The bogey of IPO overpricing

All IPOs offered a profitable exit windows at some point. If some are now below their offer prices, it's not because they were overpriced, but because the market has fallen sizeably

Rather than fret over new issue pricing, the focus should be on improving disclosures to help investors make informed decisions

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The media has, over the past several months, been flooding us with report on, and analysis of, the deluge of initial public offers (IPOs) and the losses to investors arising from the overpricing of new issues. In fact, the reportage has become so exaggerated that it has lad to the proposal of rating IPOs – an untried and questionable idea. The recent meltdown has seen such "loss" analyses in sharper focus.

What the media seems to forget is that IPOs do not operate independent of the secondary market -- once made, they list on it and are influenced by it to a large extent. The market has now fallen by over 25 per cent, and even the prices of the bluest among blue chips have taken a beating. For instance, the Reliance Industries share crashed 20 per cent to Rs 953 on 31 May from Rs 1,195 on 10 May 2006. ONGC, quoting at Rs 1,514 before the crash, fell to Rs 1112 – a fall of 27 per cent fall in less than a month! Even most equity-oriented mutual funds, on which many small investors depend, have seen erosions in their NAVs.

If that's the case, why do we expect IPOs to quote above their offer prices at all times and against all odds?

The true picture

In reality, however, the IPO scenario is not bad at all. On the contrary, it is quite encouraging. Of the 124 IPOs floated between April 2003 and April 2006 – the period of the bull run -- as many as 85 were still quoting above their offer prices as on 31 May. And the collective loss on the remaining 39 issues, at Rs 1,324 crore, was a fraction of the Rs 25,511 crore gain on the 85 winners. (Since then, the market has crashed further, and all stocks, including IPOs, have fallen).

What's more, all 124 IPOs gave investors an opportunity --- some for a few days, others for several months --- to exit at a profit. Let's take the case of Jet Airways. Its issue, listed on 14 March 2005, was priced at Rs 1,100 and was heavily oversubscribed though most analysts felt the pricing was aggressive. The share touched Rs 1,383 on 26 April and continued to quote above its offer price for several months thereafter. It was only on 21 September -- more than six months after listing -- that the quoted price dipped below the offer price for the first time, only to surpass it again a few days later. After the crash, the share price fall to Rs 738 (on 31 May). If investors were bullish on the market or the company, or were plain greedy and did not use the exit opportunity, should overpricing be blamed?

The lessons

Companies usually float issues in a buoyant secondary market. In the first phase of an IPO cycle, most issues are under-priced, as companies are generally testing the waters. When the bull run continues, the post-listing prices of issues already made also rise, keeping pace with market trends and with the share prices of peer companies. The resulting bumper returns lead to heavy over-subscriptions in newer offers, which in turn leads to more buying of such scrips on listing, thereby pushing up their price. This takes the IPO cycle to the second phase in which issuers start pricing reasonably. If the bull run persists and returns on earlier IPOs become larger still, the third phase of mild overpricing comes in. Just before the crash, we had, at best, reached the initial stages of this third phase.

Issue pricing is complex as there is no single perfect method of valuation. Although some companies do price their offers based on historical earnings, most try and sell their future (forward) earnings. Issuers do look for benchmarks, like the share prices of its peers, but it is difficult to pin IPO pricing down to a single factor, as each company is unique. That explains why the issue price PEs (based on historical earnings) of the 2004-05 IPOs ranged from 1 to 382! Until recently, when the whole market was working on forward multiples, IPOs got priced similarly.

Any analysis of IPO returns should be done only at the time of listing and for a few months thereafter, provided the secondary market has not crashed in the interim. After that, the stock becomes a regular secondary market instrument, influenced by the state of the market, macroeconomic factors and company-specific factors.

Let the market decide

Aggressive pricing is no longer possible in the new market structure. Prices are now determined through an elaborate pre-issue marketing exercise. More than half the issue has to be bought by institutional buyers, who are more discerning and will not take just any price. Moreover, the quality of issuers has improved due to tighter entry norms, better vetting and new market dynamics. In this IPO boom, most offers were from established companies. Very few were for greenfield projects from new promoters. Companies too are cautious in pricing – they have to ensure the issue sells and merchant bankers do not want issues to devolve. The bottomline: IPOs have to be bought, they cannot be sold.

What needs to be ensured is that there are no malpractices. So, the focus has to continue on better disclosures to help investors make more informed decisions, checking companies from committing irregularities and monitoring the end-use of issue proceeds. Grading of IPOs is not the solution.

The good news for the investors is that given the size of the secondary market crash, we might go back to phase one of the IPO cycle-under pricing. Provided, of course, some stability returns to the market.