Understanding of Initial Public Offerings in India: A Comparison of the Book-Building and Fixed-Price Methods

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Abstract: Pricing Mechanisms is an important decision before issuing IPOs. It plays a vital role in success and failure of any IPOs in Capital Market in India. This paper examines the popularity of book building over fixed price method, the pricing mechanisms used to issue the IPOs in Indian Capital Market and it is found that the Book building method is preferred over fixed price method. .It is also observed from data that the IPOs which failed in market adopted the Book building method, but no such evidence is found from literature review of different researcher which shows that there is any relationship between failure of IPOs and pricing tool adopted. So it is also a topic of further research to find out the relationship between failure of IPOs and the pricing tools used.

KEY WORDS: Initial Public Offer (IPO), Book Building, Fixed Price Method, Capital market

INTRODUCTION

Indian Capital Market plays a vital part in Indian economy and growth. Slight fluctuations in market affect the economy of country. Capital Market is divided into Primary Market (New Issue market) where IPOs (new shares) are issued by company and Secondary Market where existing shares are traded. The decision to go public is an important phase in life cycle of organization. It provides an exit options for stakeholders.

Initial Public Offering

An initial public offering, or IPO, is the way a firm goes public and sells shares to raise capital. It is one of the investing basics of how a company raises financing. There are two types of IPOs: fixed price method and book building method. A company can use either type separately or combined. By participating in an IPO, an investor can buy shares before they are available to the general public in the stock market.

Initial public offerings are the new issue of securities first time in primary market. It is a process by which unlisted company get listed in capital market. In India the regulatory authority of capital market is SEBI, so before going to public company has to satisfy certain criteria and guidelines as specified by SEBI for company to get listed in BSE and NSE. The company goes public to generate fund for the growth and expansion of company. Once the IPO is listed in primary market and trading start it converted into secondary market.

