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IPO grading has few takers

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A file photo of the Sebi headquarters. Photo: Abhijit Bhatlekar

Mumbai: The grading of initial public offers (IPOs), meant to help retail investors make informed investment decisions, has found few takers as markets regulator Securities and Exchange Board of India (Sebi) made it voluntary in February 2014.

None of the seven IPOs that hit the markets this year—**Ortel Communications Ltd**, **Adlabs Entertainment Ltd**, **Inox Wind Ltd**, **VRL Logistics Ltd**, **UFO Moviez India Ltd**, **MEP Infrastructure Developers Ltd** and **PNC Infratech Ltd**—got their issues graded by rating agencies.

In fact, only three IPOs have been graded since it was made voluntary. These include **Snowman Logistics Ltd**, **Wonderla Holidays Ltd** and **NCML Industries Ltd**.

IPO grading, which grades the fundamental strength of an issuer company on a scale of 1 to 5, with 5 being the highest, was introduced as a tool to help retail investors make an informed decision while investing. In grading an IPO, rating agencies look at industry outlook, the firm's strategy and positioning within its industry, financials, management quality and corporate governance.

The tool seems to have lost its relevance as neither companies nor investment banks are keen on getting IPOs graded. "After it was made voluntary, there is a fall in the number of IPO gradings," said **Prasad Koparkar**, senior director, Crisil Research.

IPO grading was introduced in April 2006 by Sebi on an optional basis and made mandatory for new share sales in April 2007. The argument against IPO grading was that post-listing, stock performance and IPO grade showed no correlation.

In a review meeting on 30 October 2013, Sebi, taking note of several reports on IPO grading, noted, "Issues with grade 4 yielded high losses compared to other low grades. Retail investors, for whom IPO grading was introduced, subscribed fully or overwhelmingly subscribed to their portion in as many as 73 out of 86 (85%) 'lower grade' IPOs (those with grades 1 or 2)." Sebi concluded that the reports showed that retail and institutional investors were not taking cues from grades.

"Qualified institutional buyers have fully subscribed to their portion in many 'lower grade' IPOs. This indicates that grading has been not a factor in investors' decision-making process," Sebi said.

Out of 109 IPOs that got a rating from 3 to 5, 78 stocks gave negative returns at the end of one year from their listing. Similarly, 60 out of 74 IPOs graded 1 and 2 gave negative returns, one year from listing, according to data from Capitaline, a corporate information database.

"Grades were meant for retail investors and if a company is given a rating of 4 or 5, then retail investors think it is a good investment and end up buying that stock," said **Prithvi Haldea**, chairman of Prime Database, a primary market tracker. "There was no correlation in terms of returns and grading and hence the idea was dropped."

"The investment decision is significantly contingent on the pricing of the issue, which IPO grading did not factor in," said an investment banker who declined to be named. Rating agencies looked at processes, people and business strategies, parameters on which most large issuers and those with private equity investors scored well and thus ended up getting higher grades, he added.

However, rating agencies say it is wrong to correlate grades with stock performance. "IPO grading is an assessment and an opinion on the fundamentals of the company and not the pricing. If a stock is overpriced at the time of issue, it may not give adequate returns to an investor even if the fundamentals are good as reflected in the IPO grading," said Crisil's Koparkar.

Other experts said grading could help investors. “For lay investors, it is difficult to go through a red herring prospectus of 500-600 pages to make a decision on whether the IPO is a good investment or not. A grading gives the investor an idea on the quality of the IPO,” said D.R. Dogra, managing director at ratings agency Care Ltd.

IPO grading faces criticism for being an additional cost and for stretching the IPO process. “It is an additional cost. Moreover, one has to spend a lot of executive time answering the queries of rating agencies and providing requisite data,” said Haldea.