International Journal of Research
Available at https://edupediapublications.org/journals

e-ISSN: 2348-6848
p-ISSN: 2348-795X
Volume 05 Issue-01
January 2018

A Study on Analysing the Position of Initial Public Offer

Dr.I.Satyanarayana[1], N.B.C. Sidhu*[2], M Anusha [3] (15X31E0013)

1.Principal, Sri Indu institute of Engineering & Technology, Sheriguda, Ibrahimpatnam,Telangana, India.
2.Assoc. Prof & HOD, Dept. of Master of Business Administration, Sri Indu Institute of Engineering & Technology, Sheriguda, Ibrahimpatnam, Telangna, India.
3.Student, Dept. of Master of Business Administration, Sri Indu Institute of Engineering & Technology, Sheriguda, Ibrahimpatnam, Telangna, India.

Abstract:

Initial public offering (IPO) or stock market launch is a type of public offering in which shares of a company usually are sold to institutional investors that in turn, sell to the general public, on a securities exchange, for the first time. Through this process, a privately held company transforms into a public company. Initial public offerings are mostly used by companies to raise the expansion of capital, possibly to monetize the investments of early private investors, and to become publicly traded enterprises. A company selling shares is never required to repay the capital to its public investors. After the IPO, when shares trade freely in the open market, money passes between public investors. Although IPO offers many advantages, there are also significant disadvantages, chief among these are the costs associated with the process and the requirement to disclose certain information that could prove helpful to competitors. The IPO process is colloquially known as going public.

Key words: *Financial Markets and functions, financial Policy, IPO History, IPO Policy…*

Introduction: **Initial public offering (IPO)**, also referred to simply as a "public offering" or "flotation," is when a company issues common stock or shares to the public for the first time. They are often issued by smaller, younger companies seeking capital to expand, but can also be done by large privately-owned companies looking to become publicly traded.

In an IPO the issuer may obtain the assistance of an underwriting firm, which helps it determine what type of security to issue (common or preferred), best offering price and time to bring it to market.

An IPO can be a risky investment. For the individual investor, it is tough to predict what the stock or shares will do on its initial day of trading and in the near future since there is often little historical data with which to analyze the company. Also, most IPOs are of companies going through a transitory growth period, and they are therefore subject to additional uncertainty regarding their future value.

However, in order to make money, calculated risks need to be taken. **Initial public offering** (**IPO**) or **stock market launch** is a type of public offering in which shares of a company usually are sold to institutional investors[1] that in turn, sell to the general public, on a securities exchange, for the first time. Through this process, a private company transforms into a public company.

Initial public offerings are mostly used by companies to raise the expansion of capital, possibly to monetize the investments of early private investors, and to become publicly traded enterprises. A company selling shares is never required to repay the capital to its public investors. After the IPO, when shares trade freely in the open market, money passes between public investors. Although IPO offers many advantages, there are also significant disadvantages, chief among these are the costs associated with the process and the requirement to disclose certain information that could prove helpful to competitors. The IPO process is colloquially known as **going public**.

Details of the proposed offering are disclosed to potential purchasers in the form of a lengthy document known as a prospectus. Most companies undertake an IPO with the assistance of an investment banking firm acting in the capacity of an underwriter. Underwriters provide several services, including help with correctly assessing the value of shares (share price) and establishing a public market for shares (initial sale).

Alternative methods such as the dutch auction have also been explored. In terms of size and public participation, the most notable example of this method is the Google IPO.[2] China has recently emerged as a major IPO market, with several of the largest IPOs taking place in that country

History:

The earliest form of a company which issued **public shares** was the *publican* during the Roman Republic. Like modern joint-stock companies, the *publican* were legal bodies independent of their members whose ownership was divided into shares, or *parties*. There is evidence that these shares were sold to public investors and traded in a type of over-the-counter market in the Forum, near the Temple of Castor and Pollux. The shares fluctuated in value, encouraging the activity of speculators, or *quaestors*. Mere evidence remains of the prices for which *partes* were sold, the nature of initial public offerings, or a description of stock market behavior. *Publicanis* lost favor with the fall of the Republic and the rise of the Empire.

The first modern IPO occurred in March 1602 when the Dutch East India Company offered shares of the company to the public in order to raise capital. All the shares were tradable, and the shareholders received receipts for the purchase. A share certificate documenting payment and ownership such as we know today was not issued but ownership was instead entered in the company's share register. In the United States, the first IPO was the public offering of Bank of North America around 1783.

