPOs at all. While Standard & Poors is the majority stakeholder in CRISIL Ltd, Moodys is the single biggest stakeholder in ICRA Ltd. Similarly, the third global player Fitch IBCA (which acquired another rating agency Dun & Bradstreet in 2000) also does not grade IPOs as yet.

Why IPO Grading?

Sometimes a company may not know whether it is performing well or not. In such a situation, getting a grading by an independent rating agency would come in handy and may be very much valuable to companies. IPO grading is supposed to be useful particularly for assessing the offerings of companies accessing the equity markets for the first time where there is no track record of their market performance. There is no denying the fact that IPO grading will be helpful to the unlisted issuing companies provided CRAs prescribe a higher score indicating stronger fundamentals. As stated earlier, the IPO grade assigned to any issue may represent a relative assessment of the 'fundamentals' of that issue in relation to the universe of other listed equity securities in India. This grading can help the prospective investor to make a right investment decision. Thus, IPO grading is additional investor information and investment assistance device to enable more realistic pricing of shares and assist investors make an informed decision. Truly speaking, if investors respond better to a graded IPO, it would prove an incentive for promoters to opt for grading in future. Needless to mention, acquiring a high grading symbol could enable issuing companies command a better premium on their offer and Issuers having underlying strength can also project themselves in a better way to their prospective investors.

There are various positive sides of an IPO grading. The most significant factors that go in favour of IPO grading are: (a) Professional and independent appraisal, (b) Removal of information overload, (c) impediment for weak companies, (d) improving investors' sophistication. It is worthwhile to have a brief description of these issues so as to understand the objectives of IPO grading.

(a) Professional and Independent Appraisal: IPO grading will create awareness about the fundamentals of the company's IPO and will provide focused company information as a key input to prospective investors that will be helpful in taking an investment decision, in a manner similar to what a credit rating is for debt investors.

(b) Removal of Information Burden: Where disclosures of issues are large and complex,

a service analysing and interpreting these disclosures independently and quickly will be extremely useful in cutting through the clutter. Thus, the usefulness of IPO grading would be particularly high for small investors as it will serve as a guide about the company coming out with the issue.

(c) Impediment for Weak Companies: While fundamentally sound companies will gain from the market, companies whose fundamentals are not very strong will be impeded in building up speculative demand among investors. Such weak companies will need to offer pricing, which will adequately compensate investors for the risks they take. Therefore, IPO grading provides disincentives for weak companies planning to come to the market to raise easy capital.

(d) Improved Investors' Sophistication: It is perceived that an independent and informed opinion on the fundamental quality of the company will bring about greater level of investor sophistication in a scientific manner. In fact, investors may take investment decisions in a better way on the basis of opinion of CRAs regarding IPO grading.

However, the assessment is not a recommendation to buy or not buy a stock. It is, instead, a powerful tool to assist the investors in making up their mind about the quality of a company proposing to offer an IPO investment option.

SEBI Guidelines Regarding IPO Grading

In exercise of the powers conferred under sub-section (1) of Section 11 of the Securities and Exchange Board of India Act, 1992, it had been decided to amend the SEBI (DIP) Guidelines, 2000. The amendment regarding IPO grading had been made on 24th April, 2006 (vide SEBI Circular No. SEBI/CFD/DIL/DIP/21/2006/24/4 dated April 24, 2006) and came into force with immediate effect. SEBI has also circulated the following amendments of IPO grading to all merchant bankers (who perform as lead managers/ intermediary in management of capital issues of primary capital market in India) as well as stock exchanges. These amendments are summed up as below:

(1) *Pre-Issue obligations in case of IPO grading:* An unlisted company making an IPO of equity shares or any other security, which may be converted into or exchanged with equity shares at a later date may opt to obtain grading for such an IPO from one or more credit rating agencies. Where an issuer opts to obtain IPO grading, it shall disclose all grades so obtained by it, including unaccepted grades, in the prospectus and abridged prospectus.

