Financial Institutions and Markets
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Lecture – 48
Stock Market – III

So, after they discussion on the valuation of equity are the different methods used for the valuation of equity we can move into another session on the Stock Market. Now, in this session will be discussing certain things related to the functioning of the market in this financial system. So, if you remember that whenever you talk about the market, every market has 2 segments and like any other market stock market also has 2 segments; one is your primary market, another one is the secondary market.

So, in this session will be discussing on the primary market; and how the pricing of the securities in the primary market is done then we can move into the discussion on secondary market in the subsequent sessions.

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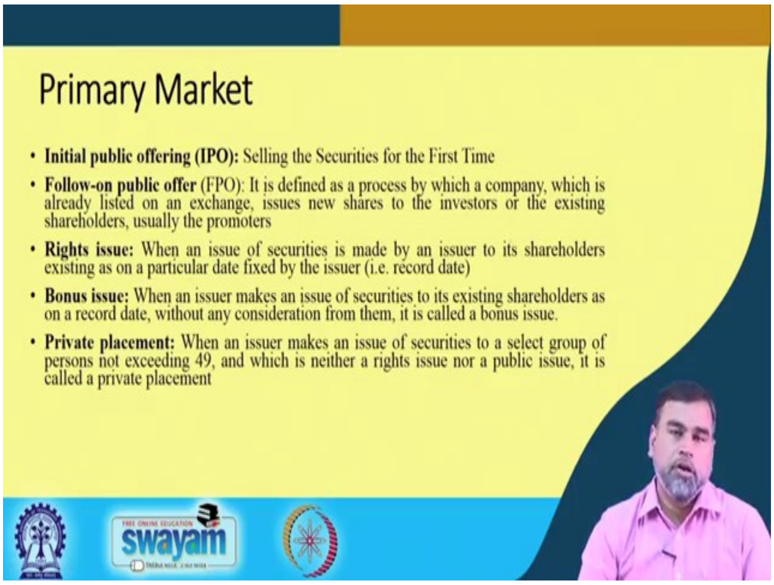

You see that whenever we talk about primary market, what exactly the primary market is? The primary market is basically what; it is the market where the securities are sold for the first time. In India it is basically popularly known as the IPO market or Initial Public Offerings.

But in primary market initial offerings, initial public offerings or IPOs are not only securities which are available or only instrument which are available. There are other securities also available in this particular segment. There are different type of securities which are available in this particular segment, which are those? One is your after this IPO we have another instrument called the follow on public offerings and what do mean by this? This is also one type of IPO.

But why we call it the follow on public offerings? Because, so this is basically offered not for the first time. Here the company basically already listed in the stock exchange, but the issues of new shares with the investors or the existing shareholders usually the promoters to increase their capital base. So, already that company is not company which is unlisted or first time they are coming to the market for the listing, but those companies are already listed and they are already issuing the equity; already they have issued by equity, but still they want to raise more equity from the public. So, because of that they can go for the FPO or the Follow on Public Offerings

That is also another instrument, another process through which the instruments in the primary market can be raised. Then we have another instrument called the right issue, what is that right issue? The right issue is basically what, when the issue of securities is made by the issuer to the shareholders which are existing, but on a particular date which are fixed by the issuer that date is called the record date. So, the rights always there given to the existing shareholders and whenever the company wants to raise the money or raise the particular kind of resources from the market the priorities are given to the existing shareholders the shareholders has the right to issue that security.

But, the date is fixed by the issuer and that is basically we call it the record date. Then another thing is the bonus issue; the bonus issue basically whenever any kind of reserves which are there in the company that can be utilized; companies tries to raise that particular thing as a bonus issue. So, it is again to the existing shareholders as an record date without any consideration from them, and there is no need to inform the shareholders that this is the issue what they are trying to make and this is basically called the bonus issue.

Then we have another issue called the private placement and when we call the private placement? Whenever the issuer basically make the issue of the securities to a select group of persons, select group of investors not exceeding 49, which is neither a right issue nor a public issue, then it is called the private placement.

That means, the equities what basically has been raised through that is private issue placed and the number of investor in that particular security should not exceed 49. So, in that context we call it is the private placement, this is also another type of instrument which are raised from the primary market.

