

Book building-A Strategic Mechanism for Issue Price Determination in IPOs-A Study on Indian Companies

G.P Nagesh* Dr. V Murugaiah**

*Research Scholar, IMS, Davangere University, Davangere

** Professor, IMS, Davangere University, Davangere

Abstract:

Initial Public offerings (IPOs) are the first public issue of share of a company to the general public. It will promote a closely held company to become widely held company. Issue price fixation is a critical task in the entire process in the new issue market activity. There are two known methods of issue price determination in India. They are fixed price method and book building method in India. Issue Company in consultation with merchant banker has fixes the issue price in case of fixed price method, but IPOs through “book building” is a big reform over fixed price method. It invites bid from the different sets of potential investors and thereby it arrives at an issue price. The current study makes an attempt of comparing book building method with traditional fixed price method. Further, the study also examines the correlation between issue price and issue size with MAER.

Key words: Initial Public Offerings (IPOs), Book building method, issue price, listing price, issue size, Market adjusted excess return (MAER)

Introduction

An initial public offering (IPO) is a company's first offering of equity to the public and IPOs are a major source of capital for firms. There are at least three distinct mechanisms available for an issuing firm- Fixed price offer, Bookbuilding, and auctions. In some countries only one of these methods is available where as in some other countries firms may have a choice. In a fixed price offer the price will be set by the issuer in consultation with the merchant banker prior to the offer and allocation. In the case of excess demand shares will be allotted on prorata basis and/or on a lottery draws. In a typical auction investors are invited to submit bids indicating both the number of shares and the price they are willing to pay. From the bids the market clearing price will be determined. Then the shares will be issued to all the successful bidders at a uniform price (popularly known as Dutch auction) set at the level of the bid of the lowest successful bidder. Bookbuilding entails soliciting investors to submit the number of shares they would like to buy and at a price that has to be in a specified price range. Once the books are closed the issue price will be set by merchant banker. (SSS Kumar, 2010).

In most of the capital market around the world, including India, the book building method is the most preferred way. In a book building method, the firm prescribes the price band. This price band is decided by the company in consultation with some leading banks after a thorough analysis of company's books and comparison with peers (if any) already listed on stock market. The firm then invites bids from potential investors. There are three categories of investors involved in every IPO floated in India- Retail, Qualified Institutional Buyers (QIBs), and Non-Institutional Investors (NIIs). In most of these cases, 35% of the IPO is reserved for retail section, 50% stake is reserved for the QIB section, and the remaining 15% is reserved for NIIs. However, in some cases, some portion is reserved for employees of the said company. (YashBansal, Anand N Desai, 2012). Some investors trust that lack of past share price performance provides an opportunity to buy but some investors think that because they have not been analyzed by the market they are reasonably riskier than stock that have been previously analyzed and scrutinized. (D.Sanjeeva Rao, 2015). In 1602, the Dutch East India Company was the first company in the world issue stocks and bonds in an initial public offering. Nirma by offering a maximum of 100 lakh equity shares through book building process is said to be first company to adopt the mechanism.

IPO Pricing Mechanisms in India

An Initial Public Offerings (IPO) or stock market launch is the first sale of stock by a company to the public. It can be used by either small or large companies to raise expansion capital and become public trade enterprises. In 1602, the Dutch East India Company was the first company in the world issue stocks and bonds in an initial public offering. There are two types of issues, one where company and lead merchant banker fix a price called fixed price and other, where the company and lead manager stipulate a floor price or a price band and leave it to market forces to determine the final price is called price discovery through book building process. Book building is the process of generating, capturing, and recording investor demand for shares during an IPO in order to support efficient discovery. Usually issuer appoints a major investment bank to act as a major securities underwriter or book runner. The price at which new shares are issued is determined after the book is closed at discretion of the book runner in consultation with issuer. Till early nineties like many other markets in India, capital markets in general and IPO price in particular was a thoroughly regulated activity with the office of the Controller of Capital Issue (CCI) determining the price. As reforms set in, CCI was abolished paving way for SEBI, IPO pricing had also undergone a change with the fixed price offer method came in to practice. Book building (known in the US as firm commitment contract) method of pricing IPOs came in to being in the mid-nineties as a result of the recommendations of the Malegam Committee which was set by SEBI in 1995 with basis of pricing the issue as one of the terms of reference. The book building process determines price of shares in between these two ends. The lower price is called floor price and upper price is called cap price. The band is not freely determined by Book running lead manager (BRLM) only the lower price limit will be specified by the BRLM then the upper price level is automatically capped at 120% of the lower price.

The efficiency of an IPO mechanism can be measured by the fact that how accurately the offer (issue) price is set so as to reflect the investor sentiment. That is there should not be a significant difference between the discovered price (issue price) and the short term market price of an IPO. The price discovered can be called efficiently only if it reflects the fundamentals. This is because the IPO markets allocation efficiency will be poor if the price diverges from the fundamentals of prospective return and risk. (Banerjee Rachna, 2009).

Literature Review:

Prof. B.Ramesh, Dr. Pournima Dhume concludes positive and negative MAER indicates over pricing and under pricing of public issues. Their study results show that over pricing is present in the short as well as long run. The study findings support the present scenario of decreasing number of IPOs. The study documents that investors who purchased the shares on the offer date earned high returns, however, over the period the returns have turned negative.

