BOOK-BUILDING PROCESS: AN EFFICIENT MECHANISM FOR MANAGEMENT OF MEGA PUBLIC ISSUES IN INDIA

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The book-building system is part of Initial Public Offer (IPO) of Indian Capital Market. It was introduced by SEBI on recommendations of Mr. Y.H. Malegam in October 1995. It is most practical, fast and efficient management of Mega Issues. Book Building involves sale of securities to the public and the institutional bidders on the basis of predetermined price range. It is an innovative method of marketing securities involving price determination and quantum of securities on the basis of the demand from the prospective shareholders. In this process the SEBI (Market Regulator) has issued various guidelines for control and regulation of book-building process. Since, inception of book-building process in India, Share of Mega Issues in total capital mobilised has increased from 60.1 per cent in 1994-95 to 92.3 per cent in 2003-04.

The stock market has been acknowledged all over the world as vital for long-term economic growth. Several empirical studies have proved that there is a strong positive correlation between the level of sophistication of a country's stock market and its level of economic growth and development. Countries with well-developed stock markets generally tend to enjoy higher economic growth and development than those with underdeveloped stock markets (Frank). There was a vital need to strengthen the capital market, which could only be achieved through structural modifications, introducing new market mechanism, instruments, and by taking steps for safeguarding the interest of the investors through more disclosures and transparency. In this context, an important mechanism named as Book-Building in the system of Initial Public Offerings (IPOs) was introduced by SEBI in India on the basis of the recommendations of the committee constituted under the chairmanship of YH Malegam in October 1995. The Book-Building is the most practical mechanism for the quick and efficient management of mega issues[1] (including offers for sale).

Meaning

SEBI guidelines, 1995 defined book-building as "a process undertaken by which a demand for the securities proposed to be issued by a body of corporate is elicited and built up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document". In general, the word "Book-building" is a method of marketing the shares of a company whereby the quantum and the price of the securities to be issued will be decided on the basis of the 'bids' received from the prospective shareholders by the lead merchant bankers. According to this method, share prices are determined on the basis of real demand for the shares at various price levels in the market.

Objectives

The main objectives of this article are as follows:

1. To understand the conceptual framework of Book-Building.
2. To study the regulatory guidelines of SEBI for Book-Building Issues.
3. To examine the recent developments in the Book-Building Process.
4. To analyse the Trends in the Book-Building Issues in India.

Malegam Panel's Recommendations:

The introduction of book-building in India in 1995 was on account of the recommendations of an expert committee appointed by SEBI under Chairmanship of YH Malegam "to review the (then) existing disclosure requirements in offer documents." Two of the terms of reference being "the basis of

[1] Mega Issue is an Initial Public Offer with a capital offered to public exceeds more than Rs. 100 crore.

pricing the issue" and "whether substantial reduction was possible in the time taken for processing applications by SEBI." The committee has submitted its report with several recommendations and the SEBI accepted the same in November 1995. The book-building route should be open to issuer companies, subject to certain terms and conditions. Some of them are presented below:

1. The option should be available only to issues exceeding Rs. 100 crore;
2. The book-building issuer companies could either reserve the securities for firm allotment or avail themselves of the book-building process;
3. Draft prospectus to be submitted to SEBI could exclude information about the offer price;
4. A book runner to be nominated from among the lead merchant bankers, charged with specific responsibilities and the name is to be submitted to the SEBI's approval; and
5. The requirement of 25 percent of the securities to be offered to the public will be continued.

There have been several amendments/revisions to the above guidelines; the first one in December 1996 made available the option of book-building to all corporate bodies which were otherwise eligible to make an issue of capital to the public, and in case of under subscription, the spill-over from the public portion could be permitted to the placement area and vice-versa. In 1997, the restriction of the facility to 75 percent of the issue was thought to severely constrain the benefits arising out of price and demand discovery, and the facility was extended to 100 percent of the issue, available only if the issue amount was Rs. 100 crore and above, compulsorily offering an additional 10 percent of the issue sise to the public through prospectus, and reserving at least 15 percent of the issue size to individual investors applying up to ten tradable lots. Further, audited financial ratios had to be disclosed, namely, EPS, P/E, average return on net worth for the last three years and net asset value based on last year's balance sheet.

