Pricing Mechanisms of IPOs - A Discussion

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ABSTRACT

Pricing of IPOs is of great importance in deciding the issue price of security to be traded in capital market. There are different pricing mechanisms followed in different capital market around the globe. The pricing mechanisms used are Auction, Book Building and Fixed price method. In this paper we have discussed the theoretical paper in which we have discussed about the IPOs its significance and the pricing mechanisms adopted. Paper further highlights the advantage of book building over fixed price option. The study found that book building pricing mechanism is quite popular in all the capital market followed by fixed price option and auction method of pricing.

This paper is based on the evidence drawn from the various researchers' work done on pricing Mechanisms of different country's capital market. The paper is divided in different section. Section 1 is Introduction, Section 2 is Literature Review, section 3 discusses the Advantage of Book building over fixed price method. Section 4 is concluding part of paper. And at last the references and bibliography is given.

Key words – Pricing mechanisms, fixed pricing, book building, auction

1.Introduction

1.1 IPOs (Initial Public Offers) - IPOs - An IPO is when a company which is presently not listed at any stock exchange makes either a fresh issue of shares or makes an offer for sale of its existing shares or both for the first time to the public. Through a public offering, the issuer makes an offer for new investors to enter its shareholding family.

IPO is an offering of either a fresh issue of securities or an offer for sale of existing securities or both by an unlisted company for the first time to the public. Initial public offer is the process through which an unlisted organization would issue new shares to the public. The public includes both the institutes and the individuals. The IPO could be issued either through fresh issuance of new shares or through offering of sale of the securities which are privately held. After the issue, the shares get traded on the stock exchange in the secondary markets.

1.2 Characteristics of IPO

Important characteristics of IPOs are

- Underpricing phenomena
- Ownership and
- Liquidity

These characteristics of IPOs influence the significance of impact upon their performance in the short as well as in long term.

