Fundamentals of Stock Market (HS408)

VII Semester (July-December 2024)

Course Instructor

Dr. Ankita Sarmah

Assistant Professor

Department of Humanities and Social Sciences

IIIT Guwahati

CONTENTS

Functioning of Stock Market

Primary and Secondary markets, Initial Public Offerings (IPOs), market orders, limit orders, stop-loss orders

Initial Public Offerings (IPOs)

- **Initial Public Offering (IPO)** is the process through which a private company offers its shares to the public for the first time, transitioning into a publicly traded company.
- This is a significant milestone for a company as it opens up access to public capital markets, allowing it to raise funds from a wide range of investors.
- IPOs are a pivotal moment in a company's lifecycle, offering both significant opportunities and challenges.
- They provide a pathway to raise capital, enhance market presence, and provide liquidity to stakeholders while introducing new levels of public scrutiny and accountability.
- There have been 6,217 IPOs between 2000 and 2024.
- The least was in 2009 with only 62. The full year 2021 was an all-time record with 1,035 IPOs, beating the previous record of 480 in the year 2020.
- **IPOs do not always have a profit**.
- **Many times a company is overvalued or valued incorrectly** and its stock price falls after the IPO and never reaches the IPO value that investors paid for, therefore, not making any money but rather losing money.

Definition:

- An IPO occurs when a private company offers its shares to the public on a stock exchange for the first time. This process involves issuing new shares to raise capital or selling existing shares held by early investors, founders, or employees.

Purpose:

- The primary purpose of an IPO is to raise capital to fund business expansion, pay off existing debt, invest in research and development, or improve infrastructure. It also provides an opportunity for early investors and company insiders to realize gains by selling some of their shares.

Transition from Private to Public:

- Before an IPO, a company's shares are privately held by founders, employees, and a limited number of investors. Going public allows the company to sell shares to a broader audience, including institutional and retail investors, which helps in building market recognition and credibility.

IPOs are generally considered riskier than regular stock investments.

This is because IPOs are often for new companies or companies that are not well-established in the market.
As a result, there is often a lot of uncertainty surrounding the company's prospects, which can make it difficult to determine its true value.

Saudi Aramco

- **IPO Date:** December 5, 2019
- **Capital Raised:** $25.6 billion
- **Industry:** Energy

This Saudi Arabian company is one of the world's largest companies, ranking in the fifth spot on Forbes Global 2000 list for 2021.

Formally called **Saudi Arabian Oil Company**, it is commonly referred to as Saudi Aramco or simply Aramco.

As an energy company, it explores, produces, transports, and sells crude oil and natural gas.

The company went public in December 2019 and began trading on the Saudi Stock Exchange. It initially raised $25.6 billion by selling 3 billion shares. That primary figure was raised to $29.4 billion after the company reportedly sold an additional 450 million shares.

It knocked Alibaba out of the top spot, making it the largest IPO in global history.

Functions of an IPO

Raising Capital for Growth:

- IPOs are a critical way for companies to access large amounts of capital that can be used to fuel growth initiatives, such as expanding operations, entering new markets, acquiring other businesses, or investing in new technologies.

Providing Liquidity to Shareholders:

- IPOs offer liquidity to early investors, founders, and employees who may have been holding shares for many years. By selling their shares on the public market, these stakeholders can cash out some of their investments, realizing returns on their initial stakes.

Enhancing Company Profile and Credibility:

- Going public enhances a company’s visibility and credibility in the market. This increased profile can attract new customers, partners, and talented employees, boosting overall business performance.

Establishing a Market Value:

- An IPO establishes a market-based valuation of the company, as the share price reflects the market’s perception of the company’s future growth prospects. This valuation can be used as a benchmark for future financing or mergers and acquisitions.

Facilitating Future Fundraising:

- Once public, companies have easier access to additional capital through secondary offerings or debt issuance. Being listed on a stock exchange provides the company with the flexibility to raise funds more quickly in response to market opportunities or needs.

Attracting and Retaining Talent:

- IPOs allow companies to offer stock options and other equity-based compensation to employees, which can be a powerful tool for attracting and retaining top talent. Employees can benefit financially as the stock price appreciates.

