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Research Paper Commerce

IPO Grading – An Insight

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ABSTRACT

Capital market plays a pivotal role in the capital formation and economic development of every country. Existence of a sound primary market consisting of a large number of investors depends very much on the availability of reliable information and the knowledge of potential investors to investigate into the fine prints of the documents issued by the companies and other relevant information. In India, domestic savings are not properly channelized and utilized for productive activities. A number of potential investors shy away from the capital market as they cannot understand the bases of investment. With the intention of development of efficient primary market SEBI has made IPO (Initial Public Offering) grading mandatory. It is expected that IPO grading provides much needed quality information to potential investors in IPOs and improves the mechanism of channelization of funds to productive activities. Hence, this paper makes an attempt to provide an insight into the significance, process and methodology of IPO grading.

Keywords : Capital Market, IPO, IPO Grading, Rating Agencies, CRISIL

Introduction
Capital market plays an important role in the channellisation of savings of individuals and institutes. Mobilization of funds through issue of equity shares has become a regular practice in the market. Gradually, in India, equity-cult is growing up. Growth of Indian economy and booming capital market have further infused an impetus to this phenomenon. This is a positive sign to the growth of capital market, in particular, and Indian economy in general. The following table provides the information on the amount of equity capital mobilised through Initial Public Offerings (IPOs).

Table - 1: Equity Funds Mobilised through IPOs

Year	Number of IPOs	Amount (Rs. crore)
1999-00	51	2,719
2000-01	114	2,722
2001-02	07	1,202
2002-03	06	1,039
2003-04	21	3,434
2004-05	23	13,749
2005-06	79	10,936
2006-07	77	28,504
2007-08	85	42,595

Source: Table prepared on the basis of the data extracted from SEBI Bulletin, May 2008

The data presented in the above table is an indication of spurt in public issues in the last three years under review. In the financial year 2000-01, though the number of IPOs were more, the amount raised through IPOs was only Rs.2,722 crore. A number of big issues came up in 2004-05. Number of IPOs were only 23 but the amount mobilized was to the tune of Rs.13,749 crore. Total amount of Rs. 1,06,900 crore raised through IPOs during the last nine years (between the financial years 1999-2000 and 2007-08). It is to be noted that the amount of capital mobilized during 2007-08 through IPOs works out to almost 40 per cent of the total amount raised during the last nine years. Growth of IPOs in terms of amount raised during 2007-08 compared to 1999-2000 is about 14.67 times. It is evident from the data and analysis that IPOs are gaining momentum in the capital market.

As the market is growing, new challenges have cropped up and a number of complexities have crept in. Availability of reliable information and its analysis are pre-requisites for taking prudent investment decision. Inadequate information leads to inefficiency in the market. SEBI (Securities and Exchange Board of India) has come out with a number of stringent measures to protect the interest of investors. It has issued Disclosure and Investor Protection (DIP) Guidelines to tighten the norms of disclosure by the companies.

Disclosure of qualitative and material information is very important to take investment decisions. At the same time, investors should be able to understand the fine prints of asymmetrically available information. Indian investors, particularly retail investors, are not prudent enough to understand the capital market nuances. Name of the issuer is no longer the assurance for the returns, and a few companies are coming to the market without the track record of management. As a result, a number of investors have burnt their fingers in the market.

In the light of above developments, SEBI has made it mandatory, based on the recommendation of SEBI Primary Market Advisory Committee, to get the IPOs rated by at least one Credit Rating Agency registered with it. All the issuers in the primary market who file their draft Red Herring Prospectus (RHP), draft prospectus or offer document on or after May 01, 2007 must get an IPO Grading.1

IPO Grading - Meaning
IPO grading is an independent opinion on the fundamentals of graded IPO expressed as a relative assessment in relation to other listed equity securities in India. The assessment is based on grading exercise carried out by a team of industrial experts of a Credit Rating Agency which is registered with SEBI. IPO Grading is an expert opinion on the fundamentals of the company. But it must be noted that the IPO Grading is not,

- a recommendation to invest or not to invest in graded instrument,
- a comment on issue price of the shares being offered, likely listing price or likely movement of post-listing price,
- an assessment of the market risk associated with equity investments,
- an audit of issuer, and

- it is not a forensic exercise that can detect frauds.

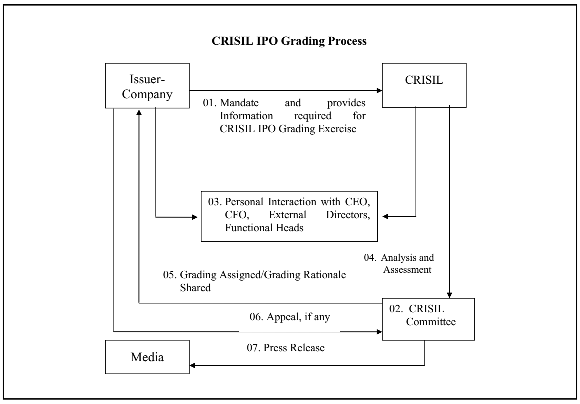
IPO Grading could be useful to the market participants to take an informed investment decision. Because,
- It provides additional input,
- The fundamentals of the company are analysed and information is interpreted comprehensively which is not possible to retail investors,
- It is helpful to assess a new company without any track record, and
- It facilitates the issuer-company to benchmark itself.