When a company lists its securities on a public exchange, the money paid by the investing public for the newly issued shares goes directly to the company (primary offering) as well as to any early private investors who opt to sell all or a portion of their holdings (secondary offering) as part of the larger IPO. An IPO, therefore, allows a company to tap into a wide pool of potential investors to provide itself with capital for future growth, repayment of debt, or working capital. A company selling common shares is never required to repay the capital to its public investors. Those investors must endure the unpredictable nature of the open market to price and trade their shares. After the IPO, when shares trade freely in the open market, money passes between public investors. For early private investors who choose to sell shares as part of the IPO process, the IPO represents an opportunity to monetize their investment. After the IPO, once shares trade in the open market, investors holding large blocks of shares can either sell those shares piecemeal in the open market, or sell a large block of shares directly to the public, at a fixed price, through a secondary market offering. This type of offering is not dilutive, since no new shares are being created.

Once a company is listed, it is able to issue additional common shares in a number of different ways, one of which is the follow-on offering. This method provides capital for various corporate purposes through the issuance of equity (see stock dilution) without incurring any debt. This ability to quickly raise potentially large amounts of capital from the marketplace is a key reason many companies seek to go public.

An IPO accords several benefits to the previously private company:

- Enlarging and diversifying equity base
- Enabling cheaper access to capital
- Increasing exposure, prestige, and public image
- Attracting and retaining better management and employees through liquid equity participation
- Facilitating acquisitions (potentially in return for shares of stock)
- Creating multiple financing opportunities: equity, convertible debt, cheaper bank loans, etc.

There are several disadvantages to completing an initial public offering:

- Significant legal, accounting and marketing costs, many of which are ongoing
- Requirement to disclose financial and business information
- Meaningful time, effort and attention required of management
- Risk that required funding will not be raised
- Public dissemination of information which may be useful to competitors, suppliers and customers.
- Loss of control and stronger agency problems due to new shareholders
- Increased risk of litigation, including private securities class actions and shareholder derivative actions[6]

The Final step in preparing and filing the final IPO prospectus is for the issuer to retain one of the major financial "printers", who print (and today, also electronically file with the SEC) the registration statement on Form S-1. Typically, preparation of the final prospectus is actually performed at the printer, where in one of their multiple conference rooms the issuer, issuer's counsel (attorneys), underwriter's counsel (attorneys), the lead underwriter(s), and the issuer's accountants/auditors make final edits and proofreading, concluding with the filing of the final prospectus by the financial printer with the Securities and Exchange Commission.[15]

Before legal actions initiated by New York Attorney General Eliot Spitzer, which later became known as the Global Settlement enforcement agreement, some large investment firms had initiated favorable research coverage of companies in an effort to aid corporate finance departments and retail divisions engaged in the marketing of new issues. The central issue in that enforcement agreement had been judged in court previously. It involved the conflict of interest between the investment banking and analysis departments of ten of the largest investment firms in the United States. The investment firms involved in the settlement had all engaged in actions and practices that had allowed the inappropriate influence of their research analysts by their investment bankers seeking lucrative fees.[16] A typical violation addressed by the settlement was the case of CSFB and Salomon Smith Barney, which were alleged to have engaged in inappropriate spinning of "hot" IPOs and issued fraudulent research reports in violation of various sections within the Securities Exchange Act of 1934.

Pricing

A company planning an IPO typically appoints a lead manager, known as a bookrunner, to help it arrive at an appropriate price at which the shares should be issued. There are two primary ways in which the price of an IPO can be determined. Either the company, with the help of its lead managers, fixes a price ("fixed price method"), or the price can be determined through analysis of confidential investor demand data compiled by the bookrunner ("book building").Historically, many IPOs have been underpriced. The effect of underpricing an IPO is to generate additional interest in the stock when it first becomes publicly traded. Flipping, or quickly selling shares for a profit, can lead to significant gains for investors who were allocated shares of the IPO at the offering price. However, underpricing an IPO results in lost potential capital for the issuer. One extreme example is theglobe.com IPO which helped fuel the IPO "mania" of the late 1990s internet era. Underwritten by Bear Stearns on November 13, 1998, the IPO was priced at $9 per share. The share price quickly increased 1000% on the opening day of trading, to a high of $97. Selling pressure from institutional flipping eventually drove the stock back down, and it closed the day at $63. Although the company did raise about $30 million from the offering, it is estimated that with the level of demand for the offering and the volume of trading that took place they might have left upwards of $200 million on the table.

