Reliability on IPO Grades for Retail Subscription- An Empirical Study

SEBI has mandated grading of the Initial Public Offers (IPO) since May 2007 in order to make more information available at the hands of the investors so as to enable them to make a better assessment of the IPO. The rationale behind compulsory rating is the fact that retail investors who are usually at a disadvantage when it comes to disclosure of information and news relating to developments about the company are given an opportunity to look at the fundamentals of the company before investing their hard earned savings and not to be deterred by the general disclaimers that equity investments are subject to market risks. Out of the total 56 public issues that were launched during the one year period from October 2009 to October 2010, 40 issues traded at a loss after one year of listing compared to their issue price. All these were rated from Grade 1 to Grade 4. This article analyses the objectives of IPO grading and its implications for retail investors on selecting a company for investment based on grading. The issues with listings period between October 2009 and October 2010 are considered for analysis.

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Out of the total 56 public issues that were launched during the one year period from October 2009 to October 2010, 40 issues traded at a loss after one year of listing compared to their issue price. All these equity issues were rated by one of the rating agencies and were assigned a rating with grades ranging from Grade 1 to Grade 4. Other anecdotal data also show that many

of the low graded issues with high oversubscriptions ending with a dismal listing raise questions such as

1. Usability of IPO grades for likely investors of the issue?
2. Extent of reliability and relevance on the ratings by investors who are not sophisticated and not capable of independently evaluating the instruments issued by the issuers?

What is IPO Grading?

According to SEBI, IPO grading is an assessment of the fundamentals of the company which is up for issue in comparison to its peers and other related securities in the country. After the grading process is completed, the CRA (Credit Rating Agency) comes out with one of the below grades as follows:

Grade1: Poor fundamentals
Grade 2: Below-average fundamentals
Grade 3: Average fundamentals
Grade 4: Above-average fundamentals
Grade 5: Strong fundamentals

What Are the Factors Which Get Evaluated?

The rating agency broadly tries to identify the strengths and weaknesses of the company under issue in terms of systematic and unsystematic risks and returns. Analysing the overall economic trend, followed by an industry analysis gives the potential investor to get a perspective of the company and its prospects for the days to come. Some of the firm level analysis done during grading includes a report on the financials of the company and information about the upcoming projects and orders. This usually forms the basis for the issue and intends to give a clear view to the investor to make a decision.

Pitfalls

There is a general impression in market circles that the rating agency undertakes a comprehensive scrutiny and in depth analysis of the company and comes out with a set of conclusions including advisability or otherwise of investing by a naïve investor into the equity shares of the said company. However, this impression is not true. In this context, it is important to look into and ascertain the following:

1. What factors don't get evaluated?
2. How to make sense of the grades?
3. Does a good grade indicate buy recommendation and a low grade indicate don't buy recommendation?

However, in the present scheme of things, there are several other factors and parameters which do not get evaluated and hence the retail investors need to keep in mind before relying on the grade declared by the rating agency.

The most basic criticism of grading is that the process of assignment of grading. Obviously the issuer pays and remunerates all other agencies like the merchant bankers and brokers at the front end and the rating agency and the Registrar & Transfer agent at the back end. Moreover, for the rating agencies it is the very nature of such fees that constitute the bread and butter of their total revenue.

1. **Issue price not considered for grading:**
   Perhaps the most critical factor while subscribing for any issue from the perspective of a retail investor would be its issue price. But the grading process and the exercise does not include any comment on the price band of the issue. In fact, the price band is not even determined by the Investment Bankers/ Issuers till the time grading is obtained. The problem arises when the investor reads the issue document and other publicity material, grading and the price band appear together at the time the issue information goes public in media and other forms. The retail investor in all fairness and natural choice of business may very well assume that the rating agency has given the grade by considering the price band with other things. So the investor many a time draws a conclusion that a highly graded issue justifies the price. Although the rating agency is not to blame for any of the assumptions that the investor may make, but somewhere this reflects the gap between perception and reality, which would incidentally affect the credibility of the rating agency.
2. **No recommendation:**
   The rating agencies view grading only as an additional input to the investor who is in the process of decision making whether or not to subscribe for an IPO. The rating agencies by themselves do not give any advice on whether the investor should invest in the issue and if yes, at what price and how much quantity. Therefore the grade still leaves the investor with more qualitative inputs but lacks with recommendation on quantitative outputs. An outcome of this process is that the retail investor in most occasions has to rely on the media reports coming through brokerages prior to the date of opening of the issue. The media generally paints a rosy picture about the prospects of the company.
3. **Transparency and accountability of rating agencies:**
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merchant bankers and brokers at the front end and the rating agency and the registrar & transfer agent at the back end. Moreover, for the rating agencies it is the very nature of such fees that constitute the bread and butter of their total revenue. Hence, the fairness of grading has come under fire and more so after the recent financial crisis. Similarly, there is practically no accountability on rating agencies if the post-issue scenario erodes the wealth of the investors. Therefore, if an investor follows a grade 4 recommendation of an issue and suppose the share crashes say on the day of listing as in many cases, the investor cannot seek compensation from the rating agencies for any loss as the Credit Rating Agencies (CRAs) only give an opinion and not a guarantee. In fact the CRA does not have any interface or contractual or otherwise relationship with the investor, who is the end consumer and for whose benefit the entire infrastructure is supposed to cater to.

