Articles

Pricing of Public Issue (IPO) – How Far Fair?

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Companies now have the freedom in the matter of deciding the price of shares to be issued for public subscription. The various legal aspects and procedural compliances relating to pricing of shares are outlined in this write up.

The concept of joint stock company emerged with the industrial revolution that began in 19th Century in Europe. Under this system company's capital is divided into small denominations and raised from large number of people. Holders of shares are known as shareholders and they enjoy the privilege of transferring their shares to any other person they wish at prevailing market price. Stock exchange – the secondary market for securities provides the forum for purchase and sale of securities of listed companies. Prior to the deregulation process which began in the year 1991, Controller of Capital Issues (CCI) - a wing of Ministry of Finance, Govt. of India used to determine/assess the fair price which could be charged for any fresh issue of capital. A company desirous of raising capital from market had to obtain prior approval of CCI for the proposed issue price.

SUBSEQUENT DEVELOPMENTS - POST DEREGULATION REGIME

The Securities and Exchange Board of India (SEBI) was established by the Govt. of India by enacting Securities and Exchange Board of India Act, 1992. Under this Act, SEBI has been given powers to regulate public issues, intermediaries connected with capital market, and to exercise control over functioning of Stock Exchange. SEBI has been constituted in line with Securities & Exchange Commission of USA. The Office of Controller of Capital Issues (CCI) was abolished. Now companies that wish to issue shares have been given full freedom to determine the price of shares to be issued by them. The SEBI has specified new capital issue regulations (SEBI - Disclosure and Investor Protection Guidelines) which contain provisions regarding issue of shares, pricing of shares etc. Amendments are made from time to time to these Regulations.

PROCESS OF ISSUING NEW SHARES

1. A company that desires to raise capital from public for its various needs which may include requirement of fund for meeting part of new project cost, expansion of unit/production capacity, meeting working capital requirement or prepayment/repayment of debts or for any other purpose, is required to undertake the following activities:-
   - (i) Appointment of Merchant Banker(s) for preparation of draft prospectus.
   - (ii) The purpose for which proposed capital is to be used is to be specified.
   - (iii) Past financial results in specified format - duly certified by Company's auditors.
   - (iv) Disclosures of information relating to the Management of company - background of promoters/directors.
   - (v) Disclosures of Particulars of group companies, associated concerns.
   - (vi) Pricing of public issues - justification for proposed share issue price - basis of price fixation, whether shares are to be issued at a fixed price or Book Building Process is to be followed.
   - (vii) Due Diligence Certificate from SEBI approved Merchant Bankers, who are required to comment on Management assertion in prospectus document and justification given for proposed share issue price.

(viii) Disclosures of Promoters' shareholding - present and post issue holding (Including holding through group companies).

(ix) Other details/particulars as specified/required in SEBI regulations.

PROMOTERS HOLDING (INCLUDING HOLDING THROUGH GROUP COMPANIES) *VIS-À-VIS* PUBLIC HOLDING/OTHERS

In the past promoters directly of through their group companies were allowed to hold shares upto 30% in a company (Section 372 of the Companies Act). For holding of shares beyond 30% in a company, prior permission of Central Govt. was required. Recently Government removed the ceiling i.e., maximum promoters shareholding cap by amending provisions contained in section 372 of the Companies Act.

Before deregulation in the year 1991, for listing of shares, public holding in a company was required to be at least 40% of the total issued share capital. After deregulation the minimum public holding was reduced to 25% of post issue capital. In case of companies engaged in creation of infrastructure facilities minimum public holding should be 10% of post issued share capital. It is thus seen that promoters' (including their group companies) can hold upto 75% of total share capital (90% in the case of infrastructure companies) and public to hold minimum 25% (or 10% as the case may be) of the share capital to be eligible for listing of its shares in the stock exchange.

PRICING OF SHARES OF PUBLIC LIMITED COMPANY

1. Promoters being founders of a company usually issue shares to themselves and to their group companies at par value. After company's business plan is chalked out and is visible to some extent, promoters commence a road show to build up corporate image before public, prepare project profile, and assess their long term and short term requirement of funds and proposed means of financing.