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Then if you see that whenever you talk about the primary market most of the people argue that the primary market development is the real development in the financial system or what we can say that the importance of the primary market it quite large. Why it is large? Whenever at a first time company has gone for IPO it increases the visibility of the company and it also increases the alternative sources of finance for the company.

And once the company became public, there is a greater transparency, everybody will come about will know about the company's financial conditions and companies are also bound to follow certain kind of regulatory norms of the regulators like securities and exchange board of India. And as well as, any kind of shareholder or any kind of people who are involved to that particular company they can always have the idea that what kind of business the company is doing and what is the pricing and all these things related to that particular company that all kind of information they can get. And I already told you it also helps in raising the capital because equity is another source of fund after the debt and this other type of instruments.

So, initial public offerings or the importance of IPO market helps to raise the capital from the market in the larger extent. And they helps basically creation of the capital for the company for the investment. Because the capital sometimes in the equity market is cheaper, because the price of the IPO is relatively less, it also helps for the investment and once the investment will go up it basically helps also to enhancing the profitability. The profitability of the company can be increased through this IPO.

Then we have a better corporate governance why we can say that raising the money from the public increases the corporate governance, because anybody who invests in their particular company through this IPO market in terms of equity. So, they are much more concerned about the operations of the company or the financial condition of the company. So, because of that the governance of this particular company will be better off, and the manager will be much more concerned about the performance and because of that the company's governance system can be always judged in a better way by the public domain.

So, this is another relevance or another importance for the development of the IPO market, after all the IPO market basically the real addition to the existing system which is not basically always we realize from the secondary market. So, the development of the IPO market is quite important, because the new capital can be generated through this development of the IPO market.

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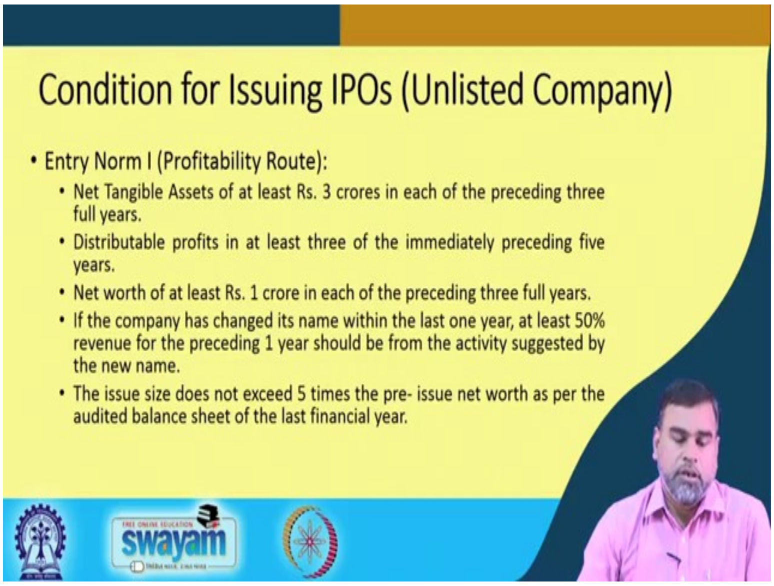

So, how this IPOs are issued? Whether all companies can issued the IPO or all company can go for IPO or not? These are the different questions. So, whenever any company basically goes for IPO the basic objective of the issuing the IPO is the company wants to raise the money from the public and as well as the company wants to be listed in the stock exchange.

If the company wants to be listed in the stock exchange, then whether is there any possibility that every company wants to, if any company wants to go for IPO they can do it or not. So, there are different ways different conditions the regulatory bodies have particularly SEBI has put for these ones of the IPO in the market. So, not all the companies can go for IPO whenever they want they have to fulfill certain conditions and after fulfilling of the conditions only they can raise the IPO from the market. Then what are those kind of conditions they basically want to put.

So, let there is an entry norm and here in the entry norm one the route is called the profitability route. So, in the profitability route what are those conditions? The company who wants to raise the IPO the net tangible asset of the particular company should be at least 3 crore in each of the preceding 3 full years. So, last 3 years the company’s net tangible asset; tangible asset in the sense the fixed assets we are referring at least the value of the tangible asset of the company should be 3 crore.

And the company has generated the profit and that is a distributable profit for at least 3 of the immediately preceding 5 years. The company is able to generate the profit from the market and that is why whenever the company has started the operation, there is some kind of distributable profit is existing with this particular company.