However, there were no takers for the 100 percent book-building facility. Based on suggestions made by leading merchant bankers, the following amendments were made to the guidelines in 1999:

1. The issuer may be allowed to disclose either the issue size or the number of securities to be offered to the public;
2. Allotment should be in demat mode only; and
3. Reservation of 15 percent of issue amount for individual investors need to the public at a fixed price. Some of the earliest mega issues through the book-building route were those of Larsen & Toubro, ICICI, Tisco and others.

SEBI Guidelines:

1. In January 2000, SEBI has issued a compendium of guidelines, circulars and instructions to merchant bankers relating to issue of capital, including those on the book-building mechanism. The compendium includes a model time frame for book-building: "After the price has been determined on the basis of bidding, statutory public advertisements for a continuous three days containing, inter alia, the price as well as a table showing the number of securities and the amount payable by an investor, based on the price determined, shall be issued and the interval between the advertisement and issue opening date should be a minimum of five days."
2. The draft prospectus to be circulated has to indicate the price band within which the securities are being offered for subscription. The bids have to be within the price bands. Bidding is permissible only if an electronically-linked transparent facility is used. An issuing company can also fix a minimum bid size. An initial bid can be changed before the final rate is determined. The mega issues such as Petronet LNG and Biocon were successfully launched through the 100 percent book-building route.
3. The Prospective bidders were advised to read the "Red herring prospectus" carefully. According to the Act, a "Red herring prospectus" means a prospectus that does not have complete particulars on the price and the quantum of securities offered. The Concise Oxford Dictionary gives the meaning of 'red herring' as a misleading clue or distraction, so named from the practice of using the scent of red herring in training hands.
4. The year 2000, Amendment to the Act gave legal cloak to the book-building route by allowing circulation of the information memorandum and the red herring prospec-

tus. According to the Act, a process is to be undertaken prior to the filing of a prospectus by which a demand for the securities proposed to be issued by a company is elicited, the price and the terms of the issue of such securities are assessed by means of a notice, circular, advertisement or document. Incidentally, the working group on the Comprehensive Companies Bill, 1997 (since lapsed) had advocated introduction of book-building. It defined the term as "an international practice that refers to collecting orders from investment bankers and large investors based on an indicative price range. In capital markets, with sufficient width and depth, such a pre-issue exercise often allows the issue to get a better idea of the demand and the final offer price of an intended public offer."

5. SEBI (Disclosure and Investor Protection) Guidelines, 2000 contains provisions for book building under chapter XI that includes guidelines for 75 per cent book-building process, 100 per cent book-building process, disclosure requirements, allocation/allotment procedure and maintenance of books and records.

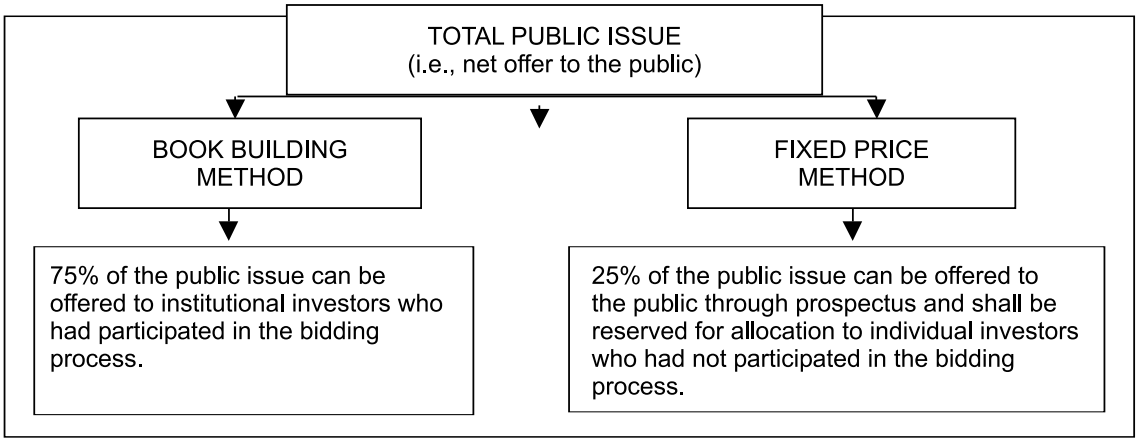
Types of Book-Building Process:

The Companies are bound to adhere to the SEBI's guidelines for book building offers in the following manner:

1. 75 per cent Book-Building Process:

Under this process 25 per cent of the issue is to be sold at a fixed price and the balance of 75 per cent through the Book Building process. Chart-1 indicates this process.