Empirical Analysis

The following analysis is done to examine whether the grades assigned to issues by CRA are an indication of the actual future performance of the stock:

1. Compute the returns of the stock on listing w.r.t. issue price.
2. Compute the returns of the stock one year from the date of listing w.r.t. issue price.
3. Find the relative gain/loss of the stock w.r.t. a benchmark index (here Nifty) to compensate for the systematic risks.
4. If the relative returns of the stock is negative, we shall consider that IPO as "Failure".

The retail investor very often desires and believes that higher the grade of an IPO, lower would be the failure rate. Ideally, the investors will expect Grade 4 and 5 IPOs to be successful as they have been awarded with "Above average fundamentals" and "Strong fundamentals".

Post Listing Returns

Out of the total 56 IPOs which got listed between October 2009 and October 2010 considered for this study, 40 of them delivered negative returns and 39 delivered relative negative returns i.e. relative performance of the stock with respect to Nifty. October 2010 is taken as the cut-off date as computing the one year return is one of the critical parameters in determining the success/failure of any issue.

IPO Grade	Failed IPOs	Total IPOs	Average Relative Returns	Failure Rate
Grade 1	1	1	-78.80%	100.00%
Grade 2	15	19	-41.12%	78.95%
Grade 3	15	20	-14.21%	75.00%
Grade 4	9	15	-0.41%	60.00%
Total	**40**	**55**	**-20.92%**	**72.73%**

Table (a)

Figure (a)

From Figure (a), 63% out of 56 i.e. 35 issues received either Grade 3 or Grade 4 grades which indicate the issuing companies must be of at least decent fundamentals. Therefore even if we ignore the timing of the issue which may drive down the prices despite good fundamentals, we will consider the returns of the stock one year from date of listing which is sufficient enough to even out periods of high volatility in secondary markets. Again the criteria for failure of the IPO would be the relative performance and not absolute performance to account for market conditions.

Figure (b)

Applying the rule for failure of an IPO as discussed

above for our time period of analysis, we find that the failure rate increases with the decrease in grading. However, the striking aspect being that even for Grade 4 IPOs, the failure rate is as high as 60%. Even for Grade 3 issues which are supposed to be "Average Fundamentals", the failure rate is 75% which is almost same to the failure rate of Grade 2 issues. Therefore practically, any issue with grading from Grade 2 to Grade 4 have almost similar failure rates irrespective of the fundamentals of the company even when the market conditions are accounted for.

Therefore, the investors have to reconsider the relevance of IPO grading as a factor while deciding whether or not to subscribe for an issue.

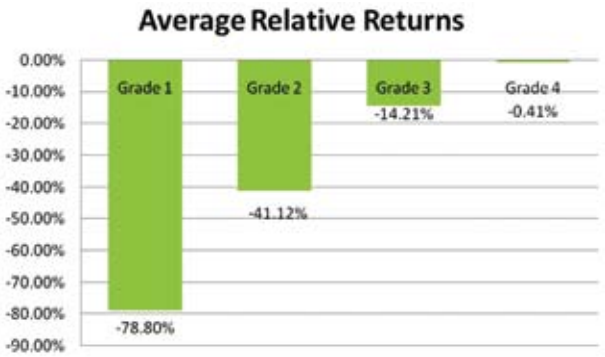

Figure (c)

Figure (c) shows the average returns generated by the cluster of each IPO grade. On an average basis, Grade 1 has the least return but that doesn't mean that issues in other Grading segments fare better. Factually, Grade 2 has the highest number of negative return earning issues with the least being of -86% returns of DB Realty. Interestingly, Grade 3 issues such as Jubilant Foodworks, Thangamayil Jewellery and Talwalkars Better Value Fitness produced returns higher than the highest returns provided by Grade 4 stocks with Jubilant Foodworks giving the highest return of 240% for the time period considered. In Grade 4 stocks, it was United Bank of India and Gujarat Pipavav port which earned the highest returns with UBI giving a return of over 50% for the time period.

