No point in grading IPOs

Sebi wants rating agencies to assign grades to IPOs to help you invest better. Right intentions, wrong approach

If grading equities was that easy, why not also rate stocks in the secondary market. And nobody would ever lose money

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I am all for empowering and protecting small investors, but 'optional grading' of IPOs, as recently proposed by Sebi, is stretching the argument. Equities, as an asset class, should not -- and cannot -- be rated or graded. No model exists the world over. Sebi's move is well intentioned -- protecting small investors -- but the problem is with the concept itself.

Wrong reasons

Sebi appears to have given in to this long-standing demand of some investor groups, who feel the flooding of IPOs and overpricing is working against the interests of the small investors . On both counts, they are wrong. One, there is no flooding -- in the last three calendar years, there have been just 90 IPOs, which is insignificant. The period from 1994-96 saw 3,515 IPOs, the memories of which probably are the reason behind this demand. And no flooding expected in the future too. Two, issues are not being overpriced -- of the 81 IPOs between June 2003 and November 2005, only two have always quoted below their offer prices.

The new issue market today is not the flea market it was in the nineties. Entry norms for companies are higher, there are fewer merchant bankers and they have reputations to protect, the market is more mature and institutionalised (issuers have to compulsorily sell half their issues to QIBs, which in an informal way validates an issue, as against pure retail issues in the nineties), there is more policing, the incompetent regional exchanges have closed down. So, chances of bad issues slipping through are slim.

Flawed model

Sure, there will be instances of aggressive pricing, but anyway, grading, in the way it is being proposed, won't solve it. A rating agency will assign a grade to a company based on its business prospects, financial risks, governance practices, accounting quality, management quality and issue objectives. Notice, nothing about issue pricing. At a high price, even a good company is a bad investment. Investors want to know whether they should invest in an IPO at the price at which it is being offered. By ignoring pricing, the value and utility of the grade gets diminished.

Even if rating agencies factored in pricing into the grades, it wouldn't make it a fail-safe service. Share prices are decided in the market by millions of investors collectively. It's impossible for rating agencies to predict with any degree of certainty the post-listing price. Equity investing is a science and an art, it is subjective, it is market-driven -- and cannot be reduced to crude approximations like grades. If it was that easy, why not get rating agencies to grade stocks in the secondary market also? No one would ever lose money.

Assigning a grade to a new issue can lull investors into a false sense of security about the risks and rewards of equity investing. It can make equity look safer than it is. Small investors may even see grading as a regulatory approval of the offering. They might stop applying their minds and instead apply solely on the basis of the rating Grading doesn't promote informed decision-making by investors.

The proposal, in any case, appears to be a non-starter, as grading will not be mandatory. It is entirely up to an issuer to go in for a grading. Good companies would not have much incentive to put themselves through the scanner, as the strength and visibility of their business should see their issue sail through. Why should they risk getting not-so-good grade?

If a grade is to be compulsorily disclosed to the public, as I am assuming it will have to be, the not-so-good companies will shy away, as a bad grade will only harm their issue prospects. Incidentally, if an issue gets a very low grade, will Sebi still allow it? Will the grading system stunt the growth of potential darkhorses? In the mid-nineties, an agency did launch IPO rating. Only bad companies opted for it, and on getting a bad rating, they simply chose to conceal it as disclosure was not mandatory.

There is another fundamental issue. Every prospective IPO is scrutinised at four levels -- by merchant bankers, stock exchanges, Sebi and the public. We don't need a fifth layer to do due diligence. What we need is the existing four to do their jobs better (See table: the way forward). If rating agencies are to be involved. they could do a crisp summary of the offer document, as these have become voluminous and tend to conceal critical information in the maze.

BOX

The way forward
Instead of grading IPOs, Sebi should do these five things to improve the IPO market

- Review entry norms for companies and merchant bankers
- Improve quality, quantity and format of disclosures for small investors
- Consider a safety net mechanism for small investors
- Monitor use of issue funds
- Revive the Central Listing Authority, which was created to improve quality of IPOs and disclosures.