

PSU FPO bidding

In the eye of the storm

By opting for Dutch auction to sell the NMDC FPO, the government acknowledged that French auction had not worked. But the real issue is pricing

An auction is a process of calling bids from prospective buyers with the objective of arriving at a price of a commodity that has been offered for sale. In the securities market, there are two kinds of auctions: Dutch and French. These methods are used to determine the price of the shares that have been offered for subscription through a public issue.

In India, primary issues of equity shares take place through book building or the Dutch auction method, which is also known as uniform price auction method. In this method, companies fix a price band. The difference between the floor price and the ceiling price in the band cannot exceed 20%. For example, the IPO of National Hydro Power Corporation (NHPC) had a price band of Rs 30 to Rs 36. An investor can submit bids within the specified price band only. On the basis of the demand at various price points, the issue price or cut-off price is determined. This is uniformly applicable for all investors who have submitted their bids at or above the cut-off



price. Hence, everyone pays the same price irrespective of their actual bid price. In case of NHPC, all the shares offered through the public issue could be sold at the upper end of the price band. Hence, Rs 36 was fixed as the cut-off price. Investors who had submitted their bids between Rs 30 to

Rs 35 were not allotted any shares.

The Securities and Exchange Board of India (Sebi) recently amended the Sebi (Issue of Capital & Disclosure Requirements) Regulations, 2009, through a notification issued on 11 December 2009, allowing companies to adopt the French auction method (also known as multiple-price auction method) for follow-on public offers (FPOs). So far companies cannot use this method for initial public offers (IPOs). This method operates on the principle that the highest bidder wins. The companies that come out with public issues involving the French auction method fix only the floor price or the reserve price and there is no ceiling price or upper limit for bidding. Qualified institutional buyers (QIBs) submit their bids above the floor price, specifying the quantity and the price at which they wish to purchase the desired quantity of shares.

Allocation of shares is done on the basis of top-down approach, with the maximum allocation to the highest bidder. However, the issuer can put a cap on allotting shares to a single bidder to prevent concentration of shareholding with a few institutional investors because this may lead to reduction in liquidity and also volatility in share prices post offer. The French auction method is meant only for institutional investors and retail investors can bid at the floor price.

The government recently used the French auction method for disinvestment of shares of public sector undertakings (PSUs) NTPC and REC in February 2010. The rationale behind the adoption of this method for sale of PSU shares was that competition among institutional investors for the shares put on the block may lead to better price discovery and, thus, enable the government to raise larger sums from disinvestment, which can reduce the fiscal deficit.

What are the advantages of the French auction method? In Dutch auction, investors have no choice, except to bid within the specified price band, where the maximum bid price cannot be more than 20% of the floor price. This may not always be indicative of

Changing norms

There was no incentive for institutional investors to subscribe to recent PSU FPOs because they could have very well purchased the shares from the market at a lower price

The floor price for the NTPC issue, which closed on 5 February 2010, was set at Rs 201 per share, whereas the share price was hovering between Rs 205 and Rs 208. As the response to the issue was not encouraging, SBI and LIC placed bids for a large portion of the issue at Rs 209 per share on the very first day to bail out the issue.

Accordingly, there was no incentive for other institutional investors as well as FIIs to bid at Rs 210 or price higher than that to obtain allotment because they could have very well purchased the shares from the market at a lower price.

Moreover, there was no option available to SBI and LIC to revise their bids downwards because French auction norms, applicable to the NTPC issue, do

not permit downward revision of bids. Perhaps the Department of Disinvestment (DoD) and the merchant bankers to the issue had never thought that such a peculiar situation could emerge. Hence, the DoD requested Sebi to change the auction norms for the FPO of Rural Electrification Corporation (REC), which opened for subscription on 19 February 2010, so as to allow institutional investors to revise their bids downwards.

REC set the clearing price of Rs 206 per share. Institutional investors who had bid below Rs 206 were not eligible for allotment of shares. Non-institutional and retail individual investors were allotted shares at the floor price of Rs 203 per share.

the fair value of the share as per the perspective of institutional investors. In French auction, the bidders have the freedom to bid at any price (above the floor price) that they estimate is the fair price for the share. Hence, this method gives better say to QIBs in the price discovery process.