The danger of overpricing is also an important consideration. If a stock is offered to the public at a higher price than the market will pay, the underwriters may have trouble meeting their commitments to sell shares. Even if they sell all of the issued shares, the stock may fall in value on the first day of trading. If so, the stock may lose its marketability and hence even more of its value. This could result in losses for investors, many of whom being the most favored clients of the underwriters. Perhaps the best known example of this is the Facebook IPO in 2012.

Underwriters, therefore, take many factors into consideration when pricing an IPO, and attempt to reach an offering price that is low enough to stimulate interest in the stock, but high enough to raise an adequate amount of capital for the company. When pricing an IPO, underwriters use a variety of key performance indicators and non-GAAP measures.[17] The process of determining an optimal price usually involves the underwriters ("syndicate") arranging share purchase commitments from leading institutional investors.

Some researchers (Friesen & Swift, 2009) believe that the underpricing of IPOs is less a deliberate act on the part of issuers and/or underwriters, and more the result of an over-reaction on the part of investors (Friesen & Swift, 2009). One potential method for determining underpricing is through the use of IPO underpricing algorithms.

Dutch auction

A Dutch auction allows shares of an initial public offering to be allocated based only on price aggressiveness, with all successful bidders paying the same price per share.[18][19] One version of the Dutch auction is OpenIPO, which is based on an auction system designed by Nobel Memorial Prize-winning economist William Vickrey. This auction method ranks bids from highest to lowest, then accepts the highest bids that allow all shares to be sold, with all winning bidders paying the same price. It is similar to the model used to auction Treasury bills, notes, and bonds since the 1990s. Before this, Treasury bills were auctioned through a discriminatory or pay-what-you-bid auction, in which the various winning bidders each paid the price (or yield) they bid, and thus the various winning bidders did not all pay the same price. Both discriminatory and uniform price or "Dutch" auctions have been used for IPOs in many countries, although only uniform price auctions have been used so far in the US. Large IPO auctions include Japan Tobacco, Singapore Telecom, BAA Plc and Google (ordered by size of proceeds).

A variation of the Dutch Auction has been used to take a number of U.S. companies public including Morningstar, Interactive Brokers Group, Overstock.com, Ravenswood Winery, Clean Energy Fuels, and Boston Beer Company.[20] In 2004, Google used the Dutch Auction system for its Initial Public Offering.[21] Traditional U.S. investment banks have shown resistance to the idea of using an auction process to engage in public securities offerings. The auction method allows for equal access to the allocation of shares and eliminates the favorable treatment accorded important clients by the underwriters in conventional IPOs. In the face of this resistance, the Dutch Auction is still a little used method in U.S. public offerings, although there have been hundreds of auction IPOs in other countries.

In determining the success or failure of a Dutch Auction, one must consider competing objectives.[22][23] If the objective is to reduce risk, a traditional IPO may be more effective because the underwriter manages the process, rather than leaving the outcome in part to random chance in terms of who chooses to bid or what strategy each bidder chooses to follow. From the viewpoint of the investor, the Dutch Auction allows everyone equal access. Moreover, some forms of the Dutch Auction allow the underwriter to be more active in coordinating bids and even communicating general auction trends to some bidders during the bidding period. Some have also argued that a uniform price auction is more effective at price discovery, although the theory behind this is based on the assumption of independent private values (that the value of IPO shares to each bidder is entirely independent of their value to others, even though the shares will shortly be traded on the aftermarket). Theory that incorporates assumptions more appropriate to IPOs does not find that sealed bid auctions are an effective form of price discovery, although possibly some modified form of auction might give a better result.

In addition to the extensive international evidence that auctions have not been popular for IPOs, there is no U.S. evidence to indicate that the Dutch Auction fares any better than the traditional IPO in an unwelcoming market environment. A Dutch Auction IPO by WhiteGlove Health, Inc., announced in May 2011 was postponed in September of that year, after several failed attempts to price. An article in the *Wall Street Journal* cited the reasons as "broader stock-market volatility and uncertainty about the global economy have made investors wary of investing in new stocks".