The rating agencies in order to remove possible misconception in the minds of retail investors, should prominently display on the grading document that the price of the issue has not been not accounted, when the grade was assigned to the issue. This would make the investor aware that the extent to which the rating agencies have scrutinised the issuer and the issue.

When the lowest returns of issues in each Grade are analysed, there seems to be a pattern. The lowest returns in each grade goes on decreasing. However, there seems to be no correlation when the returns of issues in one Grade are compared with returns of the other.

Conclusion

Considering the above facts and analysis, the investors therefore can hardly make any decisions based on the IPO grading and hence reliability on grades issued to an IPO should be kept lower with more emphasis provided to some other parameters such as the valuations of the company or the sector/economy in which the company is operating.

Recommendations

1. ***Retail Investors: Gather and analyse more information from media and experts***
   As concluded above that relying on IPO grading is not sufficient and that investors have to use their prudence in arriving at and executing an investment decision. The grading is meant for a wide audience and in no way considers the risk-return profile of any individual or investor class. Hence, the individual retail investor has to assess his risk profile and return expectations with respect to that of the issue. This process may be cumbersome for a naïve investor and hence, it is advisable for such investors to seek the guidance of an expert such as a financial planner before proceeding to invest in any issue.
2. **Credit Rating Agencies: Disclosure that price is not recommended by the rating agency**
   The rating agencies in order to remove possible misconception in the minds of retail investors, should prominently display on the grading document that the price of the issue has not been accounted, when the grade was assigned to the issue. This would make the investor aware that the extent to which the rating agencies have scrutinised the issuer and the issue. Accordingly, the investor can undertake more research before investing in the issue.
3. **Regulators: Mandate objective scoring instead of grading**
   SEBI had taken a step in the right direction by making grading of all IPOs mandatory. Now it needs to make the process of grading more objective and make it investor friendly by enhancing the utility and relevance of the said tool and empowers the retail investor to take the right decision for preservation of his wealth. The present grading system has only 5 levels, thus leaving scope for subjectivity to

creep in. It is very much possible that two issues belonging to the same grade may have quite dissimilar fundamentals. A company might have just been able to get a Grade 3 and other company might be at the far-end of Grade 2. But on a broad basis, implications will be large as the reception of Grade 2 and a Grade 3 issue will be significantly different.

A more accurate and detailed approach would be to do away with grades and assign marks/scores instead out of 100. Marks should be allotted by giving weightages to parameters such as fundamentals of the company, industry, management quality, corporate governance record and financial track record, etc.

Judging the issues by assigning scores in a scale of 1 to 100 would definitely rationalise the process and solve borderline cases whereas now in some issues we find that two CRAs come up with different grades. Additionally, with objective scores, the transparency of the ratings and credibility of CRAs will increase over time.

Annexures:

Issues having listing between October 2009 and October 2010 considered for study:

Sr. No.	Company	IPO Grade	Issue Price	Price (On Listing)	Price (1-year Post-Listing)	Relative Returns
1	Euro Multivision	3	□ 75	□ 53.20	□ 29.25	-79.67%
2	Thinksoft Global Services Limited	2	□ 125	□ 307.50	□ 77.35	-54.21%
3	Indiabulls Power Limited	3	□ 45	□ 39.25	□ 27.65	-66.27%
4	Den Networks Limited	3	□ 195	□ 163.10	□ 213.50	-5.74%
5	Astec Lifesciences Limited	2	□ 82	□ 83.90	□ 61.40	-38.66%
6	Cox And Kings (India) Limited	4	□ 330	□ 213.00	□ 269.00	-32.95%
7	MBL Infrastructures Limited	2	□ 180	□ 205.00	□ 196.00	-0.73%
8	JSW Energy Limited	4	□ 100	□ 100.75	□ 100.25	-17.22%