- The French auction method indicates genuine demand for the public issue because in Dutch auction, institutional investors have the tendency to apply for 5-10 times the quantity that they actually intend to purchase because they expect that the issue would be oversubscribed to that extent. However, in the French auction method, investors bid only for the actual quantity they intend to purchase because if their bid is successful, they would be allotted the entire quantity of shares applied for instead of allotment on a proportionate basis at a uniform price applicable in Dutch auction.
- Retail investors get the shares at the floor price, which is obviously at a discount to the bids placed by institutional investors. Thus, this method does not discourage participation by retail investors.

Every coin has two sides. The new French auction method offers several advantages over the conventional book building method (Dutch auction). At the same time, it is not free from disadvantages. Some of the disadvantages of French auction are:

- Aggressive bidding by few short-term investors like hedge funds can deny a level-playing field to the usually conservative long-term investors as hedge funds would corner a large quantity of shares due to bids placed at higher prices.
- This method facilitates better price discovery only when the market sentiment is

Bidding strategy

How Dutch and French auctions work

The Dutch auction method in a public offering works like this: Investors put in their bids for the quantum of shares and the price they are willing to pay for them. The issuer then assigns the bids starting from the highest price working downwards until all the shares are assigned. The last or the lowest price at which all the shares on offer are assigned is announced as the issue price or the cut-off price. All the investors who have bid at or above the cut-off price are

strong because in such a situation institutional investors do tend to put in bids at higher levels to get a larger chunk of shares. However, when the market sentiment is weak no one likes to risk the investment.

- If the fund manager bids aggressively, there is not much risk in Dutch auction because the allotment takes place at the cut-off price. But in French auction, the allotment takes place at the bid price. Therefore, even a small miscalculation on the part of the fund manager can land the institution into trouble. It will be saddled with huge quantity of higher-priced shares, which cannot be sold in the stock market at the issue price.

French auction seems to be more suitable for IPOs. But the irony is that Sebi regulations do not permit the use of French auction method for price discovery in IPOs. With the passage of time, this would be permitted. Sebi's move would be beneficial

allotted shares at the cut-off price, irrespective of their actual bid price.

Under the French auction method, the issuing company sets a floor price above which institutional investors have to place their bids. The allotment is made on a price-priority basis. The primary difference being that, under the French auction method, the shares are issued to institutional investors at the prices they have indicated and not at the cut-off price as is the case in the Dutch auction method.

for retail investors as they would be allotted shares at the floor price. Hence, they can expect reasonable gains on listing of shares. It would be beneficial for companies, too, because although shares reserved for retail investors would be allotted at the floor price, shares allotted to institutional investors at higher prices would make good such loss.

Most analysts blame French auction for the lukewarm response to the NTPC issue. But it is not so. The main reason for the lack of investors' interest was that the government had not left anything on the table for investors as the difference between the floor price and the market price was not even 5%.

In the NMDC FPO that closed on 12 March 2010, the government altogether dumped the French auction in favour of Dutch auction. Thus, in a way the government has also acknowledged that French auction has not worked as per expectation. However, the real reason for the dismal performance of the issues of both NTPC and REC was aggressive pricing of these issues. In other words, it cannot be concluded that French auction is completely useless. It basically implies that appropriate method has to be chosen keeping in mind market conditions. Moreover, there should be sufficient gap between the market price and the floor price. Only then will institutional investors come forward and bid enthusiastically. The French method is likely to yield results only if the pre-requisites for its success are fulfilled. Perhaps merchant bankers would be more inclined towards using the tried and time-tested Dutch auction in the forthcoming issues of PSUs.

— *Rajesh Relan*

When French auction can succeed

Robust demand and confidentiality essential for success

There should exist a robust demand for the company's share to compel the institutional investors to come forward and bid aggressively. This is possible in IPOs or for listed shares with low free float.

There should not be a reference market quotation available, which again is possible for FPOs. If a stock market quotation is already available, then no qualified institutional bidder would like to bid at a price substantially higher than

the prevailing market price.

Bids must remain confidential so that fund managers place their bids based on their own independent judgment. In the NTPC FPO, the bid price as well as the shares applied for institutional investors could be seen. As such, there was no competition. Non-confidentiality of bids encourages initial bidding at lower prices and later on upward revision of bids, depending on the response to the issue by the other institutional investors.