2. After assessing fund requirements the promoters induct experienced/retired senior government officials/retired senior bank officials/knowledgeable/reputed persons in the Board and reconstitute Board of Directors in order to project company's image before the public.

   The next step is appointment of merchant banker(s) for preparation of draft prospectus and for giving advice to the Management about the price at which the proposed public issue could be sold. How much price market can sustain without diluting management control, is to be determined. Merchant Bankers hold preliminary discussion with QIBs, FIIs, MFs and other Intermediaries and feel the pulse about the future price of proposed issue. Present market trend, market sentiment, price of existing share (if already listed), price of shares of competitive firms, Govt. Policies etc., are also looked into.

3. The existing SEBI regulations do not contain any restriction on the part of management/promoters about difference in issue price of shares i.e., between the price at which shares were issued to promoters/their group companies in the past and the price at which shares are to be offered to public now.

SEBI REGULATIONS FOR PRICING OF NEW ISSUE AND LISTING OF SHARES

ISSUE OF SHARES

Promoters' (including their group companies) holding after post issue should not exceed 75% (90% in case of infrastructure companies) of the total share capital of company.

ISSUE TO PUBLIC

Out of balance 25% shares to be issued, reservation is to be made in the manner specified below:-

(i) Not exceeding 50% of Issue to be reserved for QIB (like FII, Large Bank, FIs etc.) i.e., 12.5% of post issue total capital).

(ii) Not exceeding 20% of issue to be reserved for Mutual Funds (i.e. 5% of post issue of shares).

(iii) Not exceeding 5% of Issued Shares to be reserved for employees (i.e. 1.25% of post issue capital).

(iv) Not less than 25% of Issued Capital (Proposed New Issue) to be reserved for retail investors (i.e. 6.25% of post issue capital).

PRICING OF PUBLIC ISSUE

The present policy of a company going for public issue is to squeeze as much as possible (i.e., to get as high price for its new shares as the market can sustain). With this objective "Book Building" process of public issue is mostly followed. Only few days or one day before opening of subscription list the price band is announced through media. Bids are invited from QIBs, MFs and Retail Investors within specified price band.

If the response is lukewarm, then price band is further lowered and the date of closing of subscription list is extended. Present SEBI regulations permit this.

ROLE OF MERCHANT BANKERS ISSUING DUE DILIGENCE CERTIFICATE

Merchant Bankers are SEBI registered institutions. They do prepare draft prospectus and guide company's management in successful issue of share capital to the public. Merchant Bankers are also required to give due diligence report about the contents mentioned in the prospectus and also to comment on the pricing of public issue. For providing requisite services to the company, Merchant Bankers (MB) are, in turn, paid attractive fees by the company.

It is seen that Merchant Bankers do provide Due Diligence Certificate and vouch for the justification of proposed share price, but in reality, no liability is fixed upon them. In case the proposed basis of price turns out to be unrealistic and public who subscribed share capital based on certification/ assertion of MBs feel cheated. The Merchant Bankers remain safe and are not made liable for their reckless or negligent certification.

QIBs, MFs etc. - for whom about 70% of public issue is reserved - in terms of SEBI Regulations do subscribe to the shares when there is a clear cut possibility of making quick money. These institutions (especially FII forming part of QIB segment) usually route their business through tax heaven country in order to avoid liability of Indian Taxes. Double Taxation Avoidance Treaties between India and such tax heaven countries (like Mauritius) provide that a company based in Mauritius, deriving business profit in India shall not be liable for payment of taxes in India. Since dividend in the hands of recipient is exempt under present Indian Taxation laws, these FIIs neither pay tax on capital gain nor tax on dividend (if received). Where the expected market price after post issue is not likely to be significantly higher than IPO price, they (FIIs) seldom show any interest in subscribing to the securities. Recent Public issues of NTPC and NMDC are glaring examples of this.