Sr. No.	Company	IPO Grade	Issue Price	Price (On Listing)	Price (1-year Post-Listing)	Relative returns
9	Godrej Properties Limited	4	◻ 490	◻ 534.50	◻ 613.00	9.91%
10	D.B. Corp Limited	4	◻ 212	◻ 266.00	◻ 262.00	9.07%
11	Infinite Computer Solutions (India) Limited	2	◻ 165	◻ 191.60	◻ 177.00	1.51%
12	Jubilant Foodworks Limited	3	◻ 145	◻ 229.00	◻ 497.00	241.10%
13	Thangamayil Jewellery Limited	3	◻ 75	◻ 71.00	◻ 166.00	108.66%
14	Vascon Engineers Limited	3	◻ 165	◻ 147.00	◻ 101.00	-52.93%
15	Syncom Healthcare Limited	2	◻ 75	◻ 87.85	◻ 34.00	-68.81%
16	Aqua Logistics Ltd	3	◻ 25	◻ 24.43	◻ 18.35	-38.25%
17	D B Realty Limited	2	◻ 468	◻ 455.00	◻ 105.00	-85.88%
18	Emmbi Polyarns Limited	2	◻ 45	◻ 28.65	◻ 13.65	-77.98%
19	ARSS Infrastructure Projects Limited	2	◻ 450	◻ 736.00	◻ 603.00	25.19%
20	Hathway Cable & Datacom Limited	3	◻ 240	◻ 207.00	◻ 120.00	-59.13%
21	Texmo Pipes & Products Ltd	2	◻ 90	◻ 137.00	◻ 34.00	-69.61%
22	Man Infraconstruction Limited	3	◻ 252	◻ 350.00	◻ 143.00	-49.33%
23	United Bank of India	4	◻ 66	◻ 68.65	◻ 102.00	52.11%
24	NMDC Limited	NA	◻ 300	◻ 434.00	◻ 269.00	-19.14%
25	Pradip Overseas Limited	2	◻ 110	◻ 107.00	◻ 86.00	-31.91%
26	II&Fs Transportation Networks Limited	4	◻ 258	◻ 275.00	◻ 238.00	-17.73%
27	Persistent Systems Limited	4	◻ 310	◻ 406.00	◻ 406.00	21.17%
28	Shree Ganesh Jewellery House Limited	3	◻ 260	◻ 165.00	◻ 166.00	-45.11%
29	Intrasoft Technologies Limited	3	◻ 145	◻ 159.00	◻ 69.00	-60.77%
30	Goenka Diamond & Jewels Limited	2	◻ 135	◻ 127.60	◻ 66.30	-61.57%
31	Talwalkars Better Value Fitness Limited	3	◻ 128	◻ 163.00	◻ 220.00	65.18%
32	Nitesh Estates Limited	2	◻ 54	◻ 51.40	◻ 27.70	-55.77%
33	Tarapur Transformers Limited	1	◻ 75	◻ 57.40	◻ 21.15	-78.80%
34	Mandhana Industries Limited	3	◻ 130	◻ 133.50	◻ 180.00	28.13%
35	SJVN Limited	4	◻ 26	◻ 25.00	◻ 21.00	-30.12%
36	Jaypee Infratech Limited	3	◻ 102	◻ 91.30	◻ 53.00	-59.30%
37	Parabolic Drugs Limited	3	◻ 75	◻ 65.00	◻ 41.00	-52.49%
38	Aster Silicates Limited	2	◻ 118	◻ 200.00	◻ 23.30	-81.93%
39	Technofab Engineering Limited	3	◻ 240	◻ 296.00	◻ 133.00	-48.05%
40	Hindustan Media Ventures Limited	4	◻ 166	◻ 189.00	◻ 133.00	-22.51%
41	SKS Microfinance Limited	2	◻ 985	◻ 1,089.00	◻ 318.00	-60.66%
42	Bajaj Corp Limited	4	◻ 132	◻ 152.00	◻ 110.00	-6.90%
43	Prakash Steelage Limited	2	◻ 110	◻ 188.00	◻ 126.00	25.95%
44	Gujarat Pipavav Port Limited	4	◻ 46	◻ 54.00	◻ 66.00	53.77%
45	Indosolar Limited	3	◻ 29	◻ 24.00	◻ 9.00	-52.68%
46	Eros International Media Limited	4	◻ 175	◻ 190.00	◻ 232.00	55.77%
47	Career Point Infosystems Limited	3	◻ 310	◻ 628.00	◻ 246.00	2.55%
48	Microsec Financial Services Limited	2	◻ 118	◻ 110.00	◻ 29.00	-52.73%
49	Ramky Infrastructure Limited	3	◻ 450	◻ 387.00	◻ 205.00	-34.53%
50	Orient Green Power Company Limited	4	◻ 47	◻ 45.00	◻ 15.00	-48.17%
51	Electrosteel Steels Limited	3	◻ 11	◻ 11.25	◻ 6.00	-25.54%
52	Cantabil Retail India Limited	2	◻ 135	◻ 105.00	◻ 24.55	-65.54%
53	Tecpro Systems Limited	4	◻ 355	◻ 405.70	◻ 215.00	-23.16%
54	Ashoka Buildcon Limited	4	◻ 324	◻ 333.35	◻ 239.25	-9.24%
55	Bedmutha Industries Limited	2	◻ 102	◻ 179.00	◻ 109.00	23.78%
56	Commercial Engineers & Body Builders Co Limited	2	◻ 127	◻ 113.00	◻ 39.55	-51.77%

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