Net worth of the company at least 1 crore in each of the preceding 3 full years, the last 3 years preceding 3 years the net worth of the company should be at least 1 crore and if the company has changed its name in between and the company has started this operations or it has been founded. Then within the last 1 year, at least 50 percent of the revenue of the preceding 1 year should be from the new company. Whatever new name they have given the 50 percent of the revenue has been generated in the name of the new company and through that new whatever name basically they have given and on that name basically they are issuing the IPO.

So, because on that name they are issuing the IPO, the 50 percent of the total revenue should come from that. And the issue size does not exceed 5 times the pre issue net worth as per the audited balance sheet of the last financial year. How much basically they can raise from the market? How much equity they can raise? That depends upon their net worth. So, if the net worth is 2 crore in the last financial year.

So, they can raise maximum 10 crore because it should not exceed the 5 times of the pre issue, a net worth of that particular company whatever net worth the company has. The maximum 5 times of the net worth, so, equity they can raise it from the public. So, that is, these are the conditions the company has to satisfy if the company at all wanted to issue the IPO from the market.

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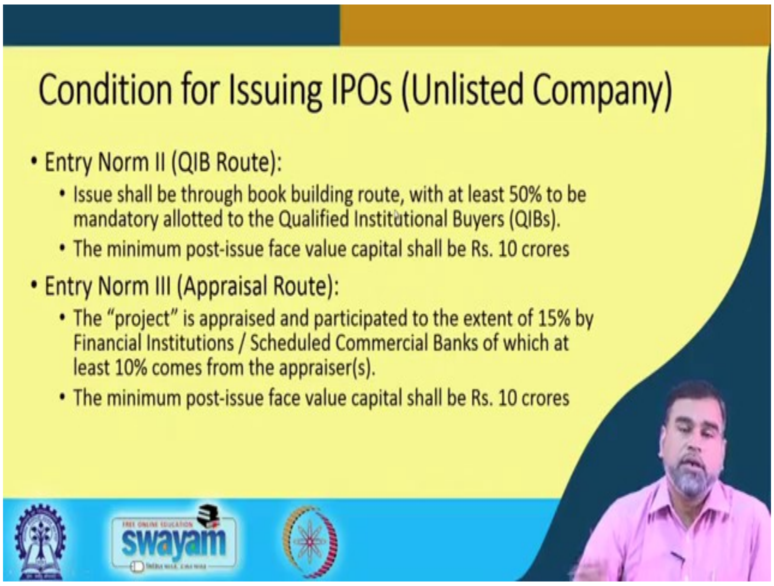

Then we have another one that is your entry norm II that is called the QIB route Qualified Institutional Buyer route. So, here what basically happens, what is the condition the SEBI has put forth? That the issue shall be through the book building route, that is a book building process for raising the IPO that we will discuss, and at least 50 percent to be mandatorily alerted to the QIBs.

There are some qualified institutional buyers exist in the market and whatever IPO they want to raise from the public out of them the 50 percent should be reserved for the QIBs, that basically they have to do and the minimum post issue face value of the capital should be 10 crore. The face value, the minimum post issue face value of the capital what they want to raise that should be 10 crore and that is called the QIB route.

That means, all the 100 percent money what they want to raise it from the public, that should not be directly from the public or the capital investors, that is 50 percent of the total money will be reserved for the QIBs and another 50 percent money can be raised from the public.

Then we have another route that is called the appraisal route; in the appraisal route the particular project is apprised and participated to the extent of 15 percent by financial institutions scheduled commercial banks of which at least 10 percent come from the appraisers and the minimum post issue value should be 10 crore. So, these are the different kind of routes through which the IPOs become, if the either of this condition the company will satisfy, then they can raise they can issue the IPO from the market.

