4

IPO Mechanisms in India: A Brief Note

Amit Bubna and N. R. Prabhala[9]

1. Policy Issue

Investing for economic growth requires capital. In India, banks have been the primary source of capital for firms. As the economy modernizes and as banks face capital constraints, markets are likely to be increasingly important providers of capital. Indian firms have traditionally raised capital through debt and equity. Between 2007 and 2013, Indian corporations made 8,022 debt offerings and 291 equity offerings to raise capital, and they raised proceeds worth INR 2,053,846 crore (Tables 1A and 1B).

This note focuses on the equity capital raised through initial public offerings (IPOs). Our specific focus is on the mechanisms by which firms conduct IPOs.

2. The IPO Market

An initial public offering (IPO) is a key milestone in a firm's life cycle. A healthy IPO market is important for many reasons. IPOs give entrepreneurs liquidity for their investments, so a vibrant IPO market can stimulate the flow of pre-IPO investments and help develop new ventures. An IPO brings in new investors to a firm, which facilitates the firm's access to future growth capital. Being public also reduces the costs of raising future capital by stimulating the supply of information from the investment community.

IPOs are significant as they are regarded as the barometer of the health of the capital market. A single bad IPO can create considerable market disruptions and stall the plans of other firms that want to go public. Relatedly, an important reason for ensuring a smoothly functioning IPO market is to manage investor frenzy. IPOs are closely watched by investors and the media. Overheated IPO markets could result in cascades in which enthusiastic investors overbid for IPOs, create bubbles, and ride them out. The subsequent correction of bubbles and the distorted real investments induced by wrong price signals could create negative externalities for the real economy.

[9] Amit Bubna (corresponding author) is Assistant Professor at Indian School of Business (email: amit_bubna@isb.edu). Nagpurnanand Prabhala is with the Centre for Advanced Financial Research and Learning (CAFRAL) and University of Maryland, College Park. (email: prabhala@umd.edu). The views expressed in this paper are those of the authors and do not represent those of CAFRAL or the Reserve Bank of India. This White Paper is adapted from Bubna, A. and Prabhala, N. (2014), "Anchor investors in IPOs," NSE-NYU Stern Working Paper. (Available at: http://www.nseindia.com/research/content/BS4.pdf)

Table 1A: Indian Capital Market Offerings—Debt and Equity Offerings (Number), 2007–2013

YEAR	Debt			Equity	
	Debt Private Placement	Public Debt Issue	External Commercial Borrowing	IPO	FPO
2007	755	1	84	100	6
2008	836	0	10	37	1
2009	730	3	15	20	1
2010	923	5	28	64	8
2011	1255	19	15	37	2
2012	1670	16	28	11	0
2013	1575	32	22	3	1
TOTAL	7744	76	202	272	19

Note: Table 1A reports the number of debt and equity offerings in India from 2007 to 2013. Debt offerings include both privately placed and publicly placed debt, as well as external commercial borrowing (ECB). Equity offerings include initial public offerings (IPO) and follow-on public offerings (FPOs). The year is based on the offer opening date.

Source: Prime Database

Table 1B: Indian Capital Market Offerings—Debt and Equity Offerings (INR Crore), 2007–2013

YEAR	Debt			Equity	
	Debt Private Placement	Public Debt Issue	External Commercial Borrowing	IPO	FPO
2007	1,18,812	1,000	67,153	34,179	10,962
2008	1,66,857	0	2,589	16,904	23
2009	1,70,925	3,500	19,271	19,544	23
2010	2,31,764	2,727	44,492	37,535	31,577
2011	2,26,294	27,268	19,982	5,966	8,055
2012	3,32,528	23,365	44,574	6,835	0
2013	2,87,955	34,643	48,301	1,284	6,959
TOTAL	15,35,135	92,503	2,46,362	1,22,247	57,599

Note: Table 1B reports the amount (in INR Crore) raised through debt and equity offerings in India from 2007 to 2013. Debt offerings include both privately placed and publicly placed debt, as well as external commercial borrowing (ECB). Equity offerings includes both initial public offerings (IPO) and follow-on public offerings (FPOs). The year is based on the offer opening date.

Source: Prime Database

From a policy perspective, the key issue in ensuring a healthy IPO market is how to enable an environment where IPOs can be reasonably priced. Fair pricing ensures that firms sell instruments at acceptable prices, and investors get appropriate risk-adjusted returns. Fair pricing for IPOs is, however, challenging. IPO firms face the markets for the first time. Relatively little is known about an IPO firm's future prospects, governance quality, and other parameters that are relevant for valuation. These information gaps could result in issues being underpriced or being valued at substantial discounts relative to fair value. Thus, a main focus of IPO regulations is to mitigate information gaps between firms and investors. Regulators facilitate this through policies to increase the quality of pre-IPO disclosures and by specifying mechanisms by which firms can make IPOs. We discuss these issues, with a particular focus on IPO mechanisms, the subject of our own past research.

3. Should Regulators Set IPO Mechanisms?

IPO regulations define the mechanisms by which firms can go public. A basic question is whether regulators should play any role at all in deciding the IPO mechanisms that should be allowed. Perhaps the market could find an optimal process for every issue, and in the process, find customized mechanisms for each IPO brought to the market. We do not necessarily agree with this view. IPO valuation and placement are among the more difficult mechanism design questions, which remain unsettled even after several decades of debate and experiences around the world. A marketplace with multiple mechanisms for bidding, pricing, and allocations would be burdensome for investors, issuers, and issue managers. It would also impose significant legal complexities, costs, and burdens on the judicial system should the participants wish to litigate outcomes. Specifying a set of permitted IPO mechanisms is a beneficial externality that provides a "safe harbor" for all participants.

The particular mechanism or mechanisms permitted by regulators need not be fixed across time. Rather, they can evolve as regulators learn from experience to find a balance between excessively frequent changes and excessive stickiness in the allowed mechanisms. Regardless of how frequently regulators alter IPO mechanisms, a key challenge is to avoid arbitrariness in the change process. For instance, idiosyncratic failures of an IPO may tempt regulators to impose undue burdens on issuers, leading many quality firms to stay away from public markets rather than bear the burdens of a costly IPO process. Changes should be driven by an objective regulatory process that is in turn backed by high quality input from market professionals as well as data and rigorous analysis on what works and why.

4. Is there One Optimal IPO Mechanism?

To the question as to whether there is a single optimal IPO mechanism, the answer is probably no. An IPO mechanism specifies a set of rules governing bidding and allocations. The best mechanism provides issuers incentives to disclose relevant information, minimizes the costs for investors to understand new issues, and produces a fair price in a liquid market. IPO managers also cite a goal of placing shares with long-term investors in firms. Unfortunately, there is no agreement about one mechanism that accomplishes these goals.

The problem of designing an optimal auction mechanism is not new. The best mechanism depends crucially on several assumptions, such as bidder behavior, costs of information gathering, and bidder entry, not to speak of the dynamics due to repeated participation by intermediaries and investors in the market place. In the absence of a consensus, the approach of policy makers around the world is to permit one or more mechanisms and to update the rules based on experience. The case in India is no different. In the following section, we summarize some insights from the IPO mechanisms allowed in India.

5. The Indian Experience with IPO Mechanisms

India has experimented with several IPO mechanisms. Starting in September 1999, issuers could choose between the fixed price and book building methods. Fixed price offers set the IPO prices prior to the offer date with no scope for revision. Share allocations are proportionate to the quantity bid. In book building methods, the underwriters allocate shares, and the allocations need not be proportional. Over the years, there have been variants of book building in the Indian market. For instance, in November 2005, the underwriters' powers over IPO allocations were withdrawn even in "book-built" IPOs. In 2009, book building came with the option of having "anchor" investors in the first stage before the public offer. More recently, an SME platform was introduced for small firms wishing to do IPOs.

Table 2 presents the number of mainstream IPOs by mechanism type between 2007 and 2013. Fixed price offerings were the preferred mechanism until 2003. After 2003, book building has dominated IPOs. This is not unusual; the dominance of book building is seen in all markets where it is permitted. We discuss the evidence from our own research on IPO mechanisms in India and offer related policy recommendations.[10]

[10] Source: Bubna, A., and Prabhala, N.R. (2011), "IPOs with and without allocation discretion: Empirical evidence," *Journal of Financial Intermediation*, 20: 530–561.

Table 2: Indian Mainstream IPOs by Mechanism (2007–2013)

YEAR	Fixed Price	Book Building		**TOTAL**
	All	All	Anchor IPOs	
1999	15	2	–	17
2000	41	14	–	55
2001	7	2	–	9
2002	4	2	–	6
2003	5	5	–	10
2004	9	14	–	23
2005	15	38	–	53
2006	17	56	–	73
2007	13	87	–	100
2008	5	32	–	37
2009	0	20	9	20
2010	2	62	26	64
2011	1	36	6	37
2012	0	11	8	11
2013	0	3	3	3

Note: Table 2 reports the number of mainstream (not SME) initial public offerings in India between 1999 and 2013. We report these numbers for both fixed price and book building mechanisms. Since 2009, the SEBI permits issuing firms to choose the book building mechanism with anchor investors. Of the book-built IPOs, we separately report the number of IPOs that had anchor investors. The year is based on the offer opening date.

Source: Prime Database; Bubna and Prabhala (2011)

5.1 Book Building

Our research studies the implications of allowing US-style book building in Indian markets. The key metric in our study, as in most international IPO studies, is IPO underpricing, which is the difference between the offer price and the market price once trading opens. Issues priced near their market price are fair for issuers and investors. We find that book-built IPOs have lower underpricing compared to fixed price IPOs. This advantage is more pronounced when underwriters control share allocations. The evidence is consistent with the extant academic literature that stresses the benefits of book building.

The main criticism of book building is the potential for cronyism. However, there is little evidence of such abuse. Instead, allocations tilt towards market participants who are likely to contribute more to price discovery. Underwriters also tend to use their allocation powers to moderate the effects of unusually high bid quantities. If proportionate allocations were imposed instead, large bids would probably freeze other bidders out of the market. Underwriters with allocation powers can help balance allocation to ensure broader investor base, a goal often desired by entrepreneurs going public, and one that helps lower the cost of capital.

5.2 Anchors

A recent variation of book building in India incorporates anchor investors. Under the anchor mechanism, the issuing firm first offers some part of the IPO to "anchor" institutional investors and makes this allocation visible to public bidders. In the next stage, the retail investors bid. If this bidding indicates that an IPO will have higher clearing prices, the issue managers can set higher prices. Subsequently, all investors (including the anchors) pay the higher price.

In principle, the anchor process seems to be a sound way of capturing the benefits of book building methods. The method allows pricing to be initially determined by the best-informed investors, i.e., the anchors. Anchors are compensated for their efforts through guaranteed allocations. In the current environment in India, the outcome of the anchor process is transparent. However, investors do not witness how many anchor investors wanted to participate, their bids, or the "talk" that leads to the selection of the anchor.

Our research provides preliminary evidence about the anchor IPO mechanism. Between 2009 and 2013, about 40% of all book-built IPOs on the regular exchange had anchor investors. On average, there were about 12 anchor investors per IPO. We do not detect any strong effects of anchors on prices. While we find nothing particularly amiss in the anchor process, understanding its impact requires a more thorough econometric evaluation. The gap is simply data. We require more issues and data related to anchors before we can draw reliable conclusions.

5.3 Institutional Investor Engagement

Because IPOs are underpriced, their market prices tend to exceed the offer prices. Thus, IPOs attract short-term investors whose trading strategy is to buy at the issue offer price and sell shares in the after-market. Such flipping exerts liquidity pressures in the after-market, which can be of concern.

In the Indian context, anchor investors are required to hold shares for at least 30 days.

This serves to limit flipping and requires the anchors to analyze issues carefully before agreeing to invest as anchors. There is little evidence that institutional flipping by anchors is a special concern in the Indian market. We analyze bulk and block deals and find no evidence that anchor investors are especially likely to sell issues that they pre-buy, even after their lock-in period. We are unaware of evidence that there is flipping by other (non-anchor) investors.

5.4 Retail Investors in IPOs

An interesting feature of Indian IPO mechanisms is that retail and institutional components have been consistently segregated. Many regulatory concerns in Indian IPOs come from the retail investor component. The challenges in this tranche are not due to IPO managers, as regulations give the underwriters no discretion in how retail shares are allocated.

There are two issues associated with retail subscriptions. Investors may apply for IPOs and flip any allocations that they receive without putting in any capital in the process. Thus, investors in IPOs could be individuals who would never participate in capital markets and for whom investing is inappropriate. To prevent this phenomenon, retail investors are now required to block funds through the Application Supported by Blocked Amount (ASBA). This step is sensible. It ensures that only genuine participants in the capital market can place orders for IPOs. Rigging through multiple bids is a second challenge. While investors cannot place multiple bids, there is evidence that they do so by taking advantage of weak investor identification systems. For instance, in the Yes Bank IPO, press reports suggest that there was misrepresentation of investor identity.[11]

The takeaway from this discussion is that while the abuse of discretionary allocation power is a key concern in the U.S., the concerns in India have been different. In India, given the absence of a robust individual identification system in the retail segment, it is difficult to ensure that there are genuine investors who have the capital required to participate. With more robust Know Your Customer (KYC) norms, these abnormalities will perhaps abate, provided the KYC systems are not tedious paper-filling exercises but are robust, manipulation-proof systems.

---

[11] Source: "YES Bank IPO scam: Her office stays closed after SEBI bar," *BusinessLine*, 17 December 2005. (Available at: http://www.thehindubusinessline.com/todays-paper/article2198796.ece)

5.5 IPO Grading

In 2007, the Securities and Exchange Board of India (SEBI) made it compulsory for firms to receive IPO "grades" from independent ratings companies. In December 2013, IPO grading was made optional in keeping with the recommendations of the Financial Stability Board to reduce reliance on credit rating agencies. Whether it is beneficial to force issuers to get IPO grades is an interesting policy question. IPO grading can act as a concise summary of the voluminous disclosures required in IPOs. Alternatively, such grades can produce extra information because of the new entities involved in assigning grades.

We make three observations related to IPO grading as a certification process. First, the opinions on equity risk and returns are traditionally the domain of the buy and sell-side analyst community rather than that of the rating agencies that grade IPOs. It is unclear what domain expertise ratings companies outside the market can bring to the table. Perhaps it is more effective to remove buy and sell-side conflicts of interest and implement more robust enforcement processes to enhance the quality of the pronouncements made by the financial community trading in shares and produce a transparent market. Second, the IPO literature identifies other mechanisms for certifying IPO value. These include the presence of venture capitalists as investors, the type of underwriter, or the nature of an IPO firm's bank relationships. Finally, India is among the most transparent countries in terms of the public disclosure of the book building process. Investors can watch bid outcomes over the time period when the bidding is open, and for anchor issues, they can observe the nature of anchors and their investment. What grading adds to this mix remains unclear. The focus of IPO grades has been on certifying company fundamentals; indeed, the grades often say that they assess fundamentals and not price. The empirical evidence on the value of IPO grades is mixed. Further research on this issue is necessary.

5.6 SME Platform and Two-Tier Listing Standards

Since 2012, the SEBI has allowed exchanges to offer a separate platform for IPOs involving small and medium enterprises (SMEs); this platform moderates the disclosure requirements and assures market making by underwriters for three years. In spirit, the program is akin to similar relaxations offered under the U.S. JOBS Act. Those regulations aimed to free issuers from the onerous Sarbanes-Oxley Act compliance requirements and mitigate "disappearing IPOs." Table 3 reports the number of deals on the India SME platform. Since the introduction of the SME IPO platform, the number of SME IPOs (50) has dominated the IPO market relative to non-SME IPOs (14). Interestingly, most of the

SME IPOs have taken the fixed price route. It is unclear whether these preferences are driven by the market or the underwriters.

Table 3: Indian SME IPOs by Mechanism (2012–2013)

YEAR	Fixed Price	Book Building	**TOTAL**
2012	13	2	15
2013	34	1	35

Note: Since 2012, SEBI allows exchanges to offer a separate platform for IPOs for small and medium enterprises (SMEs). Table 3 reports the number of SME IPOs during 2012 and 2013, using either the fixed price or the book building mechanism. The year is based on the offer opening date.

Source: Prime Database

Some market participants suggest that diluting disclosure requirements lowers the disclosure standards set for IPOs. By definition, this is true. If the existing rules are interpreted as quality standards, any changes to the existing rules would “lower standards;” however, this is specious circular reasoning. The real issue is whether the disclosure requirements impair issuers from making IPOs that the market is ready to absorb. It is important to conduct a proper impact assessment. One issue is related to informational externalities. A few unscrupulous cases can tar the entire marketplace. Another concern is the real impact of the decision to allow firms to go public. In an economy where small firms are capital-constrained, opening up public markets may free issuers from financial constraints due to stretched banking relationships or the lack of supply of private equity capital. In addition, easier exit can stimulate greater supply of risk capital in early-stage ventures. These benefits need to be recognized in assessing whether to apply different standards to facilitate the entry of smaller firms into the public markets.

Finally, regulatory capacity and enforcement capacity are vital, especially the ability to differentiate unscrupulous cases and fraud from normal exits. It is important to recognize that greater risk for small firms *should* result in more exits. This is not unhealthy but a normal part of the capital formation and reallocation process in which capital migrates to more productive uses. Thus, in our view, there is no reason to automatically preclude SMEs from IPO listing. Rather, such IPOs should be clearly differentiated and delineated and investors educated about the higher risks and potentially higher returns of such IPOs. Further data and research on the benefits of differentiated listings for SMEs are necessary before we can draw firm conclusions on tiering norms to let SMEs enter the public market more easily.

6. Conclusion

The primary policy objective in IPO markets is to facilitate access to capital at a fair price for firms. Asymmetric information between issuers and potential investors plays a significant role when issuers approach the public capital market for the first time. By offering a set of standardized mechanisms, policy provides a positive externality.

Auction formats and platforms are widely used in a variety of economic transactions to buy goods. However, these auction formats are unpopular in IPO markets across the world. Instead, book building has become the dominant mechanism wherever it is permitted. The key feature that distinguishes book building from other mechanisms is that the former gives significant allocation powers to underwriters. A large body of academic literature notes the benefits of giving allocation powers to underwriters; however, such powers inevitably worry regulators due to the potential for abuse. There is little extant evidence of such abuse in the Indian market. Book-built IPOs are not underpriced more than the other offerings entering the market at the same point of time. On the contrary, they seem to have less underpricing. Allocation powers appear to be used to allocate shares to investors who are most useful in the price discovery process; shareholdings are dispersed by moderating the impact of bidding to build large blocks.

Many of the regulatory steps that were taken to improve the Indian IPO market appear to be reasonable. The steps to curb excessive retail speculation by preventing illegal submissions of multiple bids and by requiring capital set-asides are positive. The anchor investor system appears to be a reasonable step in improving book building, although a fuller evaluation is pending for want of more data. The SME platform is at a nascent stage. Further research and more data are necessary for formal impact evaluations and to pinpoint areas for improvement. Further research is necessary on not only IPO investing but also the other externalities it spawns, such as analyst recommendations, earnings forecasts, and coverage by media.