(2) *Contents of the prospectus:* Statement indicating whether IPO grading has been opted for. If yes, disclosure of all grades so obtained, including unaccepted grades and reference of the page number where details of IPO grading, as mentioned below, are given.

(i) Name of the credit rating agency from which grading has been obtained for the proposed IPO of equity shares or any other security which may be converted into or exchanged with equity shares at a later date and the grading so obtained, including unaccepted grades.

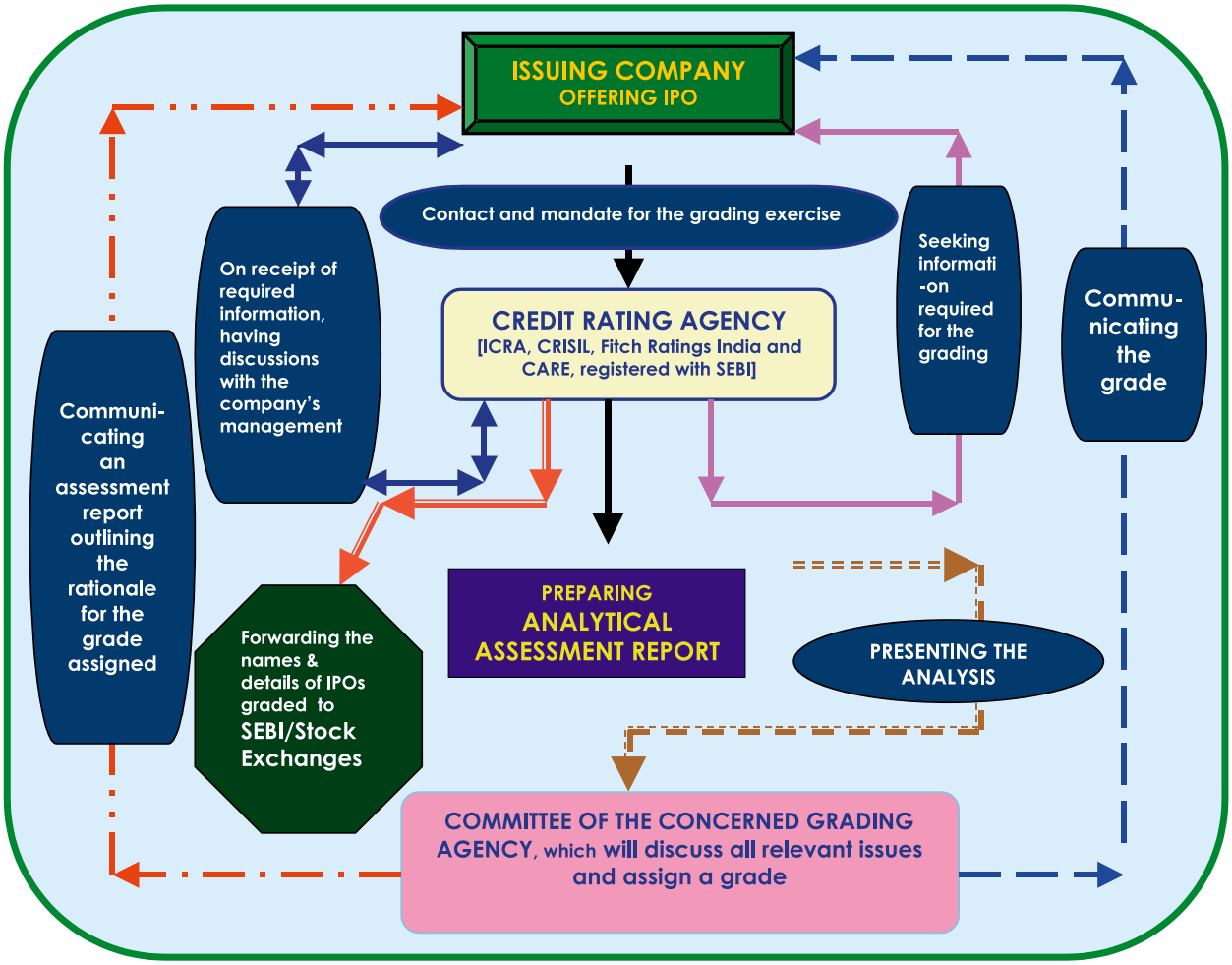
(ii) If grading has been obtained from more than one credit rating agency, disclosure shall be made of all the grades so obtained, including unaccepted grades.