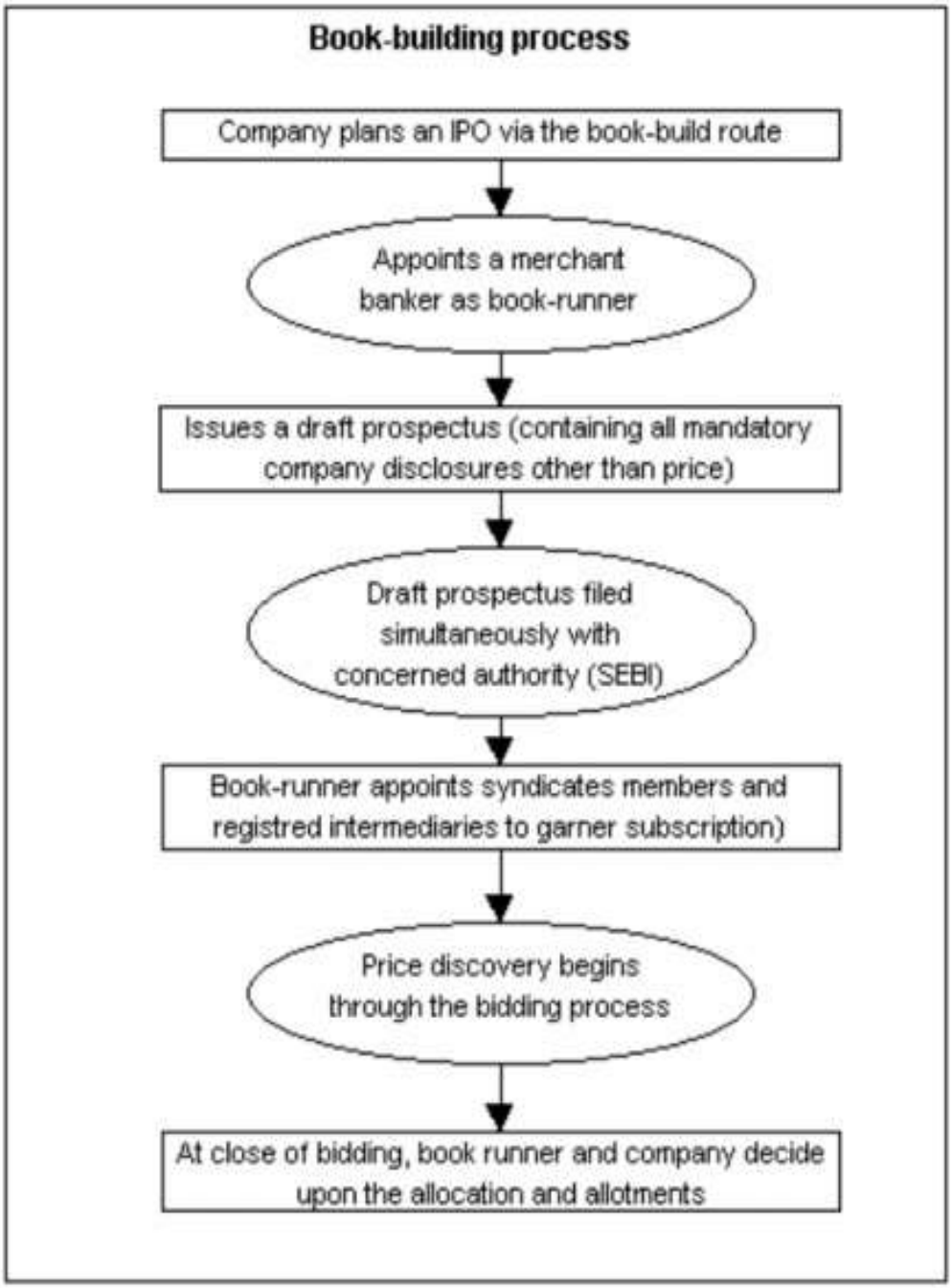
Pricing Methods in IPO

1) Book building or

2) Fixed price method

BOOK BUILDING PROCESS:

Book Building is basically a capital issuance process used in Initial Public Offer (IPO) which aids price and demand discovery. It is a process used for marketing a public offer of equity shares of a company. It is a mechanism where, during the period for which the book for the IPO is open, bids are collected from investors at various prices, which are above or equal to the floor price. The process aims at tapping both wholesale and retail investors. The offer/issue price is then determined after the bid closing date based on certain evaluation criteria.



Fixed Price Method

In fixed price offering, price is determined without formally soliciting the level of investor interest. In fixed price offer the price is set from the data the prospectus is registered. For a book-built IPO, the offer price is not finalized until the demand for the issue has been assessed with the final price typically being set very close to the listing date. Under fixed price, the company going public determines a fixed price at which its shares are offered to investors. The investors know the share price before the company goes public. Demand from the markets is only known once the issue is closed. To partake in this IPO, the investor must pay the full share price when making the application

Features	Fixed Price process	Book Building process
Pricing Method	Price at which the securities are offered/allotted is known in advance to the investor.	Price at which securities will be offered/allotted is not known in advance to the investor. Only an indicative price range is known.
Demand for Securities	Demand for the securities offered is known only after the closure of the issue.	Demand for the securities offered can be known everyday as the book is built.
Mode of	Payment if made at the time of subscription	Payment of money only after allocation

Payment	wherein refund is given after allocation.	

Book building vs fixed price method

The main difference between the book building pricing method and the fixed price method is that the issue price is not decided primarily.

The investors have to bid or quote for the shares within the price range given by the company and based on the demand and supply of the shares, the investors will choose their own price in between the price range given by the company. On the other hand, in the fixed price method, the price is decided right at the start.

Investors or people cannot choose the price, but must buy the shares at the price decided by the company. In the book building method, the demand is known every day during the offer period, but in fixed method, the demand is known only once the issue closes.

Steps involved in book building process

The following are the steps involved in book building process

a) Appointment of book runner.
b) Advertisements.
c) Members bid.
d) Issue of Red herring Prospectus.
e) Issue of Draft Prospectus to institutional buyers.
f) Analysis of bid prices
g) Submission of prospectus of the company to the ROC (Registrar of Companies)
h) Collection of application forms with money. (shares application money)
i) Allotment of securities.(like Shares)

Participants of Book Building IPO

- Institutional Investors Foreign Institutional Investors (FIIs) and MFs (Mutual Funds)
- HNI (High Networth Individuals) These individuals buy IPOs at large quantities.
- Retail Investors, These are the common people whose maximum investment limit is Rs. 25,000.

An IPO have several benefits to the company:

Advantages

- Increasing and diversifying equity capital
- Enabling cheaper (low cost) access to capital structure
- Increasing the organisation exposure, prestige, and public image
- Attracting and retaining better management and employees through liquid equity participation
- Facilitating acquisitions (potentially in return for shares of stock)
- Creating multiple financing opportunities: equity, convertible debt, cheaper bank loans, public bonds etc.

Disadvantages

There are several disadvantages to completing an initial public offering:

- Significant legal aspects, accounting and marketing costs
- Requirement to disclose financial information (like profit and loss a/c, balance sheet etc) and business information
- Meaningful time, effort and attention required of management
- Risk that required funding will not be raised
- Public dissemination of information which may be useful to competitors, suppliers and customers.
- Loss of control and stronger agency problems due to new shareholders
- Increased risk of litigation, including private securities class actions and shareholder derivative actions[

Literature Review

Degeorge, et al. (2007)

In their study finds that the book building has captured most of the market share globally but is the most costly procedure available in terms of direct and indirect initial under-pricing.