CHART-1: 75 PER CENT BOOK-BUILDING PROCESS



2. Offer to Public through Book-Building Process:

The process specifies that an issuer company may make an issue of securities to the public through prospectus in the following manner:

a. 100 per cent of the net offer to the public through book building process, or
b. 75 per cent of the net offer to the public through book building process and 25 per cent of the net offer to the public at a price determined through book building process. (Please refer to Chart 2 & 3 on the next page).

Recent Changes in Book-Building Mechanism:

The Securities and Exchange Board of India on March 29, 2005 announced sweeping changes in the IPO norms. They are as follows:

1. Increased allocation for retail investors in book-built issue from 25 per cent to 35 per cent and has also changed the definition of the retail category.
2. The market regulator has now permitted retail investors to apply for Rs. 1 lakh worth of shares in a book-built issue against Rs. 50,000 earlier. For this purpose, SEBI has redefined the retail individual investor as one who applies or bids for securities of or for a value not exceeding Rs. 1 lakh.
3. It has reduced the non-institutional category, popularly known as high net worth individuals (HNI), allocation from 25 per cent to 15 per cent.
4. Institutional investors include foreign financial institutions (FII) banks, mutual funds and Indian financial institutions like LIC or IDBI.
5. The changes have been made in the SEBI (DIP) Guidelines, 2000 on the

Chart-2: 100% of the Net Offer to the Public Through 100% Book Building Process

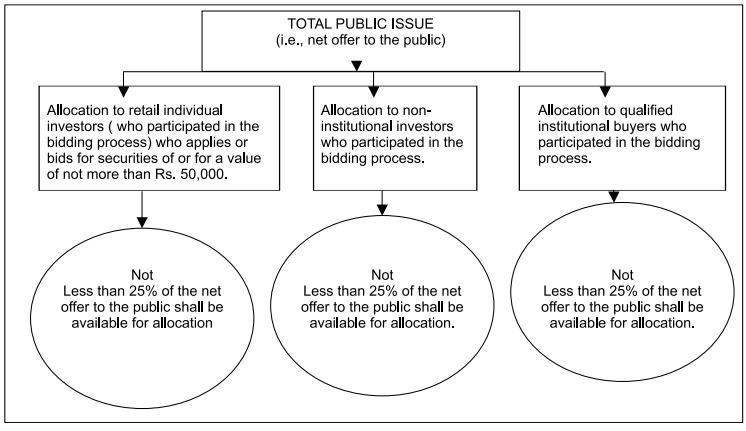
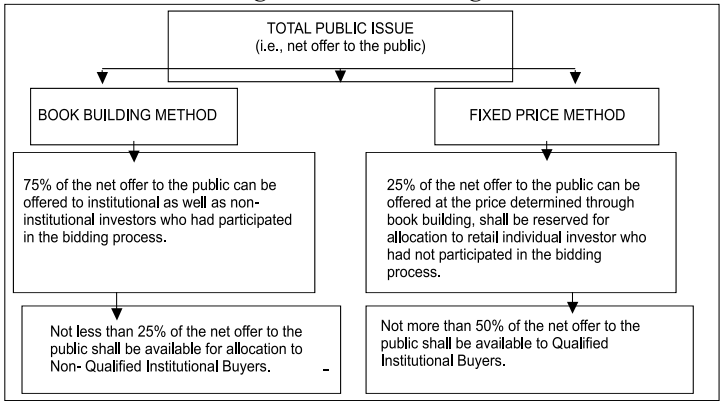


Chart- 3: 75% of the Net Offer to the Public Through Book- Building Process:



basis of recommendations made by SEBI's primary market advisory committee.