(iii) The rationale/description of the grading/s so obtained, as furnished by the credit rating agency/ies.

IPO Grading Process

It is intended that IPO fundamentals would be graded on a five-point scale from grade 5 (indicating strong fundamentals) to grade 1 (representing poor fundamentals). The credit rating agencies (CRAs) would have to affix its name before the grading symbol. The grade

is supposed to be assigned as: 'rating agency name' IPO Grade 1 or 'rating agency name' IPO Grade 5 and so on (viz ICRA IPO Grade 1, CRISIL IPO Grade 5 etc). Presently, CRAs including CRISIL Limited, Fitch Ratings India Private Ltd., ICRA Ltd., Credit Analysis & Research Ltd. (CARE) registered with SEBI will carry out IPO grading. SEBI does not play any role in the assessment made by the grading agency. The grading is intended to be an independent and unbiased opinion of that agency. The assigned grade would be a one-time assessment made at the time of the IPO and meant to assist investors who are interested in investing in the IPO. The grade will not have any ongoing validity. The company needs to first contact one of the grading agencies (i.e.CRAs) and mandate it for the grading exercise. The agency would then follow the process: (a) Seeking information required for the grading from the issuing company, (b) On receipt of required information, having discussions with the company's management and visiting the company's operating locations, if required, (c) Preparing an analytical assessment report, (c) Presenting the analysis to a committee comprising senior executives of the concerned grading agency. This committee would discuss all relevant issues and assign a grade, (d) Communicating the grade to the company along with an assessment report outlining the rationale for the grade assigned. CRAs are supposed to take 3-6 weeks ideally for completion of the grading process. However, a model of IPO grading process is suggested below:



A MODEL OF IPO GRADING PROCESS

CRAs will be required to forward the names and details of IPOs graded by them on monthly basis to SEBI/Stock Exchanges for uploading on their website for public information. The IPO grading given by CRAs shall form part of the prospectus for the IPO. As such, the company, which has opted for IPO grading, does not have a choice in accepting or rejecting the grade in this regard. If it has opted for IPO grading, the same needs to be disclosed in the Prospectus as stated in the SEBI guidelines.

A Bird's-Eye View of Indian primary capital market

Resource mobilisation from the primary market by the issuance of equity securities consisting of both the 'initial public offering' (IPO) market and the 'seasoned equity offering' (SEO) market, witnessed considerable activity in 2004 and 2005 (Table 1).

Table 1: Primary capital market scenario

Calendar year (Rs. In crores)				
Types of issues	2002	2003	2004	2005
Debt	Rs. 4,549	Rs. 5,284	Rs. 2,383	Rs. 66
Equity	Rs. 2,420	Rs. 2,891	Rs. 33,475	Rs. 30,325
Of which, IPOs	Rs. 1,981	Rs. 1,708	Rs. 12,402	Rs. 9,918
Number of IPOs	6	12	26	55

[Source: SEBI]

In 2005, Rs. 30,325 crore of resources were raised from this market, of which Rs.9,918 crore were raised by 55 companies which were listed for the first time (IPOs). It is evident that the number of IPOs per year has risen steadily from 2002 onwards (i.e. 6 to 55). Table-2 and Chart-1 and Chart-2 present a bird's eye view of IPOs during 2002-2005.

