

Three Different Mechanisms For an IPO

The decision to list a company is often taken considering the market trends. When the primary markets are strong, there is a natural temptation to take a company public. This is because, in a strong market, the company gets much more than its fair valuation. The equation gets reversed when the secondary markets are caught in a bear phase and this has a cascading effect on the primary markets.

An IPO is needed for a company to sell its stock to the general public for the 1st time and get a listing on the stock exchange (a necessary precondition to the trading of securities on an exchange). Companies normally come out with IPOs when they need fresh capital for expansion plans. Private equity investors, many a times, also use IPO as an exit route from the company. Globally, there are three different mechanisms for completing an IPO —

- (1) Auctions
- (2) Fixed Price Offerings
- (3) Book Building

(1) Auctions

In an auction, the shares are offered for sale, on a predetermined schedule, to several competing potential buyers. IPO auctions are quite similar to auctioning on eBay. In an auction at eBay, the winning bidder is the one who offers the highest price, and the price is whatever that person's final bid is. There are two types of auctions used for an IPO – 'Single Price Auction' and 'Dutch Auction'. In a Single price auction (uniform price auction), all winning bidders pay the lowest price regardless of the prices they bid. In a Dutch auction (discriminatory auction), winning bidders pay the amount they bid.

IPO auctions have been tried in many countries—Italy, the Netherlands, Portugal, Sweden, Switzerland, and the United Kingdom in the 1980s and Argentina, Malaysia, Singapore, Taiwan and Turkey in the 1990s. But they were abandoned years before book building became popular. IPO auctions were most robust in France, being used alongside both fixed-price public offers and a restricted form of book building for many years. Even in France, however, IPO auctions were abandoned once standard book-building/public offer simultaneous hybrids were allowed.

(2) Fixed Price Offering

Under a fixed-price offering, a certain number of shares are offered to retail investors at a preset price, which is generally identical to the price offered to institutional investors. Any interested investor indicates to his bank the number of shares he wishes to purchase at that price. This mechanism is rarely used now a day. However, in some countries, this method is used within the book building process. The process starts with a book building for institutional investors. The price is set and after that, there is a fixed-price offering for retail investors that typically last for five days. The private investors can buy the offered stock at the price of the book building. The trading starts only after the book building process gets completed.

(3) Book Building

Book building is the process whereby the bank marketing the IPO gets to know the price investors intend to offer and the volume of the security they are interested in. Book building mechanism allows the issuer company to make a public issue through the process of 'price discovery' rather than through a price that is fixed beforehand. Book Building process was rare outside North America in 1980s and early 1990s. However, these days approximately 90% of IPOs use book-building method.

In India, under the SEBI provisions and ICDR Regulations, it is possible to make an IPO either in the form of 100% retail issue or via book building process.

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Chapter 2, Para 2.2, Investment Banking: The Dream Begins (4th Edition)