6. The new norms will be applicable to all public issues whose draft offers documents are filed with SEBI on or after April 4, 2005.
7. SEBI has decided to reduce the bidding period from the current 5 to 10 days (including holidays) to 3 to 7 working days.
8. It has also provided more flexibility for listed companies to disclose price band/floor price for public issues one day before bid opening.
9. SEBI has decided to give an option to listed issuers to either disclose price band in RHP/application form/abridged prospectus (current practice) or to disclose the price band/ floor price at least one day before bid opening.
10. It is proposed to amend the guidelines to improve contents and ensure uniformity in data display on the websites of the stock exchanges. The date will be made available for a further period of three days after the closure of the bids/issue.

Book Building Process in India:

(i) The principal parties/intermediaries involved in a book building process are:
   (a) The issuer company,
   (b) The Book Running Lead Manager (BRLM) who is a Category I Merchant Banker registered with SEBI, and
   (c) The Syndicate Members who are intermediaries registered with SEBI and who are permitted to carry on activities as underwriters. Syndicate Members are appointed by Book Running Lead Manager.

(ii) The steps for book building process (Chart 5) are:
   (a) Preparation of draft prospectus,
   (b) Formation of Syndicate,
   (c) Record of orders,
   (d) Consolidation,
   (e) Closure of order book,
   (f) Determination of price,
   (g) Agreement with syndicate members,
   (h) Payment in advance,
   (i) Filling of prospectus,
   (j) Two Separate accounts are opened by the issuer company for collection of application money,
   (k) Collection of application for securities,
   (l) Allotment of placement and public portions,
   (m) The placement portion may be used to adjust under subscription,
   (n) Rate of allotment, and
   (o) Maintenance of records.

CHART-4: STEPS INVOLVED IN BOOK-BUILDING PROCESS
Nominate Book Runner
▼
Form Syndicate of Brokers, Arrangers,Underwriters, Financial Institutions, etc.
▼
Submit Draft Offer Document to SEBI without mentioning Coupon Rate or Price
▼
Circulate offer Document among the Syndicate Members
▼
Ask for Bids on Price and Quality of Securities
▼
Aggregate and forward all offers to Book Runner
▼
Run the Book to maintain a record of Subscribers and their Orders
▼
Consult with Issuer and Determine the issue Price as Weighted Average of the Offers Received
▼
Firm up Underwriting Commitments
▼
Allot Securities Among Syndicate Members
▼
Securities Issued and Listed
▼
Trading Commences on Exchanges
Source: Agarwal, Sanjib: Bharat's Manual of Indian Capital Market, Bharat Law House, New Delhi, 1997, p.578.

Recent Trends in Book-Building Issues in India

1. The book-building process in India is very transparent. All investors (including small investors) can see on an hourly basis where the book is being built before applying. Therefore, no asymmetry as far as information dissemination is concerned.
2. The year 2004 was a significant and bumper because companies have raised Rs. 30,511 crore through public issue and 99 per cent of this being good quality securities from established companies and almost all issues were through book-building. The Pattern of Mega Issues during 1992-93 to 2003-04 was presented in Table-1 and large issues were presented in Table-2.
3. The practice of book-building is new to the Indian capital market and the procedure is still evolving. ICICI was the first company to use Book-building method for its Rs. 1000 crore-bond issue in April 1996 followed by Rs. 4,323 crore Larsen & Toubro issue and Rs. 5,878 crore TISCO bond issue for the placement portion.
4. The recent issue of Hughes Software made history in more than one way. It was the first Indian IPO in IT industries to adopt the "Book-Building" process and the issue was highly over subscribed.
5. In November 1999 the HCL technologies has raised capital through IPO Book-building method, investors gave an enthusiastic response. The issue got over subscribed by 27 times. This was despite the fact that the company revised its original price band of Rs. 450-540 to Rs. 500-580. The final price offered was Rs. 580 for the shares.
6. Other companies which have accepted the book-building mechanism were Shree Rama Multi Tech Ltd., Sydus Cadila Healthcare Ltd., Mascot Systems Ltd., Creative Eye Ltd., MosChip Semiconductor Technology Ltd., SIP Technologies and Exports Ltd., Hughes Tele. Com India Ltd., MRO TEK Ltd., Pritish Nandy Communications Ltd., Balaji Telefilms Ltd., ASTEC Software & Technology Services Ltd., Mid-Day Multimedia Ltd., D-Link (India) Ltd., Jet Airways (India) Ltd., UTV Software Communications Ltd., Punjab National Bank, Gateway Distriparks Ltd., IVRCL Infrastructure & Projects Ltd.