Debt Repayment and Balance Sheet Improvement:

- Companies often use the funds raised from an IPO to pay down existing debt, improving their balance sheet and reducing interest expenses. This strengthens the company's financial position and lowers financial risk.

India's Biggest IPOs in the Last Decade

- **LIC:** The ₹21,000-crore initial public offering (IPO) of Life Insurance Corporation of India (LIC) is stated to be the biggest IPO in the history of the Indian stock market. The LIC IPO was open for subscription on May 4, 2022 at a price band of ₹902-949.

- **Paytm IPO:** Digital payments firm Paytm currently enjoys the title of the '**biggest IPO**' in the Indian market. The ₹18,300-crore IPO of One97 Communications Ltd., the parent company of Paytm, hit the primary markets on November 8, 2021. The price band for the public issue was set at ₹2,080-2,150 per share. The issue closed on November 10, 2021, and the shares were listed on stock exchange on November 18, 2021. Paytm IPO witnessed 1.89 times subscription led by qualified institutional buyer (QIBs) and retail investor.

- **General Insurance Corporation of India IPO:** The ₹11,176-crore worth IPO opened for public subscription from October 11 to October 13, 2017. The issue was sold in ₹855-912 price band and received 1.38 times subscription, mainly due to QIB buying while other investor categories were undersubscribed. General Insurance Corporation of India (GIC Re) is the largest reinsurance company in the Indian market.

- [**Qualified institutional buyers (QIBs)** are sophisticated investors with expertise and financial strength to assess and invest in financial markets. Compared to an individual investor, a QIB has a lot more funds, knowledge, and therefore strength to invest. E.g., Mutual funds-SBI and HDFC Mutual Fund, commercial banks, investors from foreign countries that are registered with SEBI, etc].

- **The New India Assurance Company IPO:** The ₹9,600-crore IPO of New India Assurance Company hit the street in November 2017. The IPO was sold during November 1- 3, 2017, at a price band of ₹770 to ₹800 per share. The company had offered a discount of ₹30 per share to retail investors and employees. The IPO was subscribed 1.20 times led by QIBs.

- **Zomato:** Zomato, is one of the first new-age tech companies to get listed on stock exchange. The ₹9,375-crore Zomato IPO witnessed strong interest from retail investors. The IPO opened during July 14-16, 2021, at a price band of ₹72 to ₹76 per share. Zomato IPO was subscribed 38.25 times overall.

- The **Dutch East India Co**. is widely thought to be the **first company** to allow the public to invest in its business, in what was the world's earliest initial public offering (IPO).

Advantages & Disadvantages of IPOs

Advantages of IPOs:

1. **Access to Capital:** Provides a large influx of funds that can be used for strategic growth.
2. **Enhanced Public Image:** Increases brand awareness and credibility.
3. **Increased Market Valuation:** Provides a transparent market valuation that can be used for strategic decisions.
4. **Exit Strategy:** Offers an exit route for early investors, providing liquidity and a return on investment.

Disadvantages of IPOs:

1. **Costly and Time-Consuming:** IPOs involve significant costs for legal, accounting, and underwriting fees, and require a lengthy process of regulatory approvals.
2. **Loss of Control:** Going public dilutes ownership and requires the company to adhere to strict regulations and increased scrutiny from shareholders and analysts.
3. **Market Pressure:** Public companies are subject to market pressures, requiring them to meet quarterly performance expectations, which can influence long-term strategic decisions.

Steps Involved in the IPO Process

1. **Appointing Underwriters:**

- The company appoints investment banks or financial institutions as underwriters to guide the IPO process. Underwriters assess the company's financials, help set the share price, manage regulatory compliance, and market the IPO to potential investors.

2. **Due Diligence and Regulatory Filings:**

- The company must comply with regulatory requirements, including filing a prospectus with the relevant securities regulator (e.g., SEBI in India). The prospectus provides detailed information about the company's business, financial condition, risks, and use of the IPO proceeds.

3. **Pricing the IPO:**

- The underwriters and the company decide on an initial price range for the shares based on financial analysis, market conditions, and investor demand. The final price is usually set after gauging investor interest during the roadshow process.

4. Roadshows and Marketing:

- The company and its underwriters conduct roadshows to promote the IPO to institutional investors, analysts, and fund managers. These presentations help generate interest and allow the company to gather feedback on pricing.

