

Disclosure & Investor Protection Guidelines

Issue of Shares through Book-building : An overview

In this article, the author has taken up the subject of issue of shares through the mechanism of book-building, for analysis and discussion. The author has elucidated the process of issue of such shares, its merits and demerits, and its suitability for the Indian stock market. According to the author, the book-building process is certainly beneficial to the corporates, but is against the interests of the retail investors in view of certain disadvantages. The author concludes by stating that the protection of investors' interest should be given utmost importance if the interests of the retail investors in the market are to be revived, and that the SEBI should leave no stone unturned to achieve this objective - EDITOR

Introduction

1. Book-building process for issue of securities was one of the recommendations made by Malegam Committee in the year 1995. The SEBI accepted the recommendations and, thus, a new chapter began in the Indian stock market as far as primary market offerings are concerned. Although in advanced countries like USA and UK, Initial Public Offerings (IPOs) are being made through book-building route since a long time, the Indian investors have not become fully conversant with the system till date. Under the SEBI (Disclosure and Investor Protection) Guidelines, 2000, 'Book-building' has been defined as follows:—

“Book-building’ means a process undertaken by which a demand for the securities proposed to be issued by a body corporate is elicited and built-up and the price for such securities is assessed for the determination of the quantum of such securities to be issued by means of a notice, circular, advertisement, document or information memoranda or offer document.”

Thus, the basic difference between a normal public issue of shares and issue of shares through book-building route is that in the former case, the issuer company itself fixes the issue price in consultation with the lead merchant banker whereas in the latter case, only a price band is fixed. In case of book-building, the investors are encouraged to bid for the company's shares within the indicated price band and the most accepted price is fixed as the issue price. Chapter XI of the SEBI (Disclosure and Investor Protection) Guidelines, 2000, contains the procedure to be

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followed by a company for public issue of shares through book-building. This article is an attempt to elucidate the process of issue of shares through book building route, its merits and demerits and suitability for the Indian stock market.

Book-building : Whether mandatory

2. Most of the investors have a misconception that the SEBI has made book-building mandatory for all IPOs. However, this is not true since book-building is a must for only some specified categories of issues and the other companies are free to offer their shares to the public without opting for the book-building route. An unlisted company offering shares (or any other security convertible into equity shares) to the public is not bound to opt for the book-building route if it meets the following criteria :—

- ◆ It has a pre-issue net worth of at least Rs. 1 crore in three out of the five preceding financial years, with a minimum net worth to be met during the immediately preceding two financial years.
- ◆ It has a track record of distributable profits, in terms of section 205 of the Companies Act, 1956 for at least three out of five preceding financial years.
- ◆ The issue size (*i.e.*, offer through offer document + firm allotment + promoters' contribution through the offer document) does not exceed five times its pre-issue networth as per the last audited accounts.

From the above submissions it is quite clear that if an unlisted company fails to fulfil any one of the aforesaid conditions, it will have no option but to opt for book-building route. A listed company can issue equity shares (or any other security convertible into equity shares) without opting for the book-building route if the issue size (*i.e.*, offer through offer document + firm allotment + promoters' contribution through the offer document) does not exceed five times its pre-issue net worth as per the last audited accounts. A listed company that is unable to comply with the aforesaid condition can issue shares only through book-building process.

A company (whether listed or unlisted) fulfilling all the aforesaid conditions, can still opt for the book-building process if it so desires. In case of book-building a major part of the issue is allotted to Qualified Institutional Buyers (QIBs) which include the following:—

- ◆ Public Financial Institutions as defined under section 4 of the Companies Act, 1956.
- ◆ Scheduled Commercial Banks.
- ◆ Mutual Funds.
- ◆ Foreign Institutional Investors registered with the SEBI.
- ◆ Multilateral and bilateral development financial institutions.
- ◆ Venture Capital Funds registered with the SEBI.

Book-Building process

3. For the purpose of issue of shares/securities through book-building process a company can opt for any one of the two kinds of book-building routes presently available that are : (i) 75 per cent book-building, and (ii) 100 per cent book-building.

3.1 75 per cent Book-building - Under this option a company has to offer at least 25 per cent of its issue to the public through the issue of prospectus. This portion of the issue is separately identified, as 'net offer to the public'. The balance 75 per cent of the issue is offered through book-building and is separately identified as, 'placement portion category' in the prospectus.