The Pattern of Mega Issues and their role in relation to total amount of capital mobilised by Indian companies were presented in Table-1. We observed that 112 mega issues raised Rs. 51,823 crores forming 93 per cent of total capital mobilised through public issue in the year 2003-04. This year accounted for highest amount and percentage of capital mobilised. However, 1999-00 accounted for highest number of mega issues at 192 where as the highest amount of capital mobilised was in the year 2000-01 at Rs. 69,764 crore. The share of mega issues in the total capital mobilised through public issues increased almost two times from 45.25 per cent in 1992-93 to 92.3 per cent in 2003-04.

If we observe the growth

However, book-building process has got its inherent deficiencies. For example, it is only applicable for Mega Issues, the risk return preference of the investors cannot be estimated systematically, it works only in efficient and matured markets and, possibility of price rigging by the promoters before public issue.

Table-1: Pattern of Mega Issues During 1992-93 to 2003-04

Year	No. of Mega Issues	% of Change	Amount Raised Through Mega Issues (Rs. Crore)	% of Change	Total Amount Raised (Rs. Crore)	% of Change	Share of Mega Issues in Total Capital Mobilised (%)
1992-93	34	NA	NA	NA	NA	NA	45.25
1993-94	NA	NA	7,387	NA	19,501	NA	37.88
1994-95	112	NA	33,602	354.9	55,920	186.7	60.09
1995-96	56	-50.0	19,133	-43.1	33,869	-39.4	56.49
1996-97	58	3.6	25,491	33.2	34,737	2.6	73.38
1997-98	128	54.7	43,119	69.2	50,741	46.1	84.98
1998-99	114	-10.9	55,229	28.1	62,633	23.4	88.18
1999-00	192	68.4	62,351	12.9	71,703	14.5	86.96
2000-01	160	-16.7	69,764	11.9	77,710	8.4	89.77
2001-02	155	-3.1	42,858	-38.6	49,852	-35.8	85.97
2002-03	142	-8.4	37,685	-12.1	42,712	-14.3	88.23
2003-04	112	-21.1	51,823	37.5	56,149	31.4	92.30
Average	**115**		**40,767**		**50,502**		

NA = Not Available

Source: CMIE Capital Markets Issues, August 2003 and June.

rate in the amount of capital raised during the decade, the year 1997-98 recorded at an increase of 69.2 per cent and 2001-02 recorded highest decline at -38.6 per cent. The amount of total capital mobilised from the public issues as shown significantly wide fluctuations from 186.7 per cent in 1994-95 and -35.8 per cent in 2001-02. This indicates that there is no clear-cut consistency in the number and amount of public issues. Apart from this the amount raised through mega issues was also recorded similar trends. Based on this, we can highlight that through book-building process is highly commendable.

We observe from the data of the table-2, that the total offer sise was Rs. 19,452 crore from 12 companies during 2003-04. Among them, 54.98 per cent was raised by ONGC alone and the remaining is from the rest of 11 companies.

The types of issues are consisting of voluntary offer for sale and public issue. The contribution of voluntary offer for sale is significantly higher than the public offer. Further, types of instruments issued by the companies are equity and bonds. Amount contributed through equity is 80.5 per cent as compared to 19.5 per cent of bonds. Hence, the financial year 2003-04 has claimed highest amount of funds raised through mega as well as large issues in the Indian capital market.