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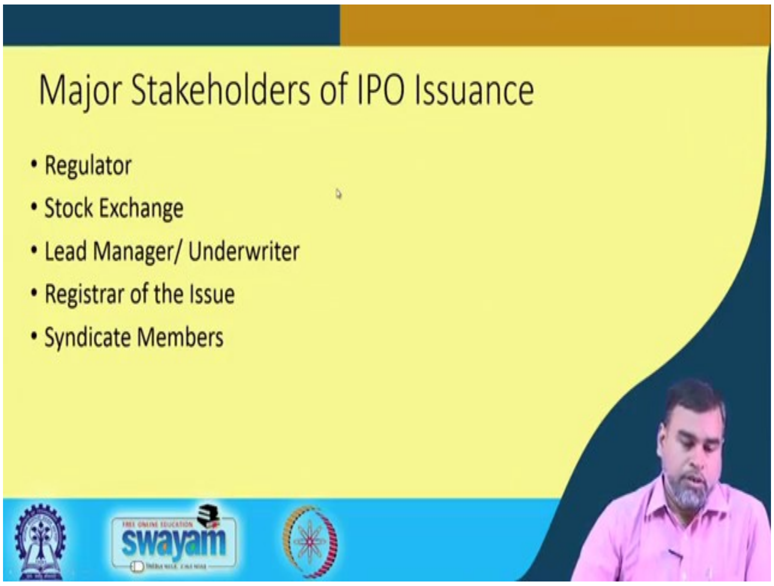

So, these are the norms which are put forth by SEBI for the issuance of the IPO by the companies in the financial system. Then whenever the IPO s are issued from the issued to the market or the company wants to issue the IPO to raise the money, which are those major stakeholders who are involved in this process? So, obviously, there is a regulator. So, in the Indian context this is SEBI, Securities and Exchange Board of India.

Then we have a stock exchange, we have the stock exchange like Bombay stock exchange National Stock Exchange and all. So, they are basically the important national stock exchange is responsible for the US market. And we have the national stock exchange or we have the Bombay stock exchange they are responsible for this.

Then they have a lead manager or the underwriter they have which is called the book runner lead manager which is basically a merchant banker. They should be there; they have a strong rule for the IPO issue once, then we have a register of this particular issue. Merchant banker appoints one register for this who basically keeps the records and everything for the transactions and all kind of process which happens to the IPOs. Then the merchant banker also appoint some Syndicate members who are registered again with the SEBI, who works as basically one of the intermediary for creating demand and supply situation in the market. So, these are the different kind of stakeholders which are involved in this IPO issuance process and they basically helpful for the issuing the IPO from the market.

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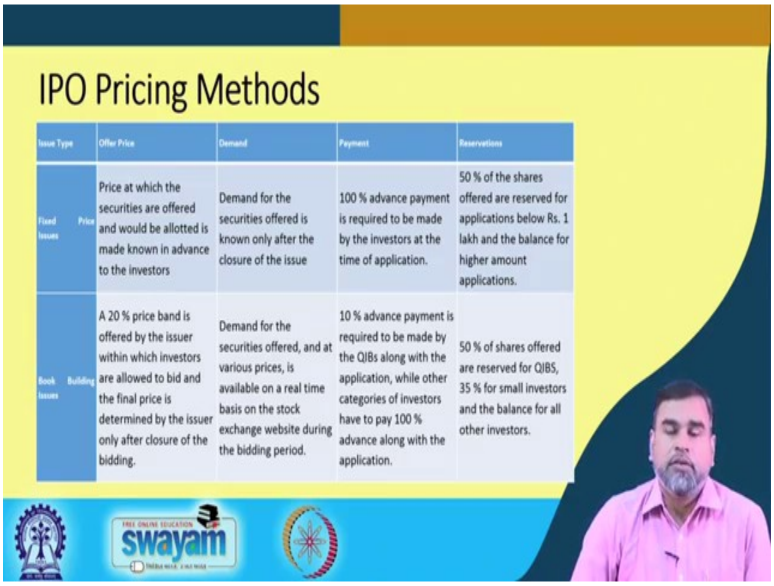

So, whenever you talk about the IPO pricing methods, there are 2 types of methods we follow, either we can go for a book building process or book building issues or we can go for a fixed price issues. There are 2 ways the IPO pricing is done from the market or IPOs are issued in the market.

So, how basically it is different if you see whenever we are using the fixed price issues, in the fixed price process the prices are known in advance to the investor at what price the IPOs are basically they are getting. So, whenever they are buying this IPOs the initial issues they know that at what price this IPO s are basically available for that whether the for issue it is 50 rupees 20 rupees 30 rupees that is known to them.