It is observed that many companies came forward to offer IPOs in 2005 as compared to 2002 (Chart-1 on next page). There was a declining trend of total equity issues as well as IPOs in 2005 in comparison with previous year's mobilisation (Chart-2 on next page). But, according to a rough estimation made in *The Economic Times* (25th April, 2006) the Indian equity market is supposed to witness a heavy rush of IPOs during 2006, which could rake up about Rs. 40000-50000 crore from the market on a cumulative basis.

Table 2: Details of IPOs

Year	IPOs of Equity Shares (in number)	IPOs of Equity Shares (Rs. crore)
2002	6	1,981
2003	12	1,708
2004	26	12,402
2005	55	9,918

IPO Grading: A Few Comments

IPO grading has been widely commented upon by the experts in the field. According to Mr. Ambarish Mukherjee (Business Line on 20th March, 2006), *"Despite more than 40 IPOs expected to hit the market in the first half of 2006-07, only four companies have approached the agencies approved by the SEBI for rating of their issues. Incidentally, they too have not accepted the ratings awarded to them because these do not match up to their expectations, according to rating agency officials. This is the first such effort anywhere in the world and SEBI kept it optional as a test exercise."* Mr. Ambarish Mukherjee also quotes a senior official in one of the approved rating agencies as saying: *"Recently one construction company gave us the mandate for rating their forthcoming IPO. We did the necessary due diligence as per SEBI specifications that cover both internal and external aspects. But the company did not find our rating up to their expectations and has not approved it. And now it would be entering the market soon without using our rating."*

Chart 1 : IPOs of Equity Shares (in number)

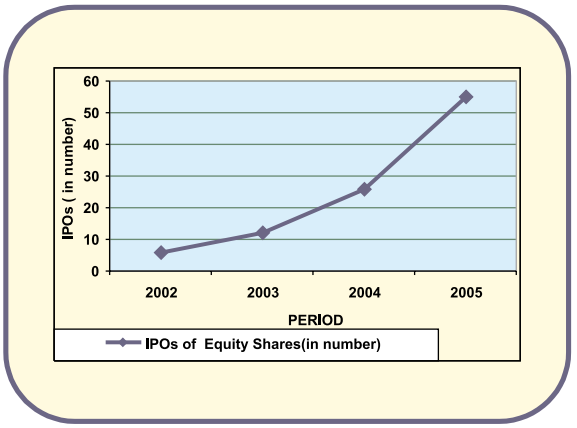
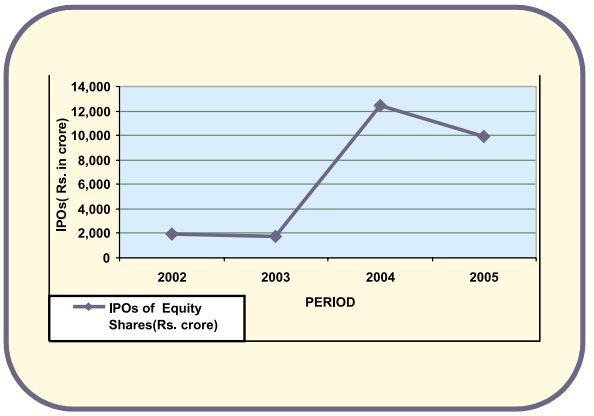


Chart 2 : IPOs of Equity Shares (Rs. in crore)



According to Mr. Prithvi Haldea, Managing Director of Prime Database of the IPO market, *"there are no incentives for the companies to rate their IPOs. First, there is no rating of IPOs anywhere in the world and thus there are no models. If a company accepts a particular rating, the concerned agency would have to report it to the SEBI and stock exchanges within the same month, which makes it public information. In such a case, a good company will not go for rating fearing that if it gets a bad rating its issue may suffer despite strong fundamentals. Similarly, a bad company too would not go for rating fearing that its cover-ups might get exposed with a poor rating."*

