My grade to IPO grading: 0

Whichever angle you look at it is from, IPO grading is uncalled for. It's flawed in concept and an inconclusive verdict on whether or not to invest in an IPO

Equity is risk capital, and investors should know their company well. And a grade just doesn't reveal enough

Prithvi Haldea

Who wouldn't like actionable investment advice from experts, that too for free? It's why small investors support IPO grading, it's what proponents of this new concept say such grades will deliver. Both are off the mark. What is being delivered is a subjective opinion on an IPO, that too incomplete to enable investors make a decision. Nothing -- the absence of an international precedent, the experience of IPOs that have already been graded, the concept itself -- suggests that IPO grading is the way to go.

I still can't put my finger on who thought of, or what led to, IPO grading. It started off as a voluntary concept, but companies didn't volunteer. Finally, of the 19 companies that were graded in the preliminary run, at least 15 were arm-twisted into doing so. This was a concept that was previously rejected by the Ministry of Company Affairs. There also is no body of research, no world experience, no concept paper, no invitation for public comments. And still, grading has been made mandatory for all IPOs!

Without a need

Now that grading has been made a rule, many explanations are being given in its support. None make sense.

There's a deluge of bad IPOs. I don't know what a deluge is. What I know is that an average of seven IPOs in a month, that too for a country of our size and amid an economic bull run, is not. Regarding quality, entry norms have become tighter, with better vetting issues by stock exchanges and Sebi. There is compulsory participation of 50 per cent in an issue by QIBs (qualified institutional buyers), who are more discerning and better informed, and their response to an issue holds cues for small investors. The fear of another vanishing company scam is unfounded. Misuse of issue continues, but grading doesn't offer any solution. Besides, even if a company gets a low grade -- say '1' -- it can still make its issue. If it's fundamentals are judged to be so bad, why doesn't Sebi stall the issue?

IPOs are overpriced. There is no such thing as overpricing; it is a statement made in hindsight. If an issue finds a huge demand leading to over-subscription and lists at a premium, how can any one accuse it of overpricing? That several IPOs are quoting at a discount to issue price is a function of the market. Thousands of secondary market stocks have fallen, but no one is crying hoarse about them. Once IPOs become listed stocks, treat likewise. Anyway, IPO grading is of no use, as it completely ignores price. And we know that even a good company at the wrong price is a bad investment.

There are information gaps. If the valuations are dubious and disclosures incomplete, the regulators should fix them, not use them as excuses to give rating agencies work.

Investors need help. The offer document is beyond the capabilities of small investors and a grading is supposed to offer a "crisp summary of the voluminous offer document". The concern is valid, the solution flawed. Regrettably, the crisp summary is missing from all the 19 IPO offer documents graded so far; what we have is only a two-para unstructured rationale for the grade awarded. The need is to revisit the contents and format of the abridged prospectus, which small investors use. Redesign the risk factors, which were introduced to highlight the negatives, but have become a joke. I would like to see a condensed version of two to three pages, which is something the rating agencies can do.

Without a rationale

By introducing grading, we are taking the small investor away from the stated objective of "informed decision making". Equity is risk capital, and investors should know about the company they invest in. If they don't know about it, they shouldn't invest in it in the first place.

Once we have grades, in spite of disclaimers and education, many small investors will only look at this number. They will reject a low-grade IPO and invest in a high-grade one. But if subsequently share prices of those companies, the barometer of performance, move in the opposite direction than the grades assigned to them, they will complain.

If low-grade IPOs do well after listing, they will complain about missed opportunities. If they lose money in high-grade IPOs, they will say they were misled. In equity, unlike debt, it is not safety, but the attractiveness of a company at a particular price for capital appreciation that drives the investment decision. Four recent low-grade IPOs were handsomely over-subscribed and are quoting above their offer prices, despite the market crash, while the IPO that got the highest grade nose-dived. Equity assessment, by its very nature, is subjective and a moving target, which IPO grading doesn't acknowledge.

IPO grading will give small investors a false sense of security, even confuse them. In the nineties, small investors lost several thousand crore investing in high-rated fixed deposits. On the other hand, grading will tarnish the reputation of credit rating agencies, so assiduously built, and of Sebi. We are going backwards, moving away from a disclosure-driven free market to one filled with controls. Protecting investor interests is also to ensure that they are not guided by subjective, incomplete advice.

I also fear that IPO grading, by blocking issues, will throttle entrepreneurship and growth, for which, rating agencies won't be held accountable. Issuers will now have to get their IPO vetted thrice. This concept is loaded against the issuers, with no accountability of rating agencies, giving them the status of God. If at all IPOs have to be graded, let it be voluntary. Let companies seek value in grading and let investors reject non-graded issues.