And the demand for the securities, how much demand is there for that IPO that will be known only after the closure of the issue. Once the issue will be closed, then only they will come to know that what kind of demand the people have or the investor has on this particular type of security. And here the payment how do they make, the 100 percent advance payment is required by the investor at the time of application.

If the investor wants to invest in that IPO, then 10 percent of the total money they have to pay; if they want to invest, they want to buy 100 shares of 100 rupees then total 100 into 100 they have to pay all those 10000 rupees to them. Then we have the reservations under 50 percent of the shares result for the applications below 1 lakh and the balance of higher amount the applications; that means, there is some kind of advantages are given to the small investors who wants to maximum 1 lakh rupees.

So, whatever IPOs will be issued these are basically reserved for the, if it is a fixed price issue, then the investor who wants to invest up to maximum 1 lakh rupees for them the 50 percent shares are reserved and another 50 percent basically can be given to the other shareholders who are the bigger share holders. Then the book building issues if you talk about here the price band is different the offer price is not exactly mention a 20 percent price band is offered by the issuer within which investor are allowed to bid and the final price is determined by the issuer only after the closure of the bidding there is a bidding time period and you can bid it there is a price band will be given their exact price will not be mentioned.

So, within that price band you can bid for this, but exactly what price will be determined that will be not basically known from the beginning. The demand for securities offered and that various prices is available on the real time basis on the stock exchange during this bidding period. What kind of demand is created for that particular IPO in the real time basis this is all reflected in the stock exchange website you can see that one.

And 10 percent of advance payment is required to be made by the QIBs along with the application, while the other categories qualified institutional buyers have to pay only 10 percent of the advance and other has to pay the 100 percent of the advance along with the application whenever they want to subscribe that particular IPO.

In terms of reservations if you see the 50 percent reservations are for the QIBs, 35 percent of the small investors and the balance is for the other investors; that means, 85 percent of reserved 50 percent for QIBs qualified institutional buyers and 50 percent reserved for the small investors who are investing less than 1 lakh rupees. And rest of the money will be offered to the other type of investors when who are not the qualified institutional buyers neither or neither their qualified institutional buyers nor they are the small investors category, so, for them only 15 percent is reserved for them for the investment.

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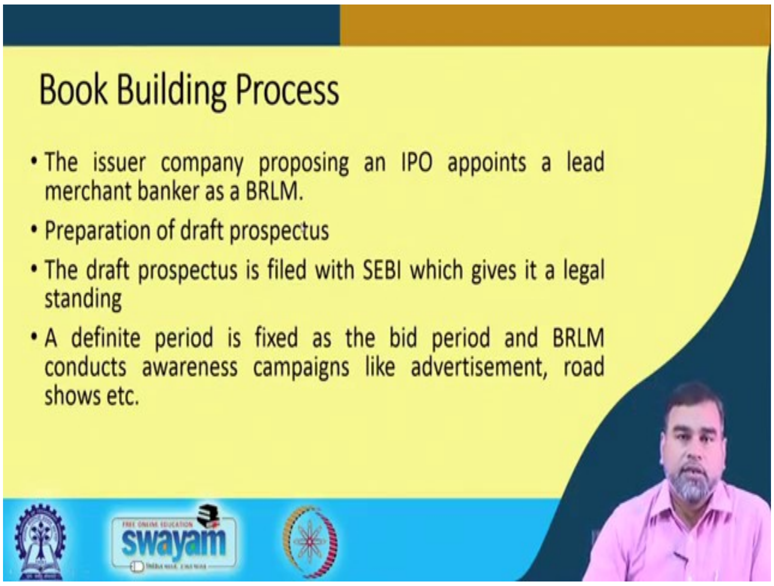

Then we can see that what exactly the book building processes is, how the book building process works? That for example, any company has gone for IPO nobody knows about the company and the company has started the business although this is there in the market for 5 years or for 10 years down the line. But the company is not listed in the market very less information is available about the company.

But the company wanted to be listed in the stock exchange and they want to raise the money from the public through this IPO market to the issuance of the IPO. Then how they decide the price and how this particular price are determined this process is basically through which process, the price is determined and the demand for that IPO is determined that is basically the process itself is called the book building process.

So, here what is the first step? The first step is, let any company has thought of by issuing the IPO in the equity market, that is the first step. And once they have thought of what is the next step they have to basically appoint one lead manager merchant banker basically or in our language also we can call them the investment banker.