IPO procedures are governed by different laws in different countries. In the United States, IPOs are regulated by the United States Securities and Exchange Commission under the Securities Act of 1933.[7] In the United Kingdom, the UK Listing Authority reviews and approves prospectuses and operates the listing regime.[8]

Advance planning

Planning is crucial to a successful IPO. One book[9] suggests the following 7 advance planning steps:

1. develop an impressive management and professional team
2. grow the company's business with an eye to the public marketplace
3. obtain audited financial statements using IPO-accepted accounting principles
4. clean up the company's act
5. establish antitakeover defences
6. develop good corporate governance
7. create insider bail-out opportunities and take advantage of IPO windows.

Retention of underwriters

IPOs generally involve one or more investment banks known as "underwriters". The company offering its shares, called the "issuer", enters into a contract with a lead underwriter to sell its shares to the public. The underwriter then approaches investors with offers to sell those shares.

A large IPO is usually underwritten by a "syndicate" of investment banks, the largest of which take the position of "lead underwriter". Upon selling the shares, the underwriters retain a portion of the proceeds as their fee. This fee is called an underwriting spread. The spread is calculated as a discount from the price of the shares sold (called the gross spread). Components of an underwriting spread in an initial public offering (IPO) typically include the following (on a per share basis): Manager's fee, Underwriting fee—earned by members of the syndicate, and the Concession—earned by the broker-dealer selling the shares. The Manager would be entitled to the entire underwriting spread. A member of the syndicate is entitled to the underwriting fee and the concession. A broker dealer who is not a member of the syndicate but sells shares would receive only the concession, while the member of the syndicate who provided the shares to that broker dealer would retain the underwriting fee.[10] Usually, the managing/lead underwriter, also known as the bookrunner, typically the underwriter selling the largest proportions of the IPO, takes the highest portion of the gross spread, up to 8% in some cases.

Multinational IPOs may have many syndicates to deal with differing legal requirements in both the issuer's domestic market and other regions. For example, an issuer based in the E.U. may be represented by the main selling syndicate in its domestic market, Europe, in addition to separate syndicates or selling groups for US/Canada and for Asia. Usually, the lead underwriter in the main selling group is also the lead bank in the other selling groups.

Because of the wide array of legal requirements and because it is an expensive process, IPOs also typically involve one or more law firms with major practices in securities law, such as the Magic Circle firms of London and the white shoe firms of New York City.

Financial historians Richard Sylla and Robert E. Wright have shown that before 1860 most early U.S. corporations sold shares in themselves directly to the public without the aid of intermediaries like investment banks.[11] The direct public offering or DPO, as they term it,[12] was not done by auction but rather at a share price set by the issuing corporation. In this sense, it is the same as the fixed price public offers that were the traditional IPO method in most non-US countries in the early 1990s. The DPO eliminated the agency problem associated with offerings intermediated by investment banks. There has recently been a movement based on crowd funding to revive the popularity of Direct Public Offerings.[13]

Allocation and pricing

The sale (allocation and pricing) of shares in an IPO may take several forms. Common methods include:

- Best efforts contract
- Firm commitment contract
- All-or-none contract
- Bought deal

Public offerings are sold to both institutional investors and retail clients of the underwriters. A licensed securities salesperson (Registered Representative in the USA and Canada) selling shares of a public offering to his clients is paid a portion of the selling concession (the fee paid by the issuer to the underwriter) rather than by his client. In some situations, when the IPO is not a "hot" issue (undersubscribed), and where the salesperson is the client's advisor, it is possible that the financial incentives of the advisor and client may not be aligned.

The issuer usually allows the underwriters an option to increase the size of the offering by up to 15% under certain circumstance known as the greenshoe or overallotment option. This option is always exercised when the offering is considered a "hot" issue, by virtue of being oversubscribed.

In the USA, clients are given a preliminary prospectus, known as a red herring prospectus, during the initial quiet period. The red herring prospectus is so named because of a bold red warning statement printed on its front cover. The warning states that the offering information is incomplete, and may be changed. The actual wording can vary, although most roughly follow the format exhibited on the Facebook IPO red herring.[14]

During the quiet period, the shares cannot be offered for sale. Brokers can, however, take indications of interest from their clients. At the time of the stock launch, after the Registration Statement has become effective, indications of interest can be converted to buy orders, at the discretion of the buyer. Sales can only be made through a final prospectus cleared by the Securities and Exchange Commission.

The above information regarding the project has been collected from the following different sources.

Secondary information

Books referred

Investment Banking and Analysis.
“Investment, Analysis and management” by Francis.
“Security Analysis” by Graham and Dodd.

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