

## ROLE OF INVESTMENT BANKS IN GRADED IPOs: EVIDENCE FROM THE INDIAN CAPITAL MARKET

*Mr. Souvik Banerjee*

*Research Scholar, VIT University, Chennai Campus*

*Dr. K.T. Rangamani*

*Senior Professor, VIT Business School, VIT University, Chennai Campus*

### Abstract

In this research paper, it is explored, whether in the post mandatory IPO Grading Period, three factors, i.e. Proportion of Expense in the IPO process with respect to the total proceeds from the IPO, number of lead managers and the lead manager reputation have any significant difference, among companies with different IPO Grades. The analysis shows that, all these three factors, have statistically significant difference among companies with different IPO Grade. This is a significant addition to the existing literature.

**Key Words:** IPO Grade, Proportion of Expense in the IPO, Lead Manager Reputation, Number of Lead Mangers

JEL Classification : E44,G11,G14*telecom Industry.*

### 1. Introduction

Indian equity market, caught the attention of the world, after 1991, the year on which, opening up of the economy, marked a watershed event for the nation. In 2001, top notch Wall Street investment bank Goldman Sachs clubbed India along with three other emerging market economies (Brazil, Russia and China) and famously termed it as "BRIC" nations, and predicted that these countries will be leading economic powers in the world, in the days to come. This further increased India's profile among the foreign institutional investors (FIIs).

India's equity culture is quite old, the first stock exchange in Asia, was set up in India, in the form of 'The Native Share & Stock Brokers Association' in 1875, later it came to be known as BSE (Bombay Stock Exchange). Among the emerging market economies, equity market in India has an unique place, as the performance of the equity market is often taken as the proxy for

the performance of the overall economy. Also India is among the few emerging countries with well developed financial markets. Initial Public Offering (IPO) by companies and their performance post listing takes considerable media space in this nation.

Indian equity market has seen complete transformation from the days of Controller of Capital Issues (CCI) to setting up of the SEBI (Securities Exchange Board of India) in 1988, to abolition of CCI in the post reform years of early 1990s.

In the reforms initiated under SEBI, centralised power to determine pricing of equity issues gave way to information dissemination in the public domain. These led to stricter information disclosure norms, Book Building (BB) of Issues, IPO Grading, Applications Supported by Blocked Amount (ASBA), SME platform in the stock exchanges etc.

In the Indian equity market now most of the issues are done through the Book Building measure, according to the website of the BSE (Bombay Stock Exchange), some of the salient features of this approach are as follows:

- A 20% price band is offered by the issuer, signifying upper limit and lower limit, within which the prospective investors have to bid; The issue price is determined by the company, post closure of the bidding.
- Demand for the securities offered, is updated in the BSE (Bombay Stock Exchange) and the NSE(National Stock Exchange) websites (quantity and price wise) on a real time basis.
- 50% of shares offered are reserved for QIBS (Qualified Institutional Bidders) or institutional investors, 35% for small investors or retail investors and the balance for all other investors, including HNIs (High Net worth Individuals). According to the latest SEBI guidelines, any investor, who puts less than Rs.200,000 in an IPO is considered as a retail investor.

Till 2006, the Indian book building process resembled the book building process as seen in the developed western markets, especially the American market. Post that period, the discretionary allotment as seen in the US market is dispensed with (Neupane et al.,2012).

Financial performance of the company preceding the issue(IPO) plays an important role, to signal investors regarding the quality of the issue. The track record and expertise of the promoters and the management team are also important signals from the prospective investors point of view. There are other formal and informal certification processes available to investors, to enable them to take an informed decision.

Some of these are reputation of the underwriter of the issue, venture capital firm affiliation, shareholding pattern of decision makers (board of directors), reputation and track record of the lead manager of the issue, promoter group

affiliations, analyst recommendations etc.

#### **Lack of penetration of Indian Equity Market:**

Number of investors in the equity market, compared to the total population is minuscule in India(about 1%). There is a significant mistrust among the risk averse investors as far as the equity market is concerned. The reasons for this trust deficit are manifold. Securities Exchange Board of India (SEBI), the statutory body that governs the stock exchanges in India, has taken several initiatives to bridge this deficit. Initial Public offer (IPO) Grading is one such initiative.

