The farce of book-building

Book-building has become the preferred route because it facilitates preferential allotments in the garb of a public issue

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Of the Rs 42,879 raised by companies through public issues between January 2003 and June 2005, Rs 41,288 crore was through book-building issues. Clearly, book-building is the preferred route. Book-building is essentially a mechanism for an issuer to obtain a market-driven 'best price' for his offering. Worldwide, this system has been misused. In India, it has been further modified to suit the interests of the few, at the expense of the majority.

Discretionary

The primary reason for the unanimous preference of book-building is the liberty to make allotments to chosen big investors. That too, for as much as 60 per cent of an issue -- the entitlement of institutional investors (termed as qualified institutional buyers, or QIBs). This element of discretion doesn't exist in the alternative to a book-built issue, a fixed-price issue, where the entire allocation is made on an anonymous basis. It is legal for an issuer to prefer one investor to another, but then the route should be a private placement or a preferential issue, and be subjected to its attendant regulations, including a lock-in.

Strangely, even listed companies, who have an available price benchmark, do follow-on public issues through book-building. Isn't it absurd to discover the price of a stock in two different markets simultaneously? Little wonder, this has facilitated several distortions and market manipulations. But importantly, since such issues have to be offered at below market price, is book-building merely being used here too to allot 60 per cent of an issue to preferred investors, at low prices?

The argument in favour of the discretionary method is that it allows selection of 'quality investors', but no data is made available to substantiate this. In any case, where is the question of quality if all QIBs have cleared Sebi's registration process? Does Sebi prevent any registered FII from operating in the secondary market? Extending this further, why are allotments to other investors also not made on the basis of quality?

Then, why bring small investors at all into book-building? The paltry quota for small investors leads to most applications being rejected or in miniscule allotments. This, coupled with the oversubscription hype, creates a huge post-listing demand. The price zooms, and QIBs make big gains.

Discovery?

The other argument given in support of book-building is that it's a more efficient way to discover the issue price. The way it currently works, there's no real price discovery happening. Instead of a fixed price, book-built issues have a narrow price band, within which investors 'discover' the price. Worse, this price band too is fixed during pre-issue consultations with big investors. This route, of course, assures an issuer subscription from QIBs, something not possible in a fixed-price issue.

If book-building is truly an instrument of price discovery, then why such heavy oversubscriptions, why such huge listing gains? It's also strange that book-building is used for the retail segment, which cannot, and does not, discover the price.

Discriminatory

The book-building process also discriminates against small investors, even works against them. They have to pay the entire application amount while placing their bid, while QIBs pay nothing. Worse, this facility is misused as several QIBs, in agreement, place huge bids the moment an issue opens. This is obviously to create oversubscription hype to lure less-informed small investors. In the name of disclosures, daily oversubscription updates, banned in fixed-priced issues are allowed in book-built ones. To prevent misuse, withdrawal of bids by QIBs was banned, but revision in bids is still allowed. But this is as good as withdrawal -- a bid for one million shares can be revised to one share!

QIBs are needed, as they validate an issue and its price for small investors. But the present system is loaded in their favour. In the past two years, discretionary allotment to QIBs has aggregated Rs 21,090 crore. At today's prices, this work out to a profit of Rs 8,165 crore, a gain that should rightfully belong to domestic investors. Given the pipeline and the future, it's not late to reform.