Fair price shop

Some new issues have not delivered. But, in general, pricing has been reasonable in this IPO boom

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When a handful of recent IPOs (initial public offerings) dipped below their issue price, it created the impression that IPOs were being overpriced. Is that so? Between June 2003, when the IPO market started picking up again, and October 2005, there have been 73 IPOs. Of these, only 12 currently quote below their offer prices, that too mostly only just and in small IPOs. Assuming all investors held on to their shares, their collective loss from these 12 'losing' IPOs would be Rs 168 crore, which is a fraction of their collective gain of Rs 19,429 crore from the 61 'winning' ones. So much for overpricing.

Looking back

Some things have changed -- for the better. Gone are the days when issue pricing was decided 'in the shower'; it is now determined through an elaborate pre-issue marketing exercise. Then, more than half the issue is bought by institutional buyers, who are better equipped to assess issue pricing and are more discerning. Gone are the days of fly-by-night companies, whose sole purpose was to raise money and decamp. Due to tighter entry norms and new market dynamics, nearly all issuers now have a track record and a commitment to their business. Companies too are cautious -- an issue, unlike a product, can't be relaunched.

Issue pricing is a diverse, complex subject. There is no one perfect method of valuation. Issue pricing is all about the future -- an unknown domain. Although a few issuers do price their offers on the basis of past performance (historical earnings), most try and sell their future (forward earnings). Issuers do look at benchmarks available, as analysts and investors tend to draw from such comparisons. For instance, how is a company priced in comparison to their peers? But it's difficult to pin issue pricing down to just one factor, as each company is unique. That explains why the issue price PEs (based on historical earnings) of the 2004-05 IPOs ranged from 1 to 382!

Any analysis of returns on IPOs should be done only at the time of listing, maybe a few months on. After that, the stock becomes a regular secondary market stock. Its price is influenced by the state of the secondary market, macroeconomic factors and company-specific factors. Within that paradigm, this IPO market has done exceedingly well.

There have been exceptions, of suspected price manipulation in some follow-on offers, of issuers making allotments to chosen qualified institutional buyers (QIBs) with the explicit intention of helping them profit at the expense of small investors. Some of the rules have been also changed to prevent the reoccurrence of such malpractices. For example, discretionary allotments to QIBs and the exemption given to them on the payment of margin money has been done away with. This will reduce the hype and lead to realistic oversubscription figures -- and more realistic pricing.

Looking ahead

Some IPOs will deliver, some won't. That's the nature of business and equity investing. Still, it's regressive to suggest that we take away the freedom given to companies to price their issues and go back to a Controller of Capital Issues-type system.

No mathematical formula can capture valuation. In any case, regulators are not analysts. Some years ago, Sebi had asked issuers to disclose, along with their issue price, the price according to the CCI formula also. Since the CCI formula generally underpriced shares, it led to huge aberrations, and the guideline was withdrawn. I am also opposed to giving credit rating to IPOs.

Let pricing remain with issuers. The regulator should instead focus on how to check companies from committing irregularities and fraud. Like monitoring utilisation of issue proceeds. Like better disclosures to help investors make a more informed decision. Such checks and balances become even more vital as the current IPO boom stretches and issue selection takes on greater importance.

In the initial phase of an IPO run, issues tend to be priced relatively conservatively. But as investor response increases, pricing tends to get aggressive. At present, investor interest in IPOs is high and aggressive pricing can be expected. Remember, you don't have to invest in every IPO. Do your due diligence: look for good promoter credentials, believable recent financial performance (spikes in the last year should be cause for investigation), potential for growth in the business, and valuations that merit investment. If you can't do it yourself, one option, though not a fail-safe one, is to look at QIB subscription -- if institutional interest under the new system is low, abstain from such issues.

BoX

This IPO boom, investors have raked it in. Of the 73 IPOs since June 2003, just 12 quote below their offer price