The Kotak Mahindra Capital Services Company followed by DSP Merrill Lynch Ltd., have become prominent Book Running Lead Managers (BRLM) of mega issues, since, the former has handled 18 and the later has managed 14 mega issues successfully. JM Morgan Stanley Private Ltd., Enam Financial Consultants Pvt. Ltd., has successfully managed 11 mega issues each and became third highest Book Running Lead Managers. All other merchant bankers have handled few of the mega issues ranging from 1 to 9 each.

IPO of Bharat Shipyard Ltd. was over subscribed by 72 times, Indoco Remedies Ltd., by 68 times, Power Trading Corporation of India, Dishman Pharmaceuticals & Chemicals Ltd., by 38 times each, NDTV 37 times, Biocon Ltd., 32 times. All other mega issues have also recorded their over subscription ranging from 6 to 30 times. It is evident that some of the mega issues were over subscribed by many times within couple of minutes from opening of the issue due to enormous support from corporate enterprises, financial institutions and high net worth investors.

Limitations of Book-Building System

The book-building system has various limitations. Some of them are as are as follows:

1. Book-building is appropriate for mega issues only. In the case of the potential investors, the companies can adjust the attributes of the offer according to the preferences of the potential investors. It may not be possible in big issues since the risk-return preference of the

Table-2: Large Issues During 2003-04						
Sr. No.	Name of the Company	Type of Issue	Type of Instrument	Date of Opening of Issue	Offer Size (Rs. Crores)	Percentage to Total
1	ONGC	Voluntary Offer for Sale	Equity	13-03-04	10,695	54.98
2	GAIL (India) Ltd.	Voluntary Offer for Sale	Equity	27-02-04	1,564	8.04
3	IPCL	Voluntary Offer for Sale	Equity	20-02-04	1,221	6.27
4	Maruti Udyog Ltd.	Voluntary Offer for Sale	Equity	12-06-04	993	5.10
5	IDBI	Public	Bond	09-03-04	588	3.02
6	Patni Comp. Systems Ltd.	Public	Equity	27-12-03	431	2.21
7	ICICI Bank Ltd.	Public	Bond	30-10-03	343	1.76
8	IDBI	Public	Bond	19-01-04	797	4.09
9	Petronet LNG Ltd.	Public	Equity	1/3/2004	391	2.01
10	IBP Company Ltd.	Voluntary Offer for Sale	Equity	23-02-04	357	1.83
11	ICICI Ltd.	Public	Bond	22-08-03	486	2.49
12	IDBI	Public	Bond	17-12-03	1,586	8.15
Total					**19,452**	**100.00**

Note: Large Issues are deemed to be of Rs. 300 Crore and above.

Source: CMIE Reports.

investors cannot be estimated easily;

2. The issuer company should be fundamentally strong and well known to the investors;
3. The book-building system works very efficiently in matured market conditions. In such circumstances, the investors are aware of the various parameters affecting the market price of the securities. But, such conditions are not commonly found in practice;
4. There is a possibility of price rigging on listing as promoters may try to bail out syndicate members.

Green Shoe Option (GSO)

A Company making an initial public offer of equity shares through the book-building mechanism can avail of the GSO for stabilising the post-listing price of its shares. The GSO means "an option of allocating shares in excess of the shares included in the public issue and operating a post-listing price stabilising mechanism through a stabilising agent (SA)." GSO in the system of IPO using book-building method was recognised by SEBI in India through its new guidelines on 14th August 2003 (Vide SEBI/CFD/DIL/DIP/Circular No.11). According to SEBI guidelines, "a company desirous of availing the GSO shall in the resolution of the general meeting authorising the public issue, seek authorisation also for the possibility of allotment of further shares to the management team, as the SA", who will be responsible for the price stabilisation process, if required. It owes its origin to the Green Shoe Company, which used this option for the first time throughout the world. Recently, ICICI Bank has, perhaps, used GSO in the first time in case of its public issue through book-building mechanism in India.

Conclusion

The spirit beyond the introduction of book-building mechanism in India is to discover the right price for a public issue, which in turn would eliminate unreasonable issue pricing by greedy promoters. The success of the book-building system depends on co-operation among the Book Runner Lead Manager, Issuing Company, Securities and Exchange Board of India (Regulator), and Investors. ❐