3.2 100 per cent Book-building - Earlier, the option of 100 per cent book-building was available only to the companies whose issue size was more than Rs. 25 crores. However, now the SEBI has relaxed this requirement and now any company can opt for 100 per cent book-building route. The term, '100 per cent book-building' does not mean that only the institutional investors can participate in such an issue and the retail investors are totally devoid of the opportunity to apply for the equity shares of the company. This is because an issuer company is compulsorily required to offer an additional 10 per cent of the issue size to the individual investors through the prospectus. Moreover, out of the book built portion also, at least 15 per cent of the issue size is to be reserved for allotment to the individual investors applying up to ten tradable lots through the syndicate members.

3.3 Information Memorandum and Redherring Prospectus - Companies (Amendment) Act, 2000 which came into force with effect from December 13, 2000 has inserted a new section 60B in the Companies Act, 1956 ('the Act') that allows companies to invite subscription to shares by issuing an information memorandum. Section 2(19B) of the Act defines an 'information memorandum' as a process undertaken prior to the filing of a prospectus by which demand for the securities proposed to be issued by a company is elicited, and the price and the terms of issue for such securities is assessed. It can be issued as a notice, circular, advertisement or document. An 'information memorandum' cannot be deemed to be a prospectus, because prospectus has been separately defined under section 2(36) of the Act. Thus, conceptually 'book-building' is synonymous with 'information memorandum'.

The companies opting for book-building route have to file a 'Redherring prospectus' with the SEBI at least three days prior to the opening of the offer. 'Redherring prospectus' means a prospectus that does not have complete particulars of the price of the security offered and its quantum of issue but contains all the other features of a prospectus, prescribed under Schedule II to the Companies Act. The 'Information Memorandum' and 'Redherring Prospectus' carry the same obligations as are applicable for a Prospectus. The company is required to highlight the variations, if any, between the 'Information Memorandum' and the 'Redherring Pros-

pectus' and intimate the same to all the persons who were invited to subscribe to the offer. The applicant or proposed subscriber has a right to withdraw the application within seven days from the date of the intimation.

3.4 Bidding procedure - The 'Information Memorandum' indicates the floor price at which the bids can be made. Each investor is free to place a bid at or above the floor price. It also contains the names and addresses of the syndicate members and the bidding terminals for accepting the bids and also the method and process of bidding. At least 5 days' time has to be given for bidding. All investors other than QIBs are required to make payment along with the application. The amount is held in an escrow account. The company nominates one of the lead merchant bankers to the issue as book runner. The book runner is responsible for maintaining the record of the orders received. At the end of each day the demand for share is shown graphically on the terminals for the information of syndicate members and investors.

3.5 Pricing of issue - On the close of bidding all bids received are ranked in descending order of the price and allotments are progressively made till the issue size is matched. The book runner and the company determine the price at which the securities are to be offered to the public for subscription. This price is known as the 'Issue Price'. If an investor had bid for shares above the issue price, then the difference between the issue price and bid price is refunded to him. The issue price for the 'placement portion' and the 'net offer to the public' portion are the same. On determination of the issue price, the number of shares to be offered is calculated (issue size divided by the price per share) and within two days thereafter the prospectus is filed with the Registrar of Companies.

3.6 Public Offer - The issuer company gets the application forms collected from the general public through the mandatory collection centers, just like a normal public issue of shares. The investors who had not participated in the bidding process or have not received the intimation of entitlement of securities can also make an application in the public offer.

3.7 Undersubscription/Oversubscription :

- ◆ **75 per cent Book-building** - In case of undersubscription in the 'placement portion' the spill over from the 'net offer to the public' portion is permitted to be carried over to the 'placement portion' and *vice versa*. In case of oversubscription the allotment is made on proportionate basis. It is worth noting that underwriting is mandatory only to the extent of net offer to the public and not for the placement portion.
- ◆ **100 per cent Book-building** - In case of undersubscription in any of the portions the company has the option to allocate it to the other category as it may deem fit and it can also allow the unsubscribed portion to lapse. In case of oversubscription in the 10 per cent issue offered to the public through prospectus the allotment is made on a proportionate basis.

3.8 Filing of Prospectus - After the offer closes, a Prospectus containing the details of the total capital raised as well as the issue price and any other details that were not complete in the Redherring Prospectus is filed with the SEBI.