IPO Grading Process
The IPO Grading commences at the request of the issuer-company to the Credit Rating Agency. An agreement will be executed between the issuer-company and the Rating Agency. The Rating Agency constitutes a Grading Team on the submission of required information by the issuer-company. Grading Team conducts basic research. This is followed by series of meetings with the management and plant/site visits. The Grading Team will have face to face discussion with CEO, CFO and other functional heads. The team will also have meetings with independent directors. Then, Grading Team prepares and presents a comprehensive report to Grading Committee. This Committee assigns grading.

Once the grade is assigned, the same will be communicated to the issuer-company along with the rationale outlining the reasons for the grade assigned. The issuer-company, if not satisfied, may appeal to the Grading Committee with substantiating information. The Grading Committee, after appropriate reviews, communicates the final decision to issuer-company. SEBI makes it mandatory to publish the grading assigned irrespective of whether the company accepts it or not. Finally, the Rating Agency issues a brief note on grading to the media.

The entire process takes three to four weeks. This process does not delay any other process for IPO issue. IPO Grading can be done at any stage of the IPO planning process, may be before or after filing the draft Red Herring Prospectus (RHP) with SEBI. But IPO Grading is required to be completed or disclosed in the final prospectus or RHP. The issuer-company has to bear the fees of IPO Grading. At present, CRISIL, ICRA and CARE are offering IPO Grading Services. All the Rating Agencies follow, more or less, the same process as presented above.

CRISIL IPO Grading[2]
IPO Grading is carried out by CRISIL Research and Information Service Limited (CRIS), a wholly owned subsidiary of CRISIL. This (i.e., CRIS) is independent of CRISIL Rating. CRISIL IPO Grading Process takes three to four weeks. IPO Grading is valid for 60 days. If it is required, the Rating Agency issues a fresh grading (at no extra cost until 120 days) after the assignment of initial grading. IPO Grading process followed by CRISIL is illustrated graphically below.



Source: Issuers' FAQs on CRISIL IPO Grading, CRISIL Research, www.crisil.com

IPO Grading Methodology[3]
IPO Grading is a tricky affair. Equity share capital is a risk capital. It has no finite life. It is an instrument of open-end nature. IPO Grading is totally an untried area and it is yet to be conceptualized. There is no international experience for IPO Grading. Moody's, Standard and Poor's and Fitch are not offering IPO Grading services. Of course, these international agencies provide some equity related service. Hence, Indian Rating Agencies have to start formulating methodologies from scratch. IPO Grading involves an in-depth assessment of various quantitative and qualitative parameters of the issuer-companies. Rating Agencies are generally following the following methodology/procedure.

01. Business Fundamentals and Prospects
In this analysis, fundamentals of the industry to which the company under consideration belongs to are analysed and assessed thoroughly. The factors like product line, availability of input resources, utilization of installed capacity, cyclicality, demand and supply factors, government policies, labour and industrial problems, future prospects, etc are analysed and assessed carefully.

02. Financial Prospects
The financial performance of the companies, usually for 3 - 5 years horizon, is critically examined using various key financial indicators. This exercise is done with a view to project the future prospects. Hence, this step is a forward looking analysis.

03. Management Quality
The track record of management is studied keeping an eye on the future prospects. Quality management will be able to steer the company during the adverse conditions. The extent to which the management is able to exploit the opportunities and to tackle the contingencies is an important ingredient of this analysis.

04. Corporate Governance
Corporate governance practice is one of the important factors in the assessment of fundamentals. Prudent practices with holistic approach are positive signs of good governance. Company's approach towards the shareholders will also be assessed.

05. Project Risk
Project-specific risks are unearthed and analysed if the amount to be raised through the public issue is for the purpose of financing the existing or the new project.

06. Compliance and Litigation History
The company's track record in following the legal aspects plays an important role in the assessment of the fundamentals. The issuer's compliance report and the litigation history will critically be examined.

The parameters prescribed supra cannot be exhaustive since the Rating Agencies have made a beginning. Over the years of experience, they will have to come out with a comprehensive methodology. After completion of the process by applying the methodology, IPO grading is provided in the following manner.

Table - 2: Grading Scale

IPO Grade	Meaning of Grade
5	Strong Fundamentals
4	Above Average Fundamentals
3	Average Fundamentals
2	Below Average Fundamentals
1	Poor Fundamentals

Conclusion
A comprehensive and well designed process and methodology followed by different Rating Agencies for grading IPOs is-

sued by different issuers help the investors, particularly retail investors, in taking informed decisions. But the Rating Agencies have to follow stringent methodology in the true spirit of protecting the interest of the investors. Then, it certainly paves the way for developing efficient and resilient capital market.

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1. http://www.bullishindian.com/ipo-grading-mandatory-from-today-may-1-2007-as-sebi-gets-tough/176/ | 2. Issuers' FAQs on CRISIL IPO Grading, CRISIL Research, www.crisil.com | 3. This section, for obvious reasons, is based on the relevant materials collected from the websites of Rating Agencies.

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