Dr. SSS Kumar (2010) Documents, total cost point of view the issuers are neither better off nor worse using either book building or the fixed price offers. Book building method might have lost its ability to discover the prices because of the lack of discretionary allocation powers previously vested with the lead managers. Size of the issue, listing delay, and the reputation of the BRLM are found to be the important determinants while choosing the IPO issuing mechanism. The research found that employing US based BRLM do not translate in to higher issue proceeds. Neither their issue-pricing skills nor the costs of using their services are significantly different from those of Indian BRLMs.

Dr. H.N Shivaprasad, Kallanagouda (2013) found that average fundamental scripts have performed better than other grade of IPOs both in terms of listing gain and market gain. IPOs with below average fundamentals and poor fundamentals have shown weak performance in terms of market gain. More surprisingly, IPOs with above average fundamentals were also found in terms of returns. The paper also identified that Index return and Listing return have exhibited positive correlation and Index return and Market return of IPOs have exhibited negative correlation.

Pradeep Kumar Samanta, et al, found that no significant relationship was observed to establish correlation among MAER with issue size, issue price and subscription duration. The regression analysis also shows that none of the factors had an impact on short term MAER.

Study methodology:

Methodology in research is an approach to carry out research in a meticulous method. The current study follows the undermentioned methodology,

Sample: Data has been collected from the secondary sources pertaining to 2009-2018. A census sample of entire 230 book built IPOs hit the market during study period has been taken in to account. Secondary data has been retrieved from www.nseindia.com, www.bseindia.com and www.chittorgarh.com

Research objective

The research has been designed by having two primary objectives in to consideration,

- To compare fixed price method and book building method in terms of fund raised under each method
- To measure short run performance of book built IPOs
- To identify and compare the independent factors with dependent factors which in turn influence on short term return

Scope of the study

The scope of the study is limited only to IPOs made during Jan 2009 to Dec 2018. The study makes an attempt to evaluate fixed price method and book building method in the light of volume of money raised under each method of public issue. The study also analyzed the short run post issue performance of book built issues.

Discussion

Fresh public issues that have followed either fixed price method or book building method has been compared in terms money mobilized. (2009-2018)

Table No: 1 Resource mobilization in each year

Year	Number of Issue Succeeded	Book built IPOs	Fixed price IPOs	Amount mobilized (Rs. In Crores)
2009	20	20	0	19,283.98
2010	57	55	2	35,251.79
2011	31	30	1	5,792.89
2012	10	10	0	6,745.17
2013	3	3	0	1,283.95
2014	5	5	0	1,200.94
2015	21	21	0	11,362.30
2016	26	26	0	26,372.49
2017	38	37	1	75,475.38
2018	24	24	0	31,731.28
Total	235	231	04	2,14,500.17

Source: www.chittorgarh.com and www.nseindia.com

Table No: 2 Resource mobilizations through each method

Sl.No	Method of Public issue	Number of issues (Non SME)	Money Raised (Rs. in Crores)
1	Fixed Price Method	4	172.37
2	Book building method	230	2,14,500.17

Source: www.chittorgarh.com and www.nseindia.com

It is very evident from the data presented in the table no: 1 that the book building method has high upper hand over traditional fixed price method.

Short term performance analysis

Raw return has been calculated in the beginning to derive MAER (Market Adjusted Excess Return) as a short run issue performance indicator. Raw return is calculated as the difference between the closing price of the stock on the first day of trading and offer price of the stock divided by the offer price.

$$R_i = \frac{P_1 - P_0}{P_0} \times 100 \text{ -----1}$$

Where,

R_i = Raw return of the stock “i”

P_0 = Offer price

P_1 = Closing price of the stock on listing day

As raw return does not consider the market condition, it is not accurate to evaluate the performance of an IPO. And hence, the study has also considered market index for calculation of market return.

$$M.R = \frac{M_1 - M_0}{M_0} \times 100 \text{ -----2}$$

Where,

M.R = Market return

M_0 = Closing value of NIFTY on the offer closing date of stock “i”

M_1 = Closing value of NIFTY on the first day of trading of stock “i”

Now, Market adjusted return of stock “i” is calculated by,

$$MAER = \frac{(P_1 - P_0)}{P_0} - \frac{(M_1 - M_0)}{M_0} \times 100 \text{ -----3}$$

Since for different companies' time taken to list changes, to normalize this annual return is calculated by the following equation,

$$\text{Annualizing factor} = \frac{365}{\text{listing lead time}} \text{ -----4}$$

Correlation Analysis

Correlation analysis has been employed to know the relationship between dependent variable and independent variable (issue price and issue size are independent variables and short term MAER is dependent variable). We can say that issue size is negatively correlated with MAER (-0.02645) and issue price is positively correlated with MAER (0.087829)

Conclusion

This paper attempts to compare the performance book building and fixed price method of public issue, the result says that, though there are some built in inefficiencies in book building method, it has been well taken by the market participants. Correlation analysis concludes that short term MAER and issue size has positive correlation while the correlation between MAER and issue size is negative.

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