5. Allocating Shares and Going Public:

- Once the IPO price is set, shares are allocated to investors, and the company's stock begins trading on the chosen stock exchange. The first trading day is closely watched, as it sets the tone for how the market perceives the company's valuation.

6. Post-IPO Stabilization:

- Underwriters may engage in price stabilization activities to prevent excessive volatility in the stock price immediately after the IPO. This helps maintain investor confidence and market stability.

Time Period for Listing IPOs

For how many days/weeks/months are IPOs listed on the stock market?

IPOs are not "listed" for a fixed number of days, weeks, or months on the stock market; instead, they involve a one-time event when a company's shares are offered to the public and subsequently become listed on a stock exchange.

Once listed, the shares of the company are traded on the stock market indefinitely, just like any other publicly traded stock, unless certain conditions arise (e.g., delisting).

Timeline of IPO Listing:

1. **Pre-IPO Phase:**
    - This involves the preparatory phase, including regulatory filings, prospectus drafting, appointing underwriters, and conducting roadshows. This phase can last several months before the actual IPO date.
2. **IPO Subscription Period:**
    - This is the period during which investors can apply for shares. Typically, the IPO subscription window lasts **3 to 5 days**. During this time, investors place their bids or applications for shares.

3. Allotment and Listing:

- After the subscription period ends, the company and its underwriters allot shares to investors based on demand. This process usually takes about a week.
- The company’s shares are then listed on the stock exchange, usually within **7 to 10 days** after the subscription period closes.

4. Trading on the Stock Exchange:

- Once listed, the company’s shares are traded on the stock exchange like any other stock.
- The shares do not have a fixed duration on the market; they continue to be traded as long as the company remains listed and complies with exchange regulations.

Factors Influencing How Long a Company Remains Listed:

1. **Regulatory Compliance:**
    - The company must adhere to the stock exchange's regulations, such as timely financial disclosures, maintaining a minimum share price, and ensuring sufficient public float.
2. **Market Performance:**
    - Market conditions, company performance, and investor demand can affect the stock’s trading but do not impact the listing duration itself.

3. Delisting Scenarios:

- **Voluntary Delisting:** A company may choose to delist itself, often due to mergers, acquisitions, or going private.
- **Involuntary Delisting:** This can occur due to failure to meet exchange requirements, such as financial non-compliance, fraud, or bankruptcy.

Summary:

- **IPO Listing Duration:** Shares are listed indefinitely after the IPO unless delisted due to specific circumstances.
- **IPO Subscription Window:** Typically 3 to 5 days.
- **Listing Timeframe:** Usually, the shares begin trading on the stock exchange within 7 to 10 days after the subscription period.

Methods of IPO Pricing

IPO Pricing Methods refer to the techniques used to determine the price at which a company's shares will be offered to the public during an Initial Public Offering (IPO). Accurate pricing is crucial because it influences investor demand, the amount of capital raised, and the company's market perception.

1. Fixed Price Method

In the **Fixed Price Method**, the company, in consultation with its underwriters, decides on a fixed price at which its shares will be offered to the public before the IPO is launched.

How It Works:

- The price is determined based on the company's valuation, expected demand, market conditions, and the company's financial health.
- The price is specified in the IPO prospectus, allowing investors to know in advance the price they will pay for the shares.
- Investors must pay the full price when applying for shares during the IPO.

Advantages:

- **Simplicity:** The fixed price method is straightforward and easy for investors to understand.
- **Certainty for Investors:** Investors know the exact price they need to pay, making investment decisions simpler.

Disadvantages:

- **Mispricing Risk:** The fixed price may not accurately reflect market demand, leading to oversubscription (high demand) or undersubscription (low demand).
- **Investor Allocation Uncertainty:** High demand can lead to limited share allocation for individual investors, resulting in unmet demand.

Example:

- If a company sets the fixed price at ₹200 per share, investors will pay this amount when applying, irrespective of the market conditions or demand levels.

2. Book Building Method

The **Book Building Method** is the most commonly used method for IPO pricing, especially for large and complex offerings. It allows the market to play a role in determining the IPO price through investor bids.

