CHAPTER 5

The IPO Markets - Part 2

5.1 - Overview

The previous chapter gave us an understanding on how a company evolved right from the idea generation stage to all the way till it decides to file for an IPO. The idea behind creating the fictional story in the previous chapter was to give you a sense of how a business matures over time. The emphasis obviously was on the different stages of business and funding options available at various stages of business. The previous chapter gives you a perspective of what a company would have gone through before it comes out to public to offer its shares.

This is extremely important to know because the IPO market, also called the **Primary market** sometimes attracts companies offering their shares to public without actually going through a healthy round of funding in the past. Few rounds of funding by credible VC, and PE firm validate the quality of the business and its promoters. Of course you need to treat this with a pinch of salt but nevertheless it acts as an indicator to identify well run companies.

5.2 - Why do companies go public?

We closed the previous chapter with few very critical questions. One of which – Why did the company decide to file for an IPO, and in general why do companies go public?

When a company decides to file for an IPO, invariably the main reason is to raise funds to fuel their Capex requirement. The promoter has 3 advantages by taking his company public..

1. He is raising funds to meet Capex requirement

2. He is avoiding the need to raise debt which means he does not have to pay finance charges which translates to better profitability

3. Whenever you buy a share of a company, you are in essence taking the same amount of risk as the promoter is taking. Needless to say, the proportion of the risk and its impact will depend on the quantity of shares you hold. Nonetheless, whether you like it or not, when you buy shares you also buy risk. So when the company goes public, the promoter is actually spreading his risk amongst a large group of people.

There are other advantages as well in going for an IPO…

1. **Provide an exit for early investors** - Once the company goes public, the shares of the company start trading publicly. Any existing shareholder of the company – could be promoters, angel investors, venture capitalist, PE funds; can use this opportunity to sell their shares in the open market. By selling their shares, they get an exit on their initial investment in the company. They can also choose to sell their shares in smaller chunks if they wish.
2. **Reward employees** –Employees working for the company would have shares allotted to them as an incentive. This sort of arrangement between the employee and the company is called the "Employee Stock Option". The shares are allotted at a discount to the employees. Once the company goes public, the employees stand a chance to see capital appreciation in the shares. Few examples where the employee benefited from ESOP would be Google, Infosys, Twitter, Facebook etc
3. **Improve visibility** - Going public definitely increases visibility as the company has a status of being publicly held and traded. There is a greater chance of people's interest in the company, consequently creating a positive impact on its growth.

So let's just build on our fictional business story from the previous chapter a little further and figure out the IPO details of this company.

If you recollect, the company requires 200 Crs to fund their capex and the management had decided to fund this partly by internal accrual and partly by filing for an IPO.

Do recollect that company still has 16% of authorized capital translating to 800,000 shares which are not allotted. The last valuation of these shares when the PE firm invested in Series B was 64Crs. The company has progressed really well ever since the PE firm has invested and naturally the valuation of these shares would have gone up.

For the sake of simplicity, let us assume the company is now valuing the 16% shares anywhere between 125 Crs to 150 Crs. This translates to a per share value, anywhere between Rs.1562 to Rs.1875/-…(125Crs/8lakh).

So if the company puts 16% on the block to the public, they are likely to raise anywhere between 125 to 150 Crs. The remainder has to come from internal accruals. So naturally, the more money they raise, better it is for the company.

5.3 - Merchant Bankers

Having decided to go public, the company must now do a series of things to ensure a successful initial public offering. The first and foremost step would be to appoint a **merchant banker**. Merchant bankers are also called **Book Running Lead Managers (BRLM)/Lead Manager (LM)**. The job of a merchant banker is to assist the company with various aspects of the IPO process including…

- Conduct a due diligence on the company filing for an IPO, ensure their legal compliance and also issue a due diligence certificate
- Should work closely with the company and prepare their listing documents including **Draft Red Herring Prospectus (DRHP)**. We will discuss this in a bit more detail at a later stage
- **Underwrite shares** – By underwriting shares, merchant bankers essentially agree to buy all or part of the IPO shares and resell the same to public
- Help company arrive at the price band for the IPO. A **price band** is the lower and upper limit of the share price within which the company will go public. In case of our example, the price band will be Rs.1562/- and Rs.1875/-
- Help the company with the road shows – This is like a promotional/marketing activity for the company's IPO

- Appointment of other intermediaries namely, registrars, bankers, advertising agencies etc. The Lead manager also makes various marketing strategies for the issue

Once the company partners with the merchant banker, they will work towards taking the company public.

5.4 - IPO sequence of events

Needless to say each and every step involved in the IPO sequence has to happen under the SEBI guidelines. In general, the following are the sequence of steps involved.

