The way to build a book

The present book-building system is inequitable. Shift to a variant of the method that Google used

Prithvi Haldea

As articulated in this space in the past few weeks, the present book-building system has flaws. There's no real price discovery happening, as issuers in negotiation with institutional investors fix the price, though in a price band. It further favours institutional investors by giving them the biggest reservation. It doesn't require them to make any upfront payment and allows discretionary allotment. About time it's done away with and replaced with something more equitable, like the Dutch auction method, which was employed by Google to sell its IPO (initial public offering).

Dutch auction method

In this system, the issuer submits the floor price in a sealed envelope to Sebi (Securities and Exchange Board of India) prior to the issue opening date. To start with, only the QIB portion will be auctioned, with the issuer giving absolutely no price indication -- like floor price or price band -- to investors. The issue window stays open for a day for interested QIBs to place their bids -- number of shares wanted and the price they are willing to pay for them. All bids are kept confidential and not visible to other investors.

At the end of the day, the bids are compiled. Allotment will be made at differential prices, on a step-down basis -- the bidder at the highest price gets shares first, then the next highest and so on. In order to prevent substantial acquisition by any single bidder, there can be a cap on allotment to a single application. If there aren't enough institutional bids above the floor price, the issuer will have the option to withdraw the issue or reset the floor price. There should be a separate book for non-institutional investors, and the same auction system should be followed.

This system can be modified to find an optimal market price for the stock. Instead of allotting on a step-down basis, the company can allot shares at a fixed price -- the price at which the entire issue is subscribed. Every investor who bids above the determined price will get the number of shares asked for, at that price.

Once the QIB issue is completed, the floor price submitted to Sebi or the lowest accepted institutional bid, whichever is lower, can be the fixed price for the small investor. This portion of the issue can stay open for three days, thus reducing the issue period from seven to four days. Every applicant should be allocated some shares, on a pro-rata basis.

Win-win situation

Two arguments are given against this system. Neither holds. One, QIBs might be hesitant to apply, as they wouldn't know what price to bid at. Aren't QIBs forever engaged in working out valuations, for example, when they buy shares of an unlisted company or even of a listed company in the secondary market? Two, the prospect of being allotted shares at multiple prices will make QIBs wary. Again, has there not been differential pricing in several public issues? When they buy shares from the secondary market, don't they buy shares of the same company at different prices?

Fact is, this method is share democracy at its purest, as it places the pricing decision entirely in the hands of the market. It encourages true price discovery. Allotment to a QIB will be determined, rightly, by how much it is willing to pay for the shares, not its identity, as in the present system. The company gets a chance to maximise the capital-raising potential of its stock. If it uses the money raised productively, it would ultimately benefit all shareholders. With so much backing it, this method should be introduced soon. And till that is done, at least the existing book-building process should be made more transparent and equitable (See box: Interim solutions). And all PSU offers should be made only to retail investors, that too through the fixed price method.

Box

Interim solutions

While we wait for the new process, the existing book-building process should be modified on these lines:

- The issue price for the retail investor should always be the lower end of the price band
- Allocation to QIBs should be done on a proportionate basis or they should be asked to pay a 10 per cent margin, or both
- If zero margin for QIBs continues, don't let them revise bids
- Discretionary allotment to QIBs should be scrapped. If not, then at least have a lock-in of one year, as in preferential issues
- Disclose names of bidding QIBs and allotment details
- HNIs presently compete with companies in their category. The HNI quota should be divided equally between individuals and companies

- FPOs should not be sold through present book-building method.