Are they worth following?

Nine of the 11 follow-on public offerings (FPOs) in 2005-06 have yielded minuscule or negative returns. What gives?

FPOs in this bull run have given investors creased brows – three of every 10 FPOs are giving negative returns

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Last week, I demolished the myth that IPOs (initial public offerings) in this bull run are being overpriced and that investors are losing money. To recollect, of the 73 IPOs made between June 2003 and October 2005 that raised Rs 22,922 crore, the collective gains from the 61 issues that have given positive returns is an impressive Rs 19,429 crore at current prices. But how have follow-on public offerings (FPOs) -- public issues made by existing listed companies – done?

Issues of pricing…

It's important to know because, unlike all previous primary market booms, this one has been pulled equally by FPOs. Although only 27 FPOs were made during this period, they accounted for Rs 24,579 crore of the Rs 47,501 crore raised -- about 51 per cent. But in terms of performance, FPOs have lagged behind IPOs in a big way. As on November 30, the percentage gains from FPOs on the amount raised was 42 per cent -- about half of the 84.8 per cent given by IPOs. Plus, a greater percentage of FPOs were quoting below their issue price than IPOs (See table: Followers, not leaders).

The picture gets alarming if we narrow our study period to the current fiscal. Of the 11 FPOs made in 2005-06 till October, five have given negative returns (Allahabad Bank, Alps Industries, Gujarat Industries Power, Jindal Polyfilms and Yash Papers), four others have given minuscule returns (Beeyu Overseas, Oriental Bank of Commerce, Southern Online and Talbros Automotive). Although one can't say conclusively, these numbers do lend strength to the argument that FPOs made at the height of a bull run tend to be priced aggressively, sometimes are even overpriced.

In an IPO, the issue price is determined through an extensive pre-issue marketing exercise. Plus, prudence demands conservative pricing for a company of unknown stock. By comparison, listed companies have tremendous pricing power in bull markets. The issue price in FPOs is generally a tempting discount to the latest price of the stock in the secondary market. What's prominently visible to investors is the discount, what's not is how the stock has moved in the run up to the issue. If there's a spike in prices and it's not backed by earnings growth, post-FPO, the stock can end up an under-performer. It's in the interest of many big market players to ensure there is a spike in prices in the lead up.

Take the PNB FPO made earlier this year. The PNB stock shot up from Rs 232 six months before its issue to an all-time high of Rs 511 on the issue date. Despite no dramatic change in the bank's fundamentals, the stock beat the Sensex by about five times and the bank index by two. But on the day the new shares got listed, it crashed to Rs 388, below its issue price of Rs 390, which is where it has hovered since. For the first time, investor faith in PSU bank issues took a beating. While the PNB issue received 776,000 applications, it fell to 144,000 for Allahabad Bank and just 28,000 for OBC.

ICICI Bank's current offering is the issue of this year. Its price band is Rs 505-545. On December 2, the stock closed at Rs 543. The issue will finally be priced at a discount to current market price; plus there is an additional 5 per cent discount on offer price for retail investors. In the recent past, the stock has risen and risen. A year ago, it was at Rs 320. Six months ago, Rs 398. Three months ago, Rs 480. A month ago, Rs 486. Its 52-week high, on September 30: Rs.615. Whether that's a fair reflection of the growth expectations from ICICI Bank or an unrealistic spike in prices, time will tell.

…and policies

I have more problems with FPOs. About 97 per cent of the amount raised by FPOs has been through the book-building route. Book-building is a mechanism of price discovery. How can it be applied to listed stocks, which have continuing price benchmarks available in the form of their secondary market prices? It's illogical to discover the price of a stock in two markets simultaneously. Is it merely being used to allot half an issue to preferred investors -- a provision that doesn't exist in fixed-priced issues?

I'm not saying that all FPOs are bad. Investors should, however, check out price movement of a stock prior to an issue and see whether dramatic rises are justified. Maybe, there's a case for pricing FPOs on the basis of the average price for the preceding three or six months, like it is done in preferential issues, though there the intention is the opposite -- not to allow promoters to make preferential allotments at low prices. Alternatively, the regulator should at least mandate publishing prominently in issue ads the share price movement over the preceding three to six months.

FPOs trail IPOs

	IPOs	FPOs
NUMBERS		
No. of issues	73	27
Positive returns	61	19
Negative returns	12	8

Losing issues (%) 1	**16.0**	**30.0**
AMOUNT		
Money raised (Rs cr)	22,922	24,579
Notional gains (Rs cr)	19,429	10,531
Gains (%) 2	**85.0**	**42.0**

1 As percentage of total number of issues in that category

2 As percentage of total money raised in that category