PRESENT GOVERNMENT POLICY FAVORING LARGE INDIVIDUAL HOLDERS/HIGH NET WORTH INDIVIDUALS

1. No wealth tax on holding of shares. Definition contained in section 2(e) of Wealth Tax Act amended to support HNI.
2. No capital gain tax if shares are held for more than one year (LTCG exempt from tax).
3. No dividend tax in the hands of recipients.
4. Tax exemption for merger and demerger of undertakings.
5. Restriction for shareholding/inter corporate holdings beyond certain limit specified under section 372 of the Companies Act removed.
6. No control over the Promoters issuing shares at par to themselves including warrant (for future issue to them at predetermined price), and subsequently charging very high price from public.
7. MMRD Act favouring large industrial houses. Royalty rates fixed very low and long term lease of mines more or less assured, but no restriction/price control over sale of finished product.
8. Tax holiday for setting up units in tax free zone/ SEZ; tax exemptions under section 10A, 10B, 80 IA of the Income tax Act,1961.
9. Benefits such as export incentives, draw back, interest rebate, import license, etc. mostly availed by large industrial houses.
10. Companies have been allowed to issue shares of different denominations/face value. Shares with face value of [Re. 1, Rs. 2, Rs. 5, Rs. 10]. In the past shares of all listed companies had to be of Rs.10 face value and fully paid up.

IMPACT OF GOVT. POLICY ON SOCIETY/ GENERAL PUBLIC

Merchant Bankers who are supposed to be experts in examining and vetting PUBLIC ISSUE (IPO) documents charging substantial fees are not made accountable. If the post issue share price fall abruptly or business forecast as specified while justifying issue price does not materialize or turns out to be false, imaginary or unrealistic people who invested their hard earned money suffer losses. Still the merchant bankers are not made responsible in any way. Promoters acquire huge wealth at the cost of innocent people. They get richer without much tax liability and accountability to the society.

FIIs, QIBs, MFs are not long term investors in capital market. These institutions are major players in the market and share price fluctuates/varies depending upon the muscle power of these groups. In addition to macro and micro factors, role of FIIs, QIBs and MFs usually decide the trend/fluctuation in share prices in Indian bourse.

REMEDIAL MEASURES

1. Concentration of economic powers in few private hands should be checked in line with Article 39C of the Constitution. Regulation contained in MRTP Act like concentration of economic power, dominant undertakings concept should be revived with enhanced limit.
2. Wealth tax and dividend tax should be revived with increased exemption limits.
3. Double Taxation Avoidance Agreements should be reviewed and all institutions whether FII, QIB, MF etc., should be required to pay tax on profit (gain) derived out of sale of securities.
4. Long term capital gain on sale of shares should be subject to tax similar to other assets, unless such gains are invested in specified securities.
5. Merchant Bankers should be made more accountable. If it is observed afterwards that Due Diligence Certificate was issued recklessly, then such MB should be made accountable to the public and should indemnify the loss suffered by the public who had relied upon his assertion and suffered losses.
6. Promoters shareholding (including group companies) should not be allowed beyond 40% of total issued capital. Price of public issue should not exceed 20% beyond the price at which shares were issued to the promoters/group companies during the last two years.
7. Reservation of Quota for QIBs, MFs etc., should be dispensed with. They should participate with general public, and at the time of allotment preference be given to general public unless lock in period for QIB, MF etc., for their holding (say two years) is specified.
8. Each proposal for merger and demerger by large industrial houses should be examined on merits keeping in view the public interest by some regulatory authority. Permission for such merger/demerger should be granted only if it is in the public interest.
9. Export Incentives/tax holiday and other fiscal incentives should be periodically reviewed to ensure that such exemptions are in public interest.
10. All companies should be required to issue shares at standard denomination say Rs. 10 per share.
11. The System of book building for public issue should be reviewed. It should be specified that if the average market price of securities during next 12 months falls beyond 20% of the PO issue price, then the company should indemnify the retail investors. For healthy growth of capital market and for prevention of concentration in economic power in few hands, Govt. of India should take appropriate remedial measures. ❑