How It Works:

- A price range, called the "price band," is set by the company and the underwriters (e.g., ₹150-₹180 per share).
- Institutional investors, retail investors, and other participants place bids within this price band, specifying the quantity of shares and the price they are willing to pay.
- Based on the bids received, the "book" is built, and the final issue price (cut-off price) is determined, usually near the equilibrium point of demand and supply.

Advantages:

- **Market-Driven Pricing:** Reflects actual market demand, helping in setting a fair price.
- **Efficient Allocation:** Shares are allocated based on bids, helping match investor interest with available shares.
- **Better Investor Insights:** The bidding process provides insights into investor sentiment and demand.

Disadvantages:

- **Complexity:** The bidding process can be complex for retail investors who may not understand how to place bids.
- **Price Volatility:** The final price may vary significantly from the initial expectations, creating uncertainty for the company.

Example:

- A company sets a price band of ₹150-₹180. If bids are mostly received near ₹175, the final price is likely to be set around ₹175.

3. Dutch Auction Method

The **Dutch Auction Method** is a less common but innovative approach where the price is determined through an auction mechanism. Investors bid for the number of shares they want and the price they are willing to pay.

How It Works:

- Bids are collected from investors, listing both the number of shares they want and their price per share.
- The bids are then arranged in descending order of price.
- The highest price at which all shares can be sold is selected as the final IPO price (clearing price).

Advantages:

- **Transparent Pricing:** Ensures the price reflects true market demand, minimizing the risk of underpricing.
- **Wide Participation:** Encourages a broad base of investors, enhancing distribution.

Disadvantages:

- **Unpredictability:** Final pricing can be unpredictable and may lead to higher volatility.
- **Potentially Lower Prices:** If investors bid conservatively, the final price might be lower than expected, reducing the funds raised.

Example:

- If the company needs to sell 1 million shares and the highest bids at various prices fill this requirement at ₹160, then ₹160 becomes the IPO price.

4. Auction-Based Methods (Open Bidding)

Auction-based pricing methods involve inviting bids from investors, with the final price set based on the highest bids that match the number of shares available.

How It Works:

- Similar to the Dutch Auction, investors bid with the price and quantity of shares they are willing to buy.
- The bids are ranked, and the clearing price is determined where the total supply meets demand.

Advantages:

- **Price Discovery:** Provides a fair and transparent way to discover the market price.
- **Inclusive:** Encourages a wide range of investor participation, including both institutional and retail investors.

Disadvantages:

- **High Complexity:** Can be complex to administer, requiring sophisticated systems and processes.
- **Risk of Low Pricing:** Aggressive bidding strategies may lead to the price being set lower than expected.

Key Players in an IPO

- **Company (Issuer):** The firm offering its shares to the public.
- **Underwriters:** Investment banks that manage the IPO process, help price the shares, and market them to investors.
- **Regulatory Authorities:** Bodies like SEBI (India) or SEC (U.S.) that ensure compliance with laws and regulations.
- **Investors:** Institutional investors (mutual funds, pension funds) and retail investors who buy shares during the IPO.
- **Legal and Financial Advisors:** Professionals who assist in preparing regulatory filings, due diligence, and compliance.

Post-IPO Considerations

- **Lock-Up Period:** Insiders and early investors are often restricted from selling their shares for a set period (usually 90 to 180 days) after the IPO to prevent excess selling pressure.
- **Ongoing Compliance:** Public companies must file quarterly and annual reports, disclose material events, and adhere to governance standards.
- **Market Performance Monitoring:** Post-IPO, companies must actively manage investor relations and market expectations.

IPO Strategies for Investors

- **Research the Company:** Review the prospectus, financials, and business model to understand the company's growth prospects and risks.
- **Understand the Pricing Method:** Knowing how the IPO price is set can help gauge the potential for mispricing or market reaction.
- **Look at Industry Trends:** Evaluate the broader industry context, competitive landscape, and economic conditions impacting the company.
- **Evaluate the Underwriters:** High-quality underwriters often indicate a more credible IPO process.
- **Consider Lock-Up Expiry:** Be aware of potential selling pressure when the lock-up period ends, as insiders may sell their shares.

Orders

In the stock market, different types of orders are used to execute trades based on specific criteria set by investors.