SEBI introduced IPO Grading on voluntary basis in April,2006. It was optional till 30th.April,2007.However, the experiment was not successful as borne out by the relevant data; although around 40 companies tapped the primary market in that time frame, only 4 companies approached the Credit Rating Agencies(CRAs) for grading. These 4 companies also did not accept the grade assigned to them. This situation aroused because there were no incentives for the companies to opt for the rating/grading. On the one hand a fundamentally good company had an apprehension, that if they do not get a good rating, their plan to raise capital may get jeopardized, on the other hand fundamentally not so good companies had the fear that, their careful cover ups may get exposed (Poudyal, 2008).

SEBI had made Initial Public Offer Grading mandatory with effect from May 1, 2007.Explaining the rationale behind making the IPO grading mandatory, the then SEBI chairman M. Damodaran explained, "When the market started going up suddenly a lot of people(companies) started coming to the market. It is not that only the best and the brightest continue to come to the market, there are a lot of other people(companies) who started entering the market. One of our concerns is whether we are going to have another round of

'vanishing companies' which will raise money and never spend it for the intended purpose. I firmly believe that (IPO) grading, if made mandatory, will prevent vanishing companies in future."

As India opened its economy in 1991, a new bull market started in India, based on the assumption that the Indian economy will now grow faster, leaving behind the history of 'Hindu Rate of Growth'. In particular, the initial years of liberalization, after 1990-91, witnessed a boom in the Indian IPO market. With fewer regulations during this period, many entrepreneurs used the primary market as the main vehicle to raise capital (Khanna and Palepu, 1997 and 2000). As equity market return zoomed, host of companies accessed the primary market to tap high investor appetite for the IPOs. However what followed from the mid 1990s onwards is a black spot till date, in the history of the equity market in India. Taking the advantage of the regulatory lacuna, hundreds of companies simply vanished. Indian authorities lacked the regulatory and the information gathering mechanism to trace these companies. At the last count as on 2009, Department of Company Affairs (DCA) identified 121 such companies (Source: Financial Times, London, Dated July 14, 2009), who duped investors to the tune of thousand of crores of Indian Rupees (INR). According to some of the observers, in such instances, there is still some regulatory lacunae exists. For example liability of merchant bankers, auditors etc. is still not clear. So entities, which are supposed to do, due diligence professionally, there is no mechanism to hold them accountable, for their acts of omission and commission.

IPO Grading is important in this context. As this instrument is supposed to bridge the information asymmetry.

Credit rating agencies (CRAs) like CRISIL, CARE, ICRA, FITCH (now renamed India Ratings & Research) and Brickwork Rating are entrusted with the job of IPO grading.

Among these CRAs, CRISIL is an affiliate of Standard & Poor (S&P) a world renowned rating agency, international rating agency Moody's is the largest shareholder of ICRA, India Rating and Research (earlier Fitch India) is the Indian subsidiary of Fitch. S&P, Fitch, & Moody's are recognized as Nationally Renowned Statistical Rating Organizations (NRSRO) of the Securities and Exchange Commission (SEC) in the United States. Whereas CARE and Brick Work (BW) are India based domestic credit rating agencies.

The rating scale used is 1 to 5, with 1 being the worst, and 5 being the best.

The grading is done of the company and not of the issue. The basic difference between grading of a company and an issue is, a company may be good, but due to mispricing the IPO may not be attractive enough, for the investors.

The primary motivation of the regulator, regarding introduction of IPO Grading was quality information dissemination in the public domain, so that Indian equity market avoids, crisis of confidence as seen in various scams, especially the 'vanishing companies scam'.

However in December, 2013, SEBI again made IPO Grading voluntary. This was done, to probably end the dry spell in the IPO market. Whether this initiative will bear fruit is yet to be seen.