So, there is a merchant banker they will appoint they are called the BRLM, the Book Runner Lead Manager. The BRLM stands for the book runner lead manager that will be appointed by the issuing company. First the book runner lead manager will be appointed. Then with the consultation of the company the book runner lead manager prepares the draft prospectus one prospectors will be prepared. You remember these prospectors will not contain about the pricing of this particular equity or pricing of the particular issue.

But, it will contain about the company, about the history of the company, what are the nature of the business the company is doing, what is the growth prospect of the company all the details. So, once the particular prospects will be prepared the draft prospect will be always files with SEBI for their approval. The SEBI will go through this draft prospect it will be sent to securities and exchange board of India. SEBI will go through the draft prospect and decide whether everything is in order or not.

And once they got this legal approval from the SEBI then what will happen that a fixed definite period will be fixed which is called the bid period. Generally 5 days a bid period will be fixed and this is the responsibility of the BRLM the book runner lead manager and merchant banker and to create the awareness about this particular issue or the IPO issuance through the advertisement they can go for the road show they can publish it in the newspapers.

So, all type of process can happen and this is the responsibility of the book runner lead manager who also acts as the under writer. And their responsibility is basically what, to create the awareness about this issue once about this particular IPO and to create the demand basically, that the major responsibilities to tell the public that this is the IPO which is issued. And this is the price band and this is the company which is issuing this is basically the age of the company this is the nature of the business of the company all the details everything will be there. And there will be a proper advertisement and the road show and that is the responsibility of the book runner lead manager.

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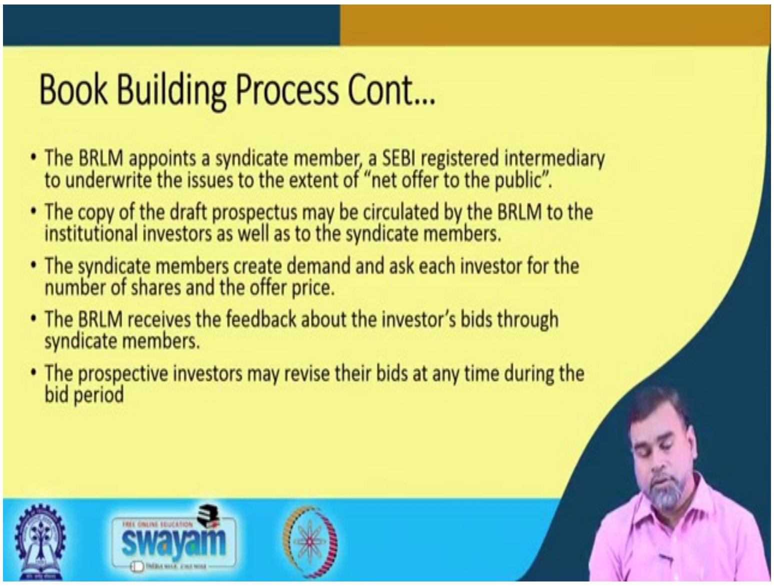

Once this is done, the next step is the book runner lead manager will appoint a Syndicate member. The Syndicate member is basically what, it is a SEBI registered intermediary the basic job of this Syndicate member is to underwrite this issues to the extent of net offer to the public or their basic job is to basically creation of the demand among the public. Then what will happen that once the Syndicate members will be decided whatever the copy the draft prospectus has been prepared that book runner lead manager will share that prospectus with the some bigger institutional investors and as well as the Syndicate members.

Now, Syndicate members have received the copies and as well as the some of the institutional investors also have received the copy of the prospectus. So, once they receive the prospectus what they will do, they will share it among the different public domain and they try to judge that what kind of demand is available with respect to this. So, then the Syndicate members create the demand and asks each investor for the number of shares and the offer price.

Then what will happen the Syndicate member will provide the feedback to the BRLM about the investors bid and once the BRLM got this feedback, then what will happen that this prospective investors may revise their bids at any time. If after knowing the prospectus and everything they want to revise the bid also, they let they have bided for

50 and what now they want to change it 51 or they want to change it to 49 that also they can do.

And accordingly, what will happen that up to that bidding time they cannot exceed that within that 5 days time period or whatever changes whatever religions they want to make they can make it. And all the information will go to the book runner lead manager and once the book runner lead manager will get all those information.