3.9 Allotment of Shares - Allotment of shares has to be made, as per the basis of allotment finalised with the Regional Stock Exchange, within 15 days of the closure of the issue failing which interest at the rate of 15 per cent has to be paid. The issuer company is required to compulsorily allot 60 per cent of the issue to QIB's failing which the entire subscription money has to be refunded. Where the individual and other investors do not subscribe to the balance 40 per cent issue, the underwriters have to take the same.

Book-building : A boon or bane

4. The benefit of book-building mechanism is that it helps in the process of price discovery. In other words, the issuer company gets the flexibility of testing the market and adjusting the offer price suitably, after analysing the market response received in the bidding process. This was not possible before the introduction of book building since the shares had to be issued to the public at a fixed price. However, a closer look at the whole process makes it quite clear that the book-building process is beneficial to corporates as it helps them in extracting the maximum possible price for their share. Similarly, it is also beneficial to the large institutional investors who get a large portion of the issue and can earn decent return on their investment by off-loading the shares in the stock market at a later date. Book-building is certainly against the interests of retail investors who are keen to participate in good primary market offerings since they consider such offers to be more safe as compared to secondary market transactions. Some of the disadvantages of book-building mechanism are discussed below :—

- ◆ As the Qualified Institutional Buyers are very limited, a substantial part of the issue, *i.e.*, minimum 60 per cent of the issue gets concentrated in a few hands. Therefore, there is lack of floating stock in the market and, hence, only a handful of market players can easily manipulate the price and when the scrip reaches its peak, they can offload these shares to unwary investors who get caught in the web. Moreover, in the quota reserved for QIBs, the lead manager is free to allocate the shares among them on a discretionary basis, hence, the chances of bias can't be ruled out.
- ◆ The excessive reservation for QIBs in the new issues offered through book-building will further diminish the interest of retail investors in the primary market that is already passing through a tough phase.
- ◆ Although under '100 per cent book-building' route, 15 per cent of the issue under 'placement portion' is reserved for individual investors applying up to ten tradable lots, still it does not serve any purpose. This is because the retail investors neither have the access to the book runners, who procure applications, nor they possess the requisite expertise to participate in the bidding process.

- ◆ The QIBs can bid for shares only above a certain price known as the 'floor price'. In almost all the issues that have been made in India so far through the book-building route, it has been observed that the issue price fixed after the bidding process is same as the floor price. Hence, the whole exercise of book-building in case of most of the issues proves to be superfluous.
- ◆ The basic objective of book-building process is to provide an effective mechanism for price discovery so that the process is beneficial both to the company and the investors. However, in India this objective has not at all been achieved. This is amply clear from the fact that today almost all the shares that were issued through book-building are rolling much below the issue price. As a result of all this the investors have once again burnt their fingers even in the primary market offerings, leave apart the secondary market scams that wipe out thousands of crore of market capitalisation in a single stroke.

Conclusion

5. In view of the aforesaid reasons, it is necessary that the SEBI takes some concrete steps to remedy the situation. The tendency of companies to charge excessive premium through book-building route needs to be curbed by framing strict regulations. Mere publication of information and disclosure of risk factors in the offer document will not serve any purpose. Rather, the companies coming out with premium issues should be required to indicate the premium amount admissible as per the time-tested valuation guidelines prescribed under the erstwhile Capital Issues (Control) Act, 1947. The premium amount that would be admissible as per the discounted cash flow method, a concept that is now quite popular, may also be given in addition to the CCI price.

If the offer price fixed through the book-building route is higher than the price calculated as per the aforesaid formulae, then it should be mandatory for companies to provide the facility of 'safety net' to the retail investors who are allotted shares up to a certain limit. The 'safety net' should be available to original allottees (retail investors only) for at least six months from the date of listing/commencement of trading of shares on the stock exchanges, if the market price of share falls below the issue price. If the offer through book-building is accompanied by safety-net, then it will provide the following benefits :—

- ◆ Firstly, the investors can participate in the issue without any fear of losing their hard-earned money, which will give a big boost to the capital market.
- ◆ Secondly, as the companies will know before hand that the issue can sail through only after the necessary arrangements are made for 'safety net' facility, they will be more realistic in deciding the floor price for the issue.

Thus, we can conclude by saying that protection of investors' interest should be given utmost importance if the interest of retail investors in the stock market is to be revived and the SEBI should leave no stone unturned to achieve this objective.