#### IPO Grading Framework:

Grade / scale	Grading Definition
5/5	Strong Fundamentals
4/5	Above Average Fundamentals
3/5	Average Fundamentals
2/5	Below Average Fundamentals
1/5	Poor Fundamentals

Table 1: IPO Grading Scale, as circulated by SEBI

According to SEBI guidelines, Credit Rating Agencies (CRAs) are supposed to analyze

companies, for the purpose of grading on the following parameters:

- a. Business Prospects and Competitive Position
  - i. Industry Prospects
  - ii. Company Prospects
- b. Financial Position
- c. Management Quality
- d. Corporate Governance Practices
- e. Compliance and Litigation History
- f. New Projects-Risks and Prospects

With respect to financial position of a company, parameters like revenue, profit after tax(PAT), return on equity(ROE), earning per share (EPS) as well as their growth rate, capital structure are considered.

Under the management quality parameter, people who are associated with the company as key decision makers, their credentials and track records are being analyzed.

A company's corporate governance practice includes, the checks and balances being in place in the top echelons of the organization structure. The credentials of the independent directors play a big role in this respect.

The costs of the Grading are to be borne by the IPO bound firm. Therefore there is likely to be conflict of interest between the rating agency (which is supposed to grade the IPO) and the equity issuing firm, which is bearing the costs of this grading process. However there is a reputational stake for the rating agencies in the longer term.

#### **IPO Grading Initiative in Other Countries:**

India had become the first country to introduce IPO Grading, i.e. rating of equity instruments. The capital market regulator SEBI (Securities Exchange Board of India) is a pioneer in that sense. Following on the SEBI's footsteps countries like Sri Lanka also initiated discussion in the public domain in this direction. The capital market regulator in Sri Lanka, Securities and Exchange Commission of Sri Lanka, has published one discussion

paper and sought opinion from various stake holders about the pros and cons of the method.

#### **Role of Investment Banks in an IPO:**

As 'manager to the issue' the Book Running Lead Manager(BRLM), is formally in charge of the pre and post issue management. Investment banks(also known as merchant banks in the Indian context), act as the BRLMs.

However, there is also a provision for appointment of co-lead managers, co-managers and advisors to the public issues. In that case, merchant bankers play a supporting and coordinating role to the lead managers in discharging their responsibilities.

#### **Issue related expenses:**

IPO bound companies incur expenses on the issue related activities, some of these are issue management fees, IPO Grading related expenses, promotional activities of the issue etc.

A case in point is Austral Coke and Projects Ltd, an IPO Graded 2 by CARE. The issue related expenses of the company, as detailed in its IPO prospectus is shown below, as an example.

Particulars	Amount (in Rs. Lakhs)	% of total issue size	% of total issue expense
Issue Management	461.44	3.24	57.94
Registrars Fees	13	0.09	1.63
IPO Grading Expenses	7.86	0.06	0.99
Fee for legal counsel	2	0.01	0.25
Printing and distribution of issue stationary	70	0.49	8.79
Advertising and Marketing Expenses	142.10	1.00	17.84
Other Expenses (Including stamp duty and initial listing fees)	100	0.70	12.56

Table 2: IPO related expenses of Austral Coke and Projects Ltd

As can be seen from the table above, that the major portion of the issue related expenses are used for paying the investment banker(s) for the issue management, followed by advertising and marketing expenses.

### Literature Review:

The role of investment banks and other financial intermediaries in the capital markets and their impact on the investor interest has been widely discussed in the academic and practitioner circles. The existing literature, have viewed investment banks as intermediaries, for the purpose of information production (Leland and Pyle (1977) and Campbell and Keracaw (1980)) as well as for the purpose of dissemination or stopping of dissemination (Welch (1992)). Credibility of the investment banks is a moot point in this regard. Because, however, robust and full proof, the information dissemination mechanisms are, there can be acts of omission and commission. It is also very difficult to distinguish between the acts of omission and commission (Chemmanur and Fulghieri, 1994).

India 90 percent resources of merchant banks are deployed to manage public issues of companies (Verma, 1990). Also size of the issue has an inverse relationship with the amount being spent (as a percentage of the issue proceeds) on issue related expenses (Murthy et al., 1993).

