Where's the overpricing?

A section of the media says there are too many IPOs hitting the market, that too priced aggressively. They are wrong on both counts

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I dislike doing any cut-off date analysis of IPO returns, as there is nothing sacrosanct about the chosen period or the cut-off date. But following the shrill concerns voiced by a section of the media on investors making losses due to a deluge of IPOs and overpricing, which shaped the questionable proposal of IPO grading, I decided to crunch some numbers.

On Diwali eve, I checked how the 10 largest IPOs made since last Diwali have fared, and it debunked many claims being made. True to my expectations, nine out of 10 stocks are quoting above their offer prices; Deccan Aviation is the exception (down 27.7 per cent), and it would only be fair to say that the airline industry is going through much turbulence. As many as five IPOs have returned over 20 per cent, which is a top return, with the best being 109.3 per cent from Tech Mahindra (See table: Investors haven't lost money). So much for overpricing.

Fair game

There is no deluge either. In the one-year period of my study, 79 IPOs raised Rs 12,898 crore -- small amounts both, judging by history. Further, analysts seem to forget that IPOs don't operate independent of the secondary market -- once made, they list on it and are influenced by conditions there. When the market fell about 25 per cent in May-June, even blue chips lost that much, even more.

When it comes to judging IPO pricing, the critical thing I look for is whether an IPO gave an opportunity to exit at a profit; if not, was the reason a weak secondary market around the time of listing? Almost all IPOs offered a profitable exit window. Of the 124 IPOs floated between April 2003 and April 2006 -- the period of the bull run -- as many as 85 were still quoting above their offer prices on May 31, 15 days after the crash. And the collective loss on the remaining 39 issues, at Rs 1,324 crore, was a fraction of the Rs 25,511 crore gain on the 85 winners.

Once a stock lists, investing in it is like investing in any secondary market stock. Take Jet Airways, which issued stock at Rs 1,100. Although analysts felt the pricing was aggressive, its issue was heavily oversubscribed. A month after listing, the stock hit Rs 1,383; its market price stayed above the offer price for about six months after listing. Today, of course, the stock quotes at Rs 614, showing the after-effects of cut-throat competition and the aborted acquisition of Air Sahara. If investors were bullish on the market or the company, or were plain greedy and did not use the exit opportunity, should pricing be blamed?

It's unfair to expect IPOs to quote above their offer prices at all times and always better the market? Any analysis of IPO returns should be done only at the time of listing and, at best, for a couple of weeks thereafter, provided the secondary market has not crashed in the interim. After that, the stock becomes a regular secondary market stock, influenced by the state of the market, macroeconomic factors and company-specific factors.

Safety checks

Proof of pricing should be based on only two parameters: the level of over-subscription and the listing price. If both are well in the positive zone, the accusation of overpricing rings hollow. Significantly, all large issues, which also means more investors, have done well. In our one-year period, 79 IPOs raised Rs 12,898 crore, of which, the top 10 accounted for Rs 7,035 crore. And if these have given positive returns, the bogey of IPO overpricing should be laid to rest.

In the new market structure, aggressive pricing is not easy to pull off. Issue prices are now determined through an elaborate pre-issue marketing exercise. More than half the issue has to be bought by institutional buyers, who are more discerning and demanding. The quality of issuers has improved due to tighter entry norms, better vetting by the two major stock exchanges and new market dynamics.

In the last three years, almost all IPOs have been from established companies. Just a handful were for greenfield projects, where too the promoters were known. Companies too are cautious in pricing -- they have to ensure the issue sells and merchant bankers don't want issues to devolve. The bottom line: IPOs have to be bought, they cannot be sold.

Your strategy

In order to get good returns from IPOs, look for three things. One, the promoter's track record should be outstanding, as it is he who will manage your money (and not the unnatural entity of company). Two, institutional participation should be significant, as it validates issue quality and price. Three, the issue should be large, as that will ensure a large float and liquidity, and allow big investors a chance to invest post-listing too.

From the policy perspective, rather than fret over issue pricing, the focus should be on improving disclosures to help investors make informed decisions. Also, we have to get rid of malpractices. That means checking companies from committing irregularities and monitoring end-use of issue proceeds. Not grading IPOs.

Investors haven't lost money

Overpricing, what overpricing? Nine of the 10 largest IPOs since last Diwali have given a positive return.

	Issue date	**size (Rs cr)**	**Issue price (Rs)**	**Current price (Rs)** 1	**Change (%)**
Tech Mahindra	Jan-06	465	365	764	**109.3**
Gujarat State Petronet	Jan-06	373	27	40	**48.1**
Sun TV	Mar-06	603	875	1,228	**40.3**
GMR Infrastructure	Jul-06	789	210	286	**36.2**
M&M Financial	Feb-06	400	200	247	**23.5**
Gitanjali Gems	Feb-06	331	195	221	**13.3**
Reliance Petroleum	Apr-06	2,700	60	65	**8.3**
Punj Lloyd	Dec-05	642	700	740	**5.7**
Jagran Prakashan	Jan-06	369	320	320	**0.0**
Deccan Aviation	May-06	363	148	107	**-27.7**

1 As on October 19

Source: PRIME Database