- **Appoint a merchant banker**. In case of a large public issue, the company can appoint more than 1 merchant banker
- **Apply to SEBI with a registration statement** – The registration statement contains details on what the company does, why the company plans to go public and the financial health of the company
- **Getting a nod from SEBI** – Once SEBI receives the registration statement, SEBI takes a call on whether to issue a go ahead or a 'no go' to the IPO
- **DRHP** – If the company gets the initial SEBI nod, then the company needs to prepare the DRHP. A DRHP is a document that gets circulated to the public. Along with a lot of information, DRHP should contain the following details..

    a.The estimated size of the IPO

    b.The estimated number of shares being offered to public

    c.Why the company wants to go public and how does the company plan to utilize the funds along with the timeline projection of fund utilization

    d.Business description including the revenue model, expenditure details

    e.Complete financial statements

    f.Management Discussion and Analysis – how the company perceives the future business operations to emerge

    g.Risks involved in the business

    h.Management details and their background
- **Market the IPO** – This would involve TV and print advertisements in order to build awareness about the company and its IPO offering. This process is also called the IPO road show

- **Fix the price band** – Decide the price band between which the company would like to go public. Of course this can't be way off the general perception. If it is, then the public will not subscribe for the IPO

- **Book Building** – Once the road show is done and price band fixed the company now has to officially open the window during which the public can subscribe for shares. For example, if the price band is between Rs.100 and Rs.120, then the public can actually choose a price they think is fair enough for the IPO issue. The process of collecting all these price points along with the respective quantities is called Book Building. Book building is perceived as an effective price discovery method

- **Closure** – After the book building window is closed (generally open for few days) then the price point at which the issue gets listed is decided. This price point is usually that price at which maximum bids have been received.

- **Listing Day** – This is the day when the company actually gets listed on the stock exchange. The listing price is the price discovered through the book building process.

5.5 - What happens after the IPO?

During the bidding process (also called the date of issue) investors can bid for shares at a particular price within the specified price band. This whole system around the date of issue where one bids for shares is referred to as the **Primary Market**. The moment the stock gets listed and debuts on the stock exchange, the stock starts to trade publicly. This is called the **secondary markets.**

Once the stock transitions from primary markets to secondary markets, the stock gets traded daily on the stock exchange. People start buying and selling the stocks regularly.

Why do people trade? Why does the stock price fluctuate? Well, we will answer all these questions and more in the subsequent chapters.

5.6 Few key IPO jargons

Before we wrap up the chapter on IPO's let us review few important IPO jargons.

Under Subscription – Let's say the company wants to offer 100,000 shares to the public. During the book building process it is discovered that only 90,000 bids were received, then the issue is said to be under subscribed. This is not a great situation to be in as it indicates negative public sentiment

Over subscription – If there are 200,000 bids for 100,000 shares on offer then the issue is said to be oversubscribed 2 times (2x)

Green Shoe Option - Part of the underwriting agreement which allows the issuer to authorize additional shares (typically 15 percent) to be distributed in the event of over subscription. This is also called the over allotment option

Fixed Price IPO –Sometimes the companies fix the price of the IPO and do not opt for a price band. Such issues are called fixed price IPO

Price Band and Cut off price –Price band is a price range between which the stock gets listed. For example if the price band is between Rs.100 and Rs.130, then the issue can list within the range. Let's says it gets listed at 125, then 125 is called the cut off price.

Recent IPO's in India*

Here is a look at few recent IPO's in India. With all the background information you now have, reading Table 5.1 in the following page should be easy

Table 5.1 - Recent IPO's in India

Sl No	Name of Issue	Issue Price (INR)	BRLM	Date of Issue	Issue Size (Lakh Shares)	Price Band (INR)
1	Wonderla Holidays Limited	125	Edelweiss Financial Services and ICICI Securities Limited	21/04/2014 to 23/04/2014	14,500,000	115 to 125
2	Power Grid Coporation of India Ltd	90	SBI, Citi, ICICI, Kotak, UBS	03/12/2013 to 06/12/2013	787,053,309	85 to 90
3	Just Dial Ltd	530	Citi, Morgan Stanley	20/05/2013 to 22/05/2013	17,493,458	470 to 543
4	Repco Homes Finance Limited	172	SBI, IDFC, JM Financials	13/03/2013 to 15/03/2013	1,57,20,262	165 to 172
5	V-Mart Retail Ltd	210	Anand Rathi	01/02/2013 to 05/02/2013	4,496,000	195 to 215

*Source : NSE India, as of June 2014

Key takeaways from this chapter

1. Companies go public to raise funds, provide an exit for early investors, reward employees and gain visibility
2. Merchant banker acts as a key partner with the company during the IPO process
3. SEBI regulates the IPO market and has the final word on whether a company can go public or not
4. As an investor in the IPO you should read through the DRHP to know everything about the company
5. Most of the IPOs in India follow a book building process