Follow-on stumps logic

There is much that is wrong with the manner in which follow-on public offerings are being made

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IPOs (initial public offerings) have been the mainstay of all the previous primary market booms. The ongoing one, in contrast, is being pulled more by follow-on public offerings (FPOs) -- public issues by listed companies -- than by IPOs. About 56 per cent of the Rs 42,879 crore raised between January 2003 and June 2005 was through FPOs. What's significant, and contentious, is that 97 per cent of it was raised through the book-building route.

Price distortions

Book-building is a mechanism of price discovery. How can it be applied to listed stocks, which have continuing price benchmarks available in the form of their secondary market prices? Isn't it absurd to discover the price of a stock in two markets simultaneously? An FPO has to be offered at a discount to the market price, or else investors would buy from the secondary market. Why then go through the farce of book-building? Is it merely being used to allot 60 per cent of an issue to preferred investors at low prices -- a provision that doesn't exist in fixed-priced issues?

When FPOs are made through the book-building route, distortions creep in, especially since such issues are announced much before they hit the market. In some cases, the secondary market price is hammered down during the lead-up period, ostensibly to compel issuers to fix a lower issue price, as happened in the divestment offerings of early-2004 like ONGC.

In some cases, operators rig prices to make extraordinary pre-issue gains, as happened in the PNB issue earlier this year. The PNB stock shot up from Rs 232 six months before its issue to an all-time high of Rs 511 on the issue date. Despite no dramatic change in the bank's fundamentals, the stock beat the Sensex by about five times and the bank index by two. But on the day the new shares got listed, it crashed to Rs 388, below its issue price of Rs 390, which is where it has hovered since. For the first time, investor faith in PSU bank issues took a beating. While the PNB issue received 776,000 applications, it fell to 144,000 for Allahabad Bank and just 28,000 for OBC.

A similar price pattern was seen in Jindal Polyfilms. An unusual surge in the lead-up, attractive pricing, price stability at those higher levels during the issue period, meltdown once the issue is closed. Such patterns create a sneaking suspicion that prices are being manipulated to enable the company get a better price for its shares, as happened in droves a decade ago.
Building hype

Besides pricing, there are three other issues facing FPOs. One, disclosures. Companies say since they make regular disclosures to stock exchanges, their offer documents should contain only transaction details. The reality is that compliance with continuing disclosure requirements has been poor; plus, whatever is disclosed is not available to the investor in an easy format.

Two, book-building in FPOs encourages oversubscription hype. In Jindal Polyfilms, the QIB portion was shown as oversubscribed. Yet, surprisingly, on allotment, the QIB allocation was reduced and additional shares were thrust upon small investors. That raises the question: how much of the QIB demand was genuine in the first place?

Three, by ignorance or by design, FPOs are wrongly referred to by issuers, market players and the media as IPOs. It happened with the ONGC, IPCL and PNB issues. It is happening with BHEL. Since FPOs have a price benchmark, on listing, they offer, at best, an arbitrage opportunity. In IPOs, which don't have a price benchmark, the rewards -- and risks -- are potentially higher. Since nearly all recent IPOs have delivered strong listing gains, there is huge retail interest in them. So, some players have a vested interest in labelling FPOs as IPOs -- and they do that to lure retail investors.

All these imperfections in FPOs have to be ironed out -- soon. Sebi wants all listed companies to have a public holding of at least 25 per cent. If implemented, it would lead to more FPOs. Unless these issues are not sorted out, follow-ons could lead to defeats.

Box

FPOs are not IPOs

It's an alphabetical difference that can make a huge difference. An IPO is a maiden offer of shares by a company. Since the stock has no price history, it has the potential (but no assurance) to deliver big listing gains. An FPO doesn't, as the company's shares are already listed and its secondary market price sets a benchmark in the short term. On listing, at best, you can expect some arbitrage profits from FPOs.