Thus, there is a serious reservation about the practicality of IPO grading because of the number of opinions against IPO grading. Equity, by its very nature, is 'risk investment' and 'Caveat emptor' holds true especially for equity investments. Ratings should not induce investors to ignore the above dictum and should not provoke investors to invest their hard earned money blindly. To try and capture that into a grading system should, for all practical purposes, be extremely difficult. Since pricing of shares is the most critical factor in evaluating IPOs, the rating's value is obviously diminished without making any comment on pricing. Another significant observation about rating is that markets do not always take the rating on its face value. For instance, in the case of debt instruments, instruments with same ratings have different prices. Keeping in mind all these matters, questions arise as to whether the CRAs can be held accountable to the prospective investors and will need to indemnify themselves from such investors relying thereon. Is this a challenge to the merchant bankers who do everything for a particular issue towards their performance in an IPO? Or, is this an attempt to remove the demarcating line between equity and debt?

Conclusion

The Government of India was keen to set up a system to avoid any shady promoters taking advantage of the stock market boom and raising money from the public. The IPO grading, a one-time exercise is supposed to be an independent and unbiased opinion of the concerned agency. It would only focus on assisting the investors, particularly retail individual investors, to take an informed investment decision about IPOs before putting in money. There may be apprehension among companies proposing to come up with IPOs over the possible adverse impact on pricing in the event of a poor grade. In this connection, one may comment by saying that grading of IPOs might be a 'tricky' affair as it could give a false sense of security to the public. However, there is no denying the fact that SEBI has taken a pioneering role in safeguarding investors' interest by increasing disclosure levels by entities seeking to access equity markets for funding.

This has caused India to be amongst one of the more transparent and efficient capital markets in the world. Moreover, these disclosures demand fairly high levels of analytical sophistication of the reader in order to effectively achieve the goal of information dissemination. It is perceived that once the IPO grading process picks up, companies would gradually realise the benefits of getting their issues graded, especially those that are confident of their fundamental strengths. In fact, majority of retail investors do not read the offer document and even where they do they may not fully comprehend the implications of all the disclosures made in the document. So, there is a vital need to rate equity offerings helping investors separate good floats from risky ones. On the other side, there is a need to keep in mind some important issues regarding IPO grading: Would IPO grading shift the responsibility of bringing out good IPOs from the merchant bankers to the CRAs gradually? Would CRAs provide any assurance to the investors as regards risk and return of a particular IPO? Will investors perceive the rating as a regulatory approval of the offering? In fact, SEBI is moving away from an approval machinery to a more transparent disclosure machinery. So, would SEBI's approval depend on the rating outcome? What would happen if the rating is modified during or after the IPO process? Can investors sue rating agencies? What would happen if the rating is high but the subsequent market performance of the company is poor? All ratings are subjective opinions of rating agencies. Should the IPO process be dependent on such subjective elements? Since this concept is untested anywhere in the world and is yet to be fully explored in near future, it is very hard to answer all these queries at this stage. Under such situation how would investors take right decision to buy a particular IPO through IPO grading? However, let companies opting to rate their offerings adopt it and let one observe the market experience. In fact, time will say in a right manner whether investors' interest will indeed be safeguarded through IPO grading in India. ❐

DID YOU KNOW

The ICAI Logo Was Conceptualised by Sri Aurobindo!

When the Institute was formed in the year 1949 in the month of June/July, C. S. Shastri, a noted Chartered Accountant of Madras went to Sri Aurobindo and requested him through a letter to give an emblem to the newly formed Institute of which he was an elected member from the South… Sri Aurobindo gave him the emblem with a *Garuda* in the centre and a quotation from the Upanishad: *Yah esa suptesu jagarti*, that person who is awake in those that sleep.

The emblem was placed at the first meeting of the Council of the Institute in New Delhi sometime in June/July, 1949 and was accepted amongst many other emblems placed by other members of the Council. So, that became the emblem of the Chartered Accountants of India. Very few people know about it and most of the Chartered Accountants do not know it.

Source: My reminiscences authored by Prasanta Mukherjee