The existing literature also explored, whether value is being added, with respect to economies of scale and scope, when investment banks get associated with any company (James, 1992; Drucker and Puri, 2005). Long term relationships of a corporate group with investment banks, give rise to switching costs, when the company (or corporate group) moves to relationship with a new investment bank(s) (Burch, Nanda and Warther, 2005). Relationship with investment banks, also enable companies to enter an established investor network (Gao and Ritter, 2010).

### Objective of the Research:

The present research, is an endeavour to find out, whether, companies with different IPO Grades, have different characteristics on three investment bank related parameters. These criteria are (i) reputation of the investment bank acting as the lead manager (including co-lead manager) for the IPO, (ii) issue expense as percentage of the total issue proceed (excluding the portion, where existing promoters, sell some part of their holding), (iii) the number of investment banks, appointed as lead managers (including co-lead managers) for IPOs.

### Hypotheses of the Research:

Null Hypotheses of this paper are as follows:

H<sub>01</sub> – There are no differences on the number of investment banks, appointed as lead managers (including co-lead managers) for IPOs of companies with different IPO Grades

H<sub>02</sub> – There are no differences in the proportion of the amount of money being spent as a percentage of the total issue proceeds, for IPOs of companies with different IPO Grades

H<sub>03</sub> – There are no difference in the reputation of the investment banks, who are appointed as lead managers (including co-lead managers) for IPOs of companies with different IPO Grades

Alternative Hypotheses of this paper are as follows:

H<sub>11</sub> – There are differences in the number of investment banks, appointed as lead managers (including co-lead managers) for IPOs of companies with different IPO grades

H<sub>12</sub> – There are differences in the proportion of the amount of money being spent as a percentage of the total issue proceeds, for IPOs of companies with different IPO grade

H<sub>13</sub> – There are difference in the reputation of

the investment banks, who are appointed as lead managers (including co-lead managers) for IPOs of companies with different IPO grades

### Research Methodology:

Issue related expenses as a whole is considered, and its proportion with respect to total money raised through IPO (excluding the portion, through which promoter group, sells their stake) is considered in percentage terms. As total issue related expense includes, promotional and advertising expenses, fees paid to investment bankers and IPO Grading related fees among others. So it should be a good proxy for lead managers interest and extent of promotion done.

Also data regarding total number of investment banks, acting as the lead manager and co-lead manager is gathered. More investment banks as lead manager, should result in more promotion of the IPO among prospective institutional investors and more interest on their part.

These data are gathered through minutely browsing all the prospectus, as filed with SEBI, by the respective companies.

Lead manager of the IPO is used as a dummy variable. Any Indian merchant banking company featuring in top ten list (by market share) in India is regarded as a reputed merchant banker. Same way any multinational investment bank featuring in the top ten list worldwide, is considered a reputed lead manager. The Indian merchant bankers, who feature in the top ten list are, Kotak Mahindra Capital, Axis Capital (formerly Enam Securities), SBI Capital. This is according to the data compiled, by Bloomberg in first seven months of calendar year 2013.

Among the multinational investment banks, top ten investment banks worldwide as per the revenue are considered as reputed investment banks. According to data collated by the Financial Times, the UK, for the first three

quarters of calendar year 2013, these banks are JP Morgan, Bank of America Merrill Lynch, Goldman Sachs, Citi, Deutsche Bank, Barclays, Credit Suisse, Wells Fargo and UBS.

Reputed merchant bankers are assigned 1, other merchant banks are assigned a value of 0.

These three variables were subjected Q-Q test, and found to be distributed not according to normal distribution. As a result non parametric Kruskal-Wallis Test is used for comparison.

In total, 171 companies are considered which accessed primary market to raise equity capital, between 2007 and 2013.