Understanding these orders—**Market Orders**, **Limit Orders**, and **Stop-Loss Orders**—is essential for effectively managing investments, minimizing risk, and achieving desired entry or exit points.

Market Orders

Definition:

A **Market Order** is an order to buy or sell a security immediately at the best available current price in the market. It guarantees execution but not the exact price at which the trade will be executed.

How It Works:

- When you place a market order, the order is filled as soon as possible at the next available price.
- Market orders are typically executed faster because they are not bound by a specific price limit.
- They are most commonly used when immediate execution is more important than the price.

Advantages:

- **Speed of Execution:** Ensures the order is filled quickly.
- **Guaranteed Execution:** The order will definitely be completed if the market is open and there is enough liquidity.

Disadvantages:

- **Price Uncertainty:** The exact execution price may differ from the current market price, especially in volatile markets.
- **Slippage:** In fast-moving markets, the price at which the order is executed can be less favorable than expected.

When to Use Market Orders:

- When you need to enter or exit a position quickly.
- For highly liquid stocks where the price difference between bid and ask is minimal.
- When exact price is not a concern, and speed is prioritized.

Market Order Example:

  - You want to buy shares of Company XYZ immediately. You place a market order, and it is filled at the next available price, even if it's slightly higher than the current market price due to rapid price changes.

Limit Orders

Definition:

A **Limit Order** is an order to buy or sell a security at a specific price or better. A buy limit order will only be executed at the limit price or lower, while a sell limit order will be executed at the limit price or higher.

How It Works:

- **Buy Limit Order:** Placed below the current market price to ensure you buy at a lower price.
- **Sell Limit Order:** Placed above the current market price to ensure you sell at a higher price.
- If the market does not reach the limit price, the order remains unfilled.

Advantages:

- **Price Control:** You set the exact price at which you are willing to trade, providing greater control over trade execution.
- **Protection Against Unfavorable Prices:** Helps avoid buying or selling at worse prices during volatile market movements.

Disadvantages:

- **No Execution Guarantee:** There is no certainty that the order will be filled if the market does not reach your set price.
- **Partial Fills:** The order may only be partially filled if there is insufficient volume at the limit price.

When to Use Limit Orders:

- When price control is more important than speed.
- For less liquid stocks or when expecting the market to move to a favorable price level.
- To take advantage of market fluctuations without constant monitoring.

Limit Order Example:

- You want to buy shares of Company ABC at ₹100 but the current price is ₹105. You set a buy limit order at ₹100. The order will only be filled if the price drops to ₹100 or lower.

Stop-Loss Orders

Definition:

A **Stop-Loss Order** is designed to limit an investor's loss on a position by triggering a market order once a specified price level, known as the stop price, is reached.

How It Works:

- **Sell Stop-Loss Order:** Placed below the current market price. If the stock price falls to or below the stop price, the order is triggered, converting it into a market order to sell.
- **Buy Stop-Loss Order:** Used to buy securities. It is placed above the current market price, triggering a buy order if the stock price rises to or above the stop price.

Advantages:

- **Risk Management:** Helps limit potential losses by automatically exiting a position at a predetermined price.
- **Emotional Discipline:** Prevents emotional decision-making by automating exit strategies.

Disadvantages:

- **Execution Price Uncertainty:** Since a stop-loss converts into a market order when triggered, it may be executed at a less favorable price, especially in fast markets.
- **Triggered by Market Noise:** Stop-loss orders can be triggered by temporary price fluctuations or "noise," leading to an unwanted exit.

When to Use Stop-Loss Orders:

- To protect against significant losses in volatile or declining markets.
- For investors who cannot monitor the market continuously.
- To enforce disciplined trading by setting predetermined exit points.

Stop-Loss Order Example:

- You hold shares of Company DEF bought at ₹200, and to protect your investment, you set a sell stop-loss order at ₹180. If the price falls to ₹180, your shares are automatically sold, limiting your loss.

Securities and Exchange Board of India (SEBI)

SEBI plays a crucial role in regulating and overseeing the securities market in India.

Established in 1988 and given statutory powers through the SEBI Act of 1992, SEBI's primary objective is to protect investors, ensure fair and transparent market practices, and develop the securities market to maintain its efficiency and integrity.