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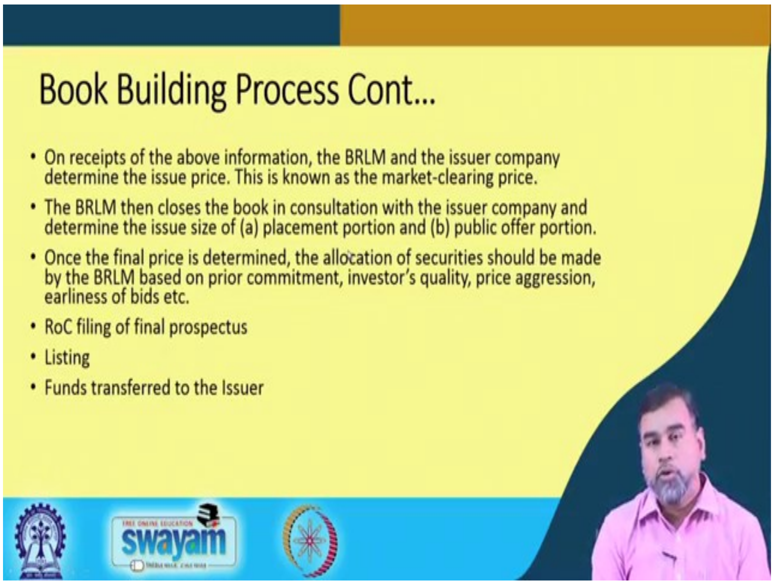

Then what will happen, after that the book runner lead manager and the issuer company determine the issue price depending upon the demand of that particular issue they decide the final price which is called the market clearing price. After the final price are determined what we always define it as the market clearing price.

And once the market clearing price will be decided, then the book runner lead manager then close the book in consultation with a issuer company and determine the issue size that how much will be reserved for the specific group of investor and how much will be given to the public. Then what will happen the allocation of the securities will be made based on the prior commitments, investor's quality, price aggression, earliness of the bids etcetera.

There are different factors they can consider then after considerations what will happen that they will allocate this particular funds or allocate this particular resource to the different type of investors. And finally, once the allocation is made then ROC filing of the final prospectus will be made. The ROC means, the record filing what basically they do it the register of companies filing of the prospectors they do that.

Then once it is done with the SEBI once it is done then the company can be listed and the funds transferred to the issuer whatever money basically the company the investors are bided the money will be transferred to the different issuers or the issuing company who wants to issue this particular shares. And once it is listed then finally, this become the capital of the company and company can use that particular fund for their investments. So, that is the detailed step of the book building process this is the way the price of this equity can be determined in this particular market.

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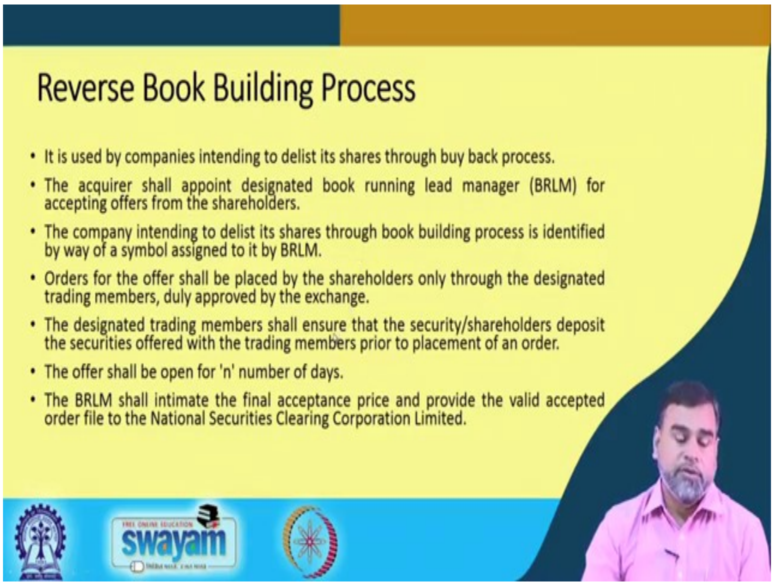

So, there is another process called the reverse book building where the companies intended to delist their shares through the buy back, they have gone for the book building they have listed, but they want to delist themselves by backing the shares. Then what they do, again they can appoint the book run lead manager, they can go for they again the reverse book building process and order will be placed by the shareholders only through the designated trading members duly approved by the stock exchange then the offer will be again open for some days then the BRLM will initiate the final aspect acceptance price and provide the valid accepted order file to the National Securities Clearing Corporation Limited.