Bora et al. (2012)

In their study, covering period from April 2001 to June 2011 which concludes that Book-Building method is preferred to Fixed Price method for efficient pricing determination. But, Fixed Price method is relatively more promising in long term as compared to the issues made through Book-Building process. The study also concludes that most of the companies with smaller issue sizes opted for fixed price mechanism and companies with bigger issue sizes had opted for book building mechanism and that Book Building has encountered less under-pricing when compared with Fixed Price offer.

Kumar (2012)

Finds that book building is more popular than fixed price option and major IPOs follow book building method over fixed price option .It is also observed from data that the IPOs which failed in market adopted the Book building method, but no such evidence is found from literature review of different researcher which shows that there is any relationship between failure of IPOs and pricing tool adopted. So it is also a topic of further research to find out the relationship between failure of IPOs and the pricing tools used.

Khanna (2012)

States, "As far as magnitude of under-pricing is concerned, the book-built and fixed price option gave different results**.** We found significant difference in level of magnitude of Under-pricing in IPOs that priced through book built with those that are priced through the fixed price option."

Rashid (2013)

Has presented general idea of Initial public offering **(**IPO) and mentioned the listing procedure in Bangladesh. He has made an attempt to focus on Book Building method in the security market of Bangladesh and discussed about its problems created by manipulators. He finds that Book building method is apparently a sophisticated and widely used concept but unfortunately, this method is being misused with some motive. It needs adequate efforts by regulatory agencies to customize it for implementation in Bangladesh context.

Jain (2012)

Found that those IPOs that were issued by book building method were also underpriced and was the result of investor's high willingness to pay, high demand of issue, high firm values and high fluctuations in the market returns. They also found that high value firm is more underpriced in India.

Research Objectives

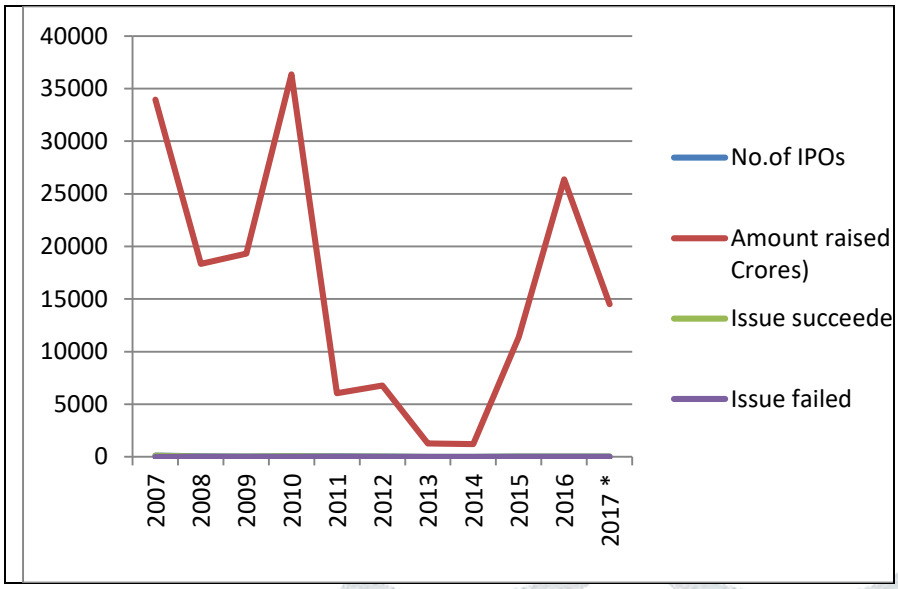
Followings are the objectives of the study:

- To study the preference given by the issuer as efficient pricing mechanism between the two methods, Book Building and Fixed Price
- To study the average issue sizes being offered under both book building pricing method and fixed price method
- To study the impact of book building and fixed price methods on IPO in India

Year Wise List of IPO's - Report of Public Issues in India Stock Market

Year	No.of IPOs	Amount raised (Rs.in Crores)	Issue succeeded	Issue failed
2007	108	33,946.22	104	4
2008	39	18,339.92	36	3
2009	22	19,306.58	21	1
2010	66	36,362.18	64	2
2011	40	6,043.57	37	3
2012	13	6,770.17	11	2
2013	5	1,283.95	3	2
2014	7	1,200.94	5	2
2015	21	11,362.30	21	0
2016	27	26,372.48	26	1
2017 *	10	14,521.60	10	0

*partial year data.



Conclusion:

Every business organisation needs to raise funds for its business activities. It can raise funds either externally or through internal sources. When the companies want to go for the external sources, they use various means for the same. Two of the most popular means to raise money are Initial Public Offer (IPO) and Follow on Public Offer (FPO). During the IPO or FPO, the company offers its shares to the public either at fixed price or offers a price range (book building) , so that the investors can decide on the right price with their own choice. It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices, which are within the price band specified by the issuer. The process is directed towards both the institutional investors as well as the retail investors.

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