### Empirical Results and Analysis :

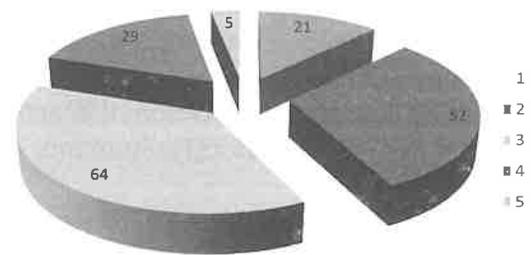


Figure 1: Grade wise breakup of the companies

SPSS output of the Kruskal-Wallis test is given below:

	Ranks		
	IPO Grade	N	Mean Rank
Percentage of Issue Proceeds spent on issue expense	1	19	75.37
	2	52	95.85
	3	64	92.48
	4	29	64.34
	5	5	32.80
	Total	169	
Number_Lead_Manager	1	21	47.38
	2	52	59.67
	3	64	97.43
	4	29	125.90
	5	5	144.30
	Total	171	
Reputation of IB	1	21	51.50
	2	52	59.72
	3	64	94.25
	4	29	131.10
	5	5	137.00
	Total	171	

Test Statistics<sup>a,b</sup>

	Percentage of Issue Proceeds spent on issue expense	Number_Lead_Manager	Reputation of IB
Chi-Square	15.647	67.373	77.556
df	4	4	4
Asymp. Sig	.004	.000	.000

a. Kruskal Wallis Test

b. Grouping Variable: IPO Grade

From the SPSS output, it is apparent, that for all the three factors, there is significant difference among companies, with different IPO Grades, at 5% level of significance, as the p values (Asymp. Sig value) range from 0.000 for number of lead manager and reputation of the investment bank to 0.004 for percentage of issue proceeds spent as the issue related expenses. The mean rank on all the three parameters differ statistically significantly for companies with different IPO Grades. So all the three, null hypotheses are rejected.

### Conclusions:

The research done clearly shows, that companies with different IPO Grade(signifying their fundamental quality), have quite different approaches, regarding their investment bank related practices in the time of IPO. As it is proved that fundamentally better companies(as signified by their IPO Grade) have more reputed investment banks, to manage their IPOs. Similarly they spend , more money spent as issue related expenses(as a proportion of total issue proceed), and have more number of investment banks as lead managers(including co-lead managers). These are significant addition to the literature on IPO Grading.

### Recommendations:

In view of the above findings, it may be recommended, that SEBI can put a cap on proportion of IPO proceeds, that can be used for IPO related activity. It will put all the companies, irrespective of their IPO Grade, in the same footing.

In the future researches, it can be explored, whether these factors contribute to investor appetite for IPOs.

### References:

- Burch, T. R., V. Nanda, and V. Warther (2005). Does it pay to be loyal? An empirical analysis of underwriting relationships and fees. *Journal of Financial Economics*, 77, 673–699.
- Chemmanur, T.J. and Fulghieri, P.(1994). Investment bank reputation, information production, and financial intermediation. *Journal of Finance*, 49, 57-80.
- Campbell, T. S., and Keracaw, W.A. (1980). Information Production, Market Signalling, and the Theory of Financial Intermediation. *Journal of Finance*, 35, 863-882.
- Drucker, S. and M. Puri (2005). On the benefits of concurrent lending and underwriting. *Journal of Finance*, 60, 2762–2799.
- Gao X. and J. R. Ritter (2010). The marketing of seasoned equity offerings. *Journal of Financial Economics*, 97, 32 – 52.
- James, C. (1992). Relationship-specific assets and the pricing of underwriter services. *Journal of Finance*, 47, 1865 – 1885.
- Leland, H. E., and Pyle, D. (1977). Informational Asymmetries, Financial Structure and Financial Intermediation. *Journal of Finance*, 32, 371-387.
- Murthy M.R. and Alok Puranik (1993), Cost of Raising Capital- A Study of Public Issues Made During 1992-93, Institute for Studies in Industrial Development, New Delhi.
- Neupane Suman, Paudyal Krishna and Thapa Chandra(2012). Firm Quality Or Market Sentiment: What Matters More For IPO Investors? Retrieved On 6.3.2014 From.

- Poudyal Sanjay (2008). "Grading Initial Public Offerings (IPOs) in India's Capital Markets A Globally Unique Concept", W.P. No.2008-12-08, IIM, Ahmedabad
- Verma, J.C. (1990), Merchant Banking- Organization and Management, Tata McGraw Hills Publishing, New Delhi.
- Welch, Ivo(1992). Sequential Sales, Learning, and Cascades. Journal of Finance, 47 (2), 695-732.

\*\*\*\*\*