So, all those details, it is same process, but the process is reversed. So, there the company wants to delist itself from the stock exchange.

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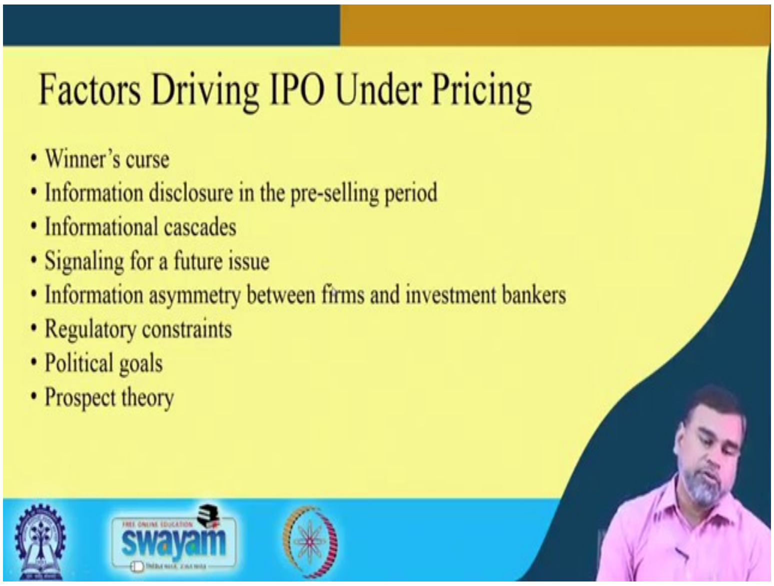

Then generally it is observed the IPOs are under priced in nature and why it is underpriced there are various reasons for that you see there is one reason is winners curse, winner curse means there are 2 types of investors available in the market; one is informed another one is uninformed.

So, sometimes what happens that whenever the allocation is made the particular investors who are uninformed they always feel that whatever quotations have give they got all kind of IPOs because they deserve to get that IPOs, but maybe there are certain things they are not aware about, that is why the bidding whatever they have made that is relatively in the higher zone about the informed investors may not look at that.

So, in that context intentionally if the price will be relatively low then that kind of problem will not arise in the particular system. Then sometimes also what happens this information disclosure may happen to the pre selling period the book run lead manager book run a BRLM basically can save this information to some specific group of the investors and to attract them for the investment they can give that particular price relatively low. Informational cascades; that means, basically what happens that creates some kind of information gap between the different group of the investors which exist in the market.

So, because of lack of information with some group maybe the reluctant to go and invest in this IPO to attract them for the investment, generally what the companies do they reduce that particular price and the book runner lead manager intentionally reduced the price or keep the price low for their investment. Then sometimes also they keep this price relatively low which gives a signal for the future issuance and the future they can do there can be information asymmetry between farms an investment banker or the merchant banker because merchant banker has more idea about this IPO pricing than the company.

So, they can use because of that they intentionally keep the price low. There are some regulatory constant also in some of the countries, they cannot give the price to a higher level. Then, they have political goals sometimes the companies are going for the IPO the reason is basically they want to provide those kind of IPOs to their own people or the party members who wants to support them and the political system. So, because of that they always compel this companies to reduce that IPO price by that everybody can invest in that and there are some psychological or the behavioral theories also involved in this. The biases are to attract this investors to participate in the process sometimes also the pricing relatively always kept low for the IPOs.

So, these are the different factors which are responsible for the under pricing of the IPOs, because once the IPO is listed the price all of sudden goes up that you might observe 99 percent of the cases the IPOs are highly always is under priced in the market and once it is listed you will find that the price all of sudden will go up by 50 25 to 30 percent. That always we have seen in the market system. So, this is about the different IPOs and the factors deriving the IPO pricing.

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So, these are the references you can go through for this particular session and you can get the detail idea about this IPO and IPO pricing.

Thank you.