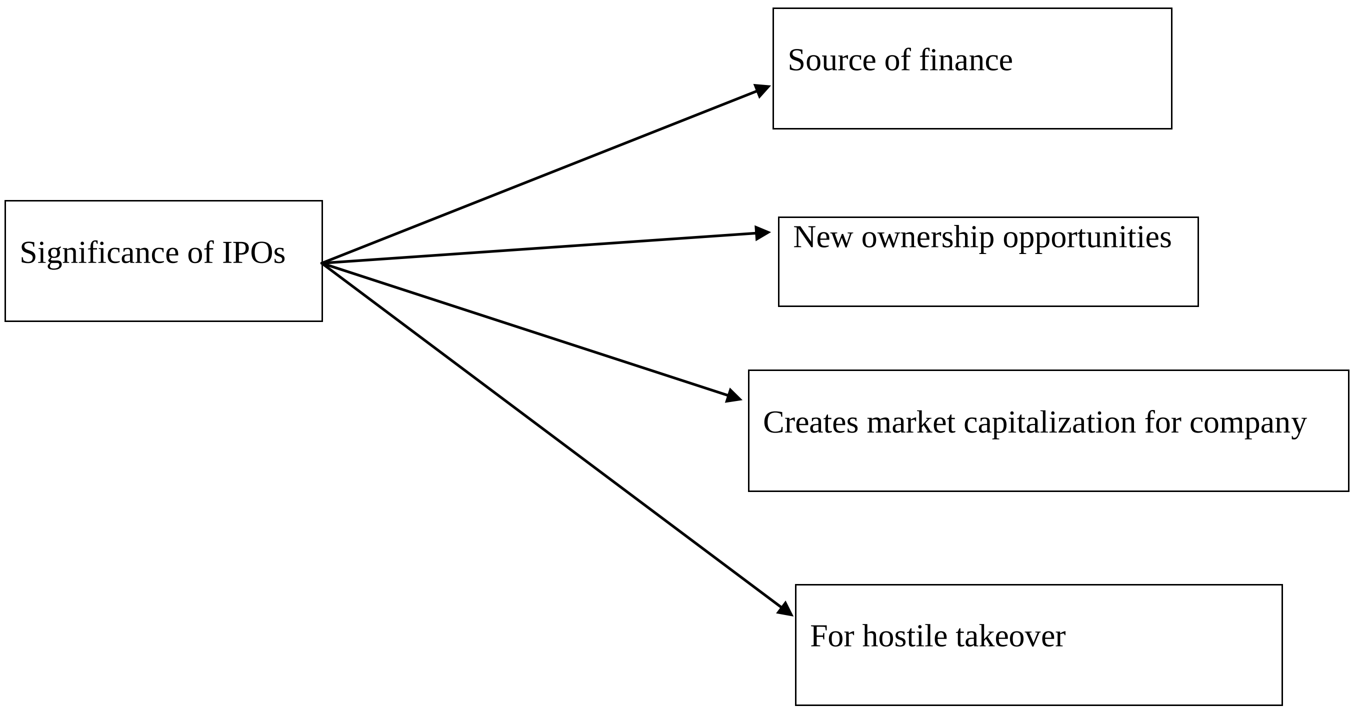
1.3 Background of Indian IPO Market

India has a relatively mature capital market, with a long history of uninterrupted operations even across the World Wars. Historically, the only alternative available for a firm contemplating a public issue was to make a fixed price offering. The firm going public would set a price and open the issue for subscription. Allocations were made on a strictly proportionate basis. Until 1992, issuers and investment banks had no pricing flexibility because issue prices were effectively constrained to accounting par value or the accounting book value of equity. More pricing flexibility was allowed in 1992, but issue managers were still allowed no discretion in allocation.

The process of IPO deregulation took a major step forward in 1999 when pricing flexibility was coupled with discretion in allocation. After 1999, issuers could still opt for conventional fixed price offerings in which investment banks allocated shares on a **prorata basis**. Alternatively, they could choose a version of book building, in which a quota of shares, usually 50% of an offering, was set aside for discretionary allocation to QIBs, i.e., **qualified institutional buyers**.

Thus, 1999 represents a natural structural break point in the availability of different issuance mechanisms in the Indian IPO market.

1.4 Significance of an IPO



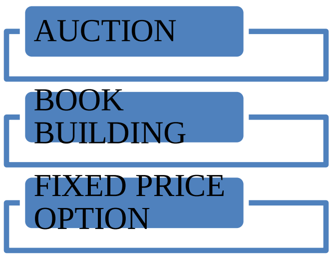
1.5 IPO Decision

Pre-Postage decision relate with timing of the IPO decision. Post-Postage decision relates with continuity or discontinuity of listed status.

Timing on IPO is strategic financial and merchant banking decision. The strategic decision is to make whether listing in needed and is fit with corporate philosophy, financial decision is to decide whether company require capital to raise then how much and how effectively, the merchant banking decision is made to determine the appropriate structure, pricing, timing and marketing strategy for the IPO.

1.6 Pricing Mechanisms of IPOs

There are three type of mechanisms are widely used they are as follows



1.6.1 Auction In this the auctioneer begins with a high asking price and it is lowered until some participant is willing to accept the auctioneer's price. This was one of the popular method used in French Market before the coming of Book building method.

1.6.2 Fixed Price Mechanism

In fixed price, the price is set from the date the prospectus is registered. Price at which the securities are allotted is known in advance to the investor. Demand for the securities offered is known only after the closure of the issue. While payment is made at the time of subscription where in refund is given after allocation.

In fixed price offering, price is determined without formally soliciting the level of investor interest. In fixed price offer the price is set from the data the prospectus is registered. For a book-built IPO, the offer price is not finalized until the demand for the issue has been assessed with the final price typically being set very close to the listing date.

1.6.3 The Book Building Mechanism

Book building was permitted from 2000

Book building is a process undertaken by which demand for the securities proposed to be issued by a body corporate is elicited and built up and the price for such securities is assessed for the determination of the quantum of securities to be issued by means of a notice, circular, advertisement , document or information memoranda or offer document.------ ***SEBI***

Book Building is essentially a process used by companies raising capital through Public Offerings-both Initial Public Offers (IPOs) and Follow-on Public Offers (FPOs) to aid price and demand discovery. It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices, which are within the price band specified by the issuer. The process is directed towards both the institutional as well as the retail investors. The issue price is determined after the bid closure based on the demand generated in the process.

2. Literature review

Mishra, A. in his paper "Underpricing of Initial public offerings in India: A comparison of the fixed price and book building methods" explains that for **IPOs using a book-build a significant positive relationship** is documented between revisions in the offer price and the ensuing level of underpricing.

Degeorge, F., F. Derrien, and K.L. Womack, 2007, in their study states the **book building has captured most of the market share** globally but is the most costly procedure available in terms of direct and indirect initial under pricing.

Bora, Bedanta; Anindita Adhikari and Andajeya Jha (2012), in their paper "An empirical Perspective on Book building as Effective tool for price discovery" proved that **Book building mechanisms is preferred over other price mechanisms followed in India** but the issue raised through fixed price are relatively more promising in long terms as compared to the issue raised through book building method.

Ritter, Jay R. (2003) in his study "Difference between European and American IPO Markets." Examines that **fixed price offerings have become uncommon in recent years in France as well as other European nation**

3. Book building vs. Fixed price

Book Building

In book building offering the lead managers solicits non-binding bid at various prices within a nominated price range from investors. The indicative bids are consolidated and the lead manager in conjunction with the company determines the final offer price, which reflects anticipated public demand and the motivation to ensure orderly trