



MANDATORY IPO GRADING: DOES IT IMPACT ON INVESTORS PERCEPTION

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ABSTRACT

The paper examines the market impact of a unique IPO certification recently introduced in India mandatory grading of IPOs by a credit rating agency. The grading was expected to improve the IPO pricing efficiency by providing comprehensive issue-related information to the market, specially to the retail investors. The results indicate that grading has only a limited influence on the IPO demand of retail and institutional investors. The low grade issues appear to have weaker demand from investors relative to the ungraded IPOs. But there is no evidence to support IPO pricing improvement due to the introduction of IPO grading. What were the forces which compelled SEBI to make it voluntary option within 7 years of making it mandatory? During this period, around 300 public issues were graded by different rating agencies, but some of them failed to deliver expected output. SEBI's Chairman U.K. Sinha accepted the fact that the IPO Grading System has not served the purpose. Many of the IPOs were traded at a very low price than there issue prices even after having higher grading, though IPO grading was not mandatory for SMEs (Small & Medium Enterprises).

The study will also focus on the process of IPO Grading on its return and sectoral analysis to find which sector is more sensitive about the IPO grading than others. The paper also tries to establish a relationship between the issue size of IPO with the grade assigned to that. The duration of the study will be from 2007 to 2014. Using sampling method, representative IPOs will be selected with all kind of grading to examine the economic performance of the issue from the investor's prospective as well as from issuer point of view the research will also bring out process inefficiency and analyze logical reasons of failure of the current system of IPO grading.

KEYWORDS: IPO Grading, Price Efficiency, Return on IPO, IPO Issue Size.

INTRODUCTION

The Initial Public Offering (IPO) is a financial instrument, which is widely used to raise funds for the company. It is also used as exit mode for promoters (if required). Apart from above, an IPO also gives an opportunity to suitable investors to invest money in respective company. Prior to making any investment every investor tries to extract more and more information about the company, which may affect return of the equity share. Returns constitute of mainly two components here i.e. Dividend and Capital Gain. In case of equity shares, capital gain contributes significantly. Therefore, every company which is going to bring IPO in the market needs to bring a published document called Red Hearing Prospectus. This document consists of all the details about the Issuer company, Purpose of IPO, Price of IPO, Price Mechanism, Issue and Allotment process, Size and Minimum lot size, Tick size, Name of Banker, Book Running Lead Manager (BRLM), Registrar, in principle consent of stock exchange in which that IPO is going to be listed and IPO grading done by recognized rating agencies. This rating is conducted considering fundamental of the company, divided in 5 point grade scale. 5 for strongest and 1 for weakest, indicating various levels of soundness or financial strength of the Issue. Therefore, a higher rating share creates more

demand among the shareholders than the low rated issue. This ultimately, fetches higher premium on the issue. Higher premium issues have psychological impact who mainly thinks that High Premium Issues will give Higher Rate of Return and this greed provoked them to purchase and hold higher premium issues. But, after certain period of time, if the company's fundamentals are poor, then it can't bring handsome return on equity which disappoint majority of the Retail Investors and due to this the investors try to sell their shares any price which increases the supply than demand, which lowers the market price of the share drastically and also creates bad name of the company due to volatility in its stock prices. It also demands the objectivity of IPO grading and assurance about its consistent good returns for the shareholders. In May 2007, SEBI made it mandatory for issuers to have their IPO Grading by at least one recognized rating agencies. This grading of IPO requires lot of analysis about the company's fundamentals and its future prospects to make it understandable to a common investor in the form of High and Low Grading. But, in many of the cases it was found that higher grading does not mean higher return to the investor.

Types of IPO grading

Any grading agency has following 5 point scale used for grading an IPO.

Grading Scales	Evaluation
5	Strong Fundamentals
4	Above Average Fundamentals
3	Average Fundamentals
2	Below Average Fundamentals
1	Poor Fundamentals

Rules and Regulation for IPO grading

Grading Agencies use following parameters evaluation.

- Business Fundamental and Prospects
- Financial Position
- Management Quality
- Corporate Governance Practice
- Project Risk
- Compliance and Litigation History

In the above context, it is an urgent need to examine the situation in Indian Equity Market and find out the impact of IPO Grading on its return.

Objective of the Study:

The present study intends to –

- Examine and compare the process of IPO grading by various Credit Rating Agencies (CRAs).
- Find out the relationship between the grading and IPO Issue
- Analyze relationship of grading point and IPO returns

REVIEW OF LITERATURE

- Banerjee, Hansen and Hrnjic, 2012, finds that by taking large ownership stake prominent institutions into young firm value as such investment is perceived as an endorsement of firm quality and has a positive impact on future performance. During the IPO Book-building process, under writers allocate under price shares to secure commitments from institutional investors to hold most of the shares, allocations for a long term. The research examines issuing firm's affiliation with under writers and institutional investors and their impact on the prestige on the IPO Pricing Process. Security Data Company (SDC) keeps Worldwide New Issues Database. Under writer reputation has a significantly positive impact on holding, for every holding period. Institutional investors take stakes in the IPO and provide long term monitoring of the firm.
- Firth, Li and Wang, 2008, explore IPO Valuations in an emerging market. They examined the value relevance of price earning multiple disclosed by managers in IPO Prospects in China based on sample of IPOs issued during 1992-2002. The study found the price earning

multiples disclosed by IPO Firms, which provides significance power in explaining price formation in the capital market. The study found out the impact of price earnings multiples disclosed in IPO by cross checking it through Post-IPO Returns. They also examine the rising errors with econometrics model of regression based on the price earnings ratio after 7 days, 28 days, 1 year and 2 years after IPO listing. The standard deviation of earnings over 5 year period is also calculated to measure firm specific risk. The study used co-relation matrix to find out the relationship among the PE Ratio (Profit Earning Ratio) for different periods. The sensitivity analysis examined the key results about the valuation relevance of price earnings multiples. The study supports that disclosure of price earnings multiples is informative IPO Quality in China.

- Meoli, Paleari and Vismara, 2008, find out that value of IPO is driven by firm and offer specific variables such as age, size, under-pricing and ownership structure affect the IPO Valuation. Investor's expectation on returns on IPO is also influenced by the ownership structure of the company. Ordinary Least Square (OLS) Method is used to regress market to book value for selected companies with reference to IPO operations between 1995-2006 in UK, Italy, and Germany and in the Euronext Countries. The study finds the evidence that the market valuation is supported by under pricing and participation ratio while firm age, firm size, etc have negative impact on market value.
- Mahajan and Anand, 2008, Studies the IPO Grading which is made mandatory by SEBI for investor production easy availability of market driven information in the most transparent way is main property of efficient capital market. It also examines the quality of assessment of Issuer Company by Credit Rating Agencies (CRAs). The paper also questions that should CRAs grade the IPO? CRAs are generally involved in debt instrument rating with various factors which are significantly different from factors to be assessed for equity market, because IPO grading involves study of future of the firms, its future capital and growth. Subjectivity of the assessment and the lack of uniformity in the rating system are also very controversial issues which are not properly addressed by SEBI. Investor also takes IPO Rating as a recommendation. If IPO Grading does not match with its future returns, it also questions the quality of IPO Grading done by CRAs.
- Crouzet, Ginglinger and Vijayraghavan, 2002, Studies the IPO Pricing in France when a seasoned offering follows the IPO. By getting the signals from the market, the company can plan subsequent issues of other instruments like convertible bonds. The market feedback hypothesis explains that market participants are better informed than managers are, and there aggregate demand will reveal their information to the firm. The results of the study shows that average initial returns is higher for those companies who issue other securities for other instruments followed by the IPO within four year period

of the IPO. So, the management uses that market feedback to get correction in the pricing of the subsequent securities. It also reveals the fact that the fixed price method of IPO is now out-dated and the book-building process is dominating. The immediate market feedback, measured by underpricing, seems to help to predict the type of subsequent security offering, but not the financing itself. The initial underpricing is calculated as the difference between the first market clearing price and the IPO offer price, as a percentage of the offer price. Logit Model is used to find the probability of subsequent security offering.

- Khurshed, Paleari, Pande & Vismara, examine the effect of IPO grading on its pricing. Study tries to find the answer of whether the IPO grading adding value issuer, investor and regulator or not. Information asymmetry also demands this grading of equity. The Credit Rating Agency (certifying agency) must have its reputation at stake. The role of credit rating agency also been questioned several time due to their unfair valuation of few companies who failed to perform in the market. After 1st May 2007, every IPO need be graded by any recognized rating agency on 5 point scale, where 1 represent poor fundamental and 5 represent strong fundamental. The rating agencies focused that investment decision should be based on, analysis of fundamental, analysis of returns and investors preference. IPO grading neglects third one i.e. investors preference. IPO grading is not able to reduce the risk of ex ante returns. The study finds that retail investors get regulatory transparency in the books of accounts to get more relevant information than grading.
- Krishnamurti, Thong & Vishwanath discuss the effects of third party certification in Indian Capital market. Grading is no significant impact on under pricing. Study supports the role of credit rating agency in providing useful information about the issuer company to the retail and institutional investors. In Indian Capital market, the investors are less protected than the financial markets of west. The composition of market participants is different, than the west like in India retail investors are more financially illiterate and most importantly the many of issues are oversubscribed so the lead manager is required to do pro rata allotment. Therefore, in Indian Capital Market, the certification of IPO form third party is a controversial issue. In the favor of this, it enhances the level of useful information about the issue and discourages poor fundamental issues, but against this, cost and time unnecessarily delay the process and make it burdensome for the small firms.
- Jain & Sharma, argument that inferior investment decision may occur due to limited information processing capability of a common investor and overloaded information provided by the issuer. The grading has pros and cons like though it discourages the low quality issues, and aiming at investors protection but at the same it also creates problems for SMEs due to high cost of grading charged by CRAs and some time the credibility of CRAs

also questioned due to their unfair valuation of the company or instruments. In Indian Capital market, huge amount of capital raised through IPO route, therefore, it is must to ensure that money invested by small investors, who are not so aware about the financial market, should not go in unworthy investments. In India, many shareholders hold the shares of those companies even they have been de-listed from the stock exchange. While making complex decision people adopt simplified strategies. It is also argued that concept of rating traditionally accepted, should not be imported to IPOs (equity shares). Lack of uniformity in rating methodology, high subjectivity of parameters involved gross ignorance certain industry specific factors etc. give the place of criticism of IPO grading.

RESEARCH METHODOLOGY

The present research is based on secondary data collected from website of National Stock Exchange (NSE) during May 2007 to December 2015. The reports of SEBI and other Credit Rating Agencies will also taken into account achieve research objectives. Correlation will be find out between IPO grading and Issue size of IPO, Issue price of IPO and Post Issue price between various sectors, Grading & IPO returns.

H0: IPO Grading does not help the corporate houses to take decision regarding the issue size in IPO

Data Analysis

Due to Lack of Uniformity in Data available on Bombay Stock Exchange and National Stock Exchange, it is almost impossible to include all the IPOs which are issued during May,2007 to December, 2015. There are other sources of data privately published by not so known organizations which do not seem to be reliable. Therefore, the data of IPO has been extracted from National Stock Exchange only. This is somehow a compromise with the completeness of data. Another issue is that at National Stock Exchange, there are many IPOs for which IPO Grade Points are missing which has to be excluded for the study and at the same time there are few IPOs which are graded by more than one Rating Agency at different grades. Two different grades will create ambiguity. Therefore, those IPOs have been excluded from the study. Rest one hundred eight IPOs have been taken for analyzing the trend and checking the above null hypotheses. However, the trend analysis shows that grading has a significant impact on average benefit, considering all the fluctuating variables of the stock market as constant. And, there is no impact of firm size, issue size, firm sector, etc on the return of the IPO. In real life, ignoring these variables is not a good idea. However, this trend shows the average benefit is positive only in case of IPOs Graded at Point 4 and Point 5. Whereas, IPO having lesser grades like 1, 2, 3 have significant tendency to bear average loss.

Around 165 companies data is analyzed who has received various gradings along with their IPO issue size. Regression and ANOVA test has been conducted and the following results have obtained.

Regression

Table-1

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.209 ^a	.044	.038	10070.0755670

a. Predictors: (Constant), grade

The table present the results of a simple regression. “*R Square*” (.044) indicates that this model accounts only for almost 4.4% of the total variation in the data

.It represents null hypothesis to be rejected with the statement that grading may determine the issue size.

Table-2 Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-3018.769	2373.815		-1.272	.205
	grade	2171.895	800.325	.209	2.714	.007

a. Dependent Variable: issue_size

The slope and the y-intercept as seen in **Error! Reference source not found.** should be substituted in the following linear equation to predict the IPO Issue size: $Y = aX + b$. In this case, the values of **a**, **b**, **x**, and **y** will be as follows:

a = 2171.895

b = -3018.769

X = Grading of IPO (values of independent variable)

Y = Issue size of IPO (values of dependent variable)

Analysis of Variance

Tests of Between-Subjects Effects

Dependent Variable: issue_size

Source	Sum of Squares	df	Mean Square	F	Sig.
grade	1249556643.286	4	312389160.821	3.119	.017
Error	15823688421.885	158	100149926.721		
Total	17073245065.171	162			

a. R Squared = .073 (Adjusted R Squared = .050)

grade	N	Mean	Std. Deviation
1	15	403.443309	1277.7090145
2	49	1145.041186	3517.8780848
3	58	2315.124326	7848.0775882
4	36	8127.865539	18258.0838769
5	5	1857.160880	2670.7299794
Total	163	3057.207622	10265.9827409

The significance level of “0.017” is less than the threshold value of 0.05 and indicates that the null hypothesis can be rejected, the grading of IPOs may determine the issue size of IPOs.

H0: Post IPO market price will be equal or more to issue price during the first year after issue Out of the 365 IPO issues from April 2007, around seven sectors have been randomly picked up for the study. The mean return of issue price and post IPO price of each sector is analyzed and interpret with the result.

Table-3

Grading Assigned		Price on 16.12.2015 (Rs.)	Issue Price (Rs.)	Return (%)
No Grade	N	25	25	25
	Mean	380.8000	292.1600	35.5922
	Std. Deviation	338.67469	249.86658	49.91896
Grade - 1	N	9	9	9
	Mean	346.7000	245.4444	136.0538
	Std. Deviation	498.37835	235.06016	371.24396
Grade - 2	N	34	34	34
	Mean	186.4356	229.0294	2.8588
	Std. Deviation	219.04373	214.86817	152.19989
Grade - 3	N	51	51	51
	Mean	154.2416	210.3137	-5.1409
	Std. Deviation	248.45897	234.55196	157.24431
Grade - 4	N	38	38	38
	Mean	153.7539	146.9211	-11.4770
	Std. Deviation	253.41817	142.95026	85.62823
Grade - 5	N	8	8	8
	Mean	562.5063	361.8750	164.8482
	Std. Deviation	334.83293	342.26992	291.85210
Total	N	165	165	165
	Mean	225.3826	221.2364	17.1634
	Std. Deviation	299.60294	224.94059	163.87709

Table-4 Correlations

		Grading Assigned	Price on 16.12.2015 (Rs.)	Issue Price (Rs.)	Return (%)
Grading Assigned	Pearson Correlation	1	-.141	-.125	-.046
	Sig. (2-tailed)		.072	.108	.557
	N	165	165	165	165
Price on 16.12.2015 (Rs.)	Pearson Correlation	-.141	1	.531**	.650**
	Sig. (2-tailed)	.072		.000	.000
	N	165	165	165	165
Issue Price (Rs.)	Pearson Correlation	-.125	.531**	1	-.092
	Sig. (2-tailed)	.108	.000		.242
	N	165	165	165	165
Return (%)	Pearson Correlation	-.046	.650**	-.092	1
	Sig. (2-tailed)	.557	.000	.242	
	N	165	165	165	165

** . Correlation is significant at the 0.01 level (2-tailed).

As shown above, the correlation index for the relationship between “return(%)” and “Grading Assigned” is -0.046, which is between- 0.04-0.05. The results from these analyses indicate that there is a high, negative relationship between IPO return (%) and the grade assigned to them.

Limitations:

The present study suffers from following limitations:

- Lack of Uniformity of Data

- Missing value of grade assigned on various IPOs.
- Not availability of data in form of Sector-wise data with grades assigned and benefits.

CONCLUSION

As we all know that the return on equities is not only a function of company’s fundamentals but it contributes significantly in the returns, therefore, the trend shows

the IPO Grading works more as a signaling effect than the proper recommendation. Because grading is based on various assumptions which may not hold good during course of time and may bring some unexpected results. Average value also has a limitation of aggregation. Therefore, it is always advised to have individual assessment of each and every company about the return in the capital market

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