Key Roles and Functions of SEBI

1. **Regulation of the Securities Market**
   - SEBI regulates all market participants, including stock exchanges, brokers, sub-brokers, depositories, and other intermediaries. This ensures that the securities market operates fairly and transparently.
2. **Protecting Investor Interests**
   - SEBI's primary mandate is to safeguard investors' interests by enforcing regulations that prevent fraudulent activities, market manipulation, and other malpractices. It ensures that investors have access to timely and accurate information for making informed decisions.

Promoting and Regulating IPOs

- SEBI oversees the entire IPO process, ensuring that companies adhere to strict disclosure norms and guidelines. It reviews the draft prospectus filed by companies planning an IPO to ensure transparency and protect investors from misleading information.

Supervision of Mutual Funds

- SEBI regulates mutual funds, setting guidelines on their operations, disclosures, and marketing practices. This helps ensure that mutual funds operate transparently and in the best interests of their investors.

Market Development

- SEBI works towards the development of the securities market by introducing innovative financial instruments, improving market infrastructure, and ensuring the smooth functioning of trading systems.

Regulating Market Intermediaries

- SEBI registers and regulates various market intermediaries such as stockbrokers, merchant bankers, registrars, underwriters, and portfolio managers. It sets standards for their conduct and operations to maintain market integrity.

Insider Trading Regulation

- SEBI strictly prohibits insider trading by enforcing rules that prevent individuals with access to non-public information from unfairly benefiting in the securities market. It monitors trades and imposes penalties on violators.

Surveillance and Enforcement

- SEBI continuously monitors market activities to detect and investigate irregularities, such as market manipulation, price rigging, and fraudulent practices. It has the authority to take enforcement actions, including imposing fines, suspending trading, and banning entities from the market.

[**Insider Trading** refers to the buying or selling of a company's securities (such as stocks or bonds) by individuals who have access to non-public, material information about the company. This information gives insiders an unfair advantage over regular investors who do not have access to such details, making insider trading illegal and unethical when conducted without proper disclosure.]

Establishing Codes of Conduct

- SEBI established codes of conduct for various participants, including listed companies, market intermediaries, and financial analysts. This ensures that all parties adhere to ethical standards and transparent practices.

Investor Education and Awareness

- SEBI actively promotes investor education and awareness programs to help individuals understand market risks, investment opportunities, and their rights as investors.

Regulating Corporate Governance of Listed Companies

- SEBI enforces stringent corporate governance norms for listed companies, including requirements for independent directors, transparency in financial reporting, and disclosures of related party transactions to ensure accountability.

Handling Grievances and Dispute Resolution

- SEBI provides a platform for investors to file complaints against listed companies, brokers, and other market participants. It facilitates grievance redressal through platforms like SCORES (SEBI Complaints Redress System).

Approval of Takeovers, Mergers, and Acquisitions

- SEBI regulates takeovers, mergers, and acquisitions involving listed companies through the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations. This ensures that such transactions are fair and in compliance with established norms.

Specific Actions SEBI Undertakes in Its Role

- **Issuing Guidelines and Regulations:** SEBI frequently issues new guidelines and amends existing regulations to adapt to changing market conditions, ensuring that the market remains efficient and investor-friendly.
- **Conducting Inspections and Audits:** SEBI regularly conducts inspections and audits of stock exchanges, mutual funds, and other market participants to ensure compliance with its regulations.
- **Imposing Penalties and Sanctions:** SEBI has the authority to impose penalties, including monetary fines, suspension of trading rights, and debarment from the market, against entities that violate securities laws.

Significance of SEBI in the Indian Financial Market

- **Maintaining Market Integrity:** By regulating market activities and enforcing stringent rules, SEBI helps maintain the trust and confidence of investors in the Indian securities market.
- **Enhancing Market Transparency:** SEBI's disclosure requirements ensure that all market participants have access to accurate and timely information, reducing information asymmetry.
- **Investor Protection:** SEBI's focus on investor protection helps prevent scams, frauds, and unfair practices, making the market safer for individual investors.
- **Promoting Financial Stability:** Through its regulations and surveillance activities, SEBI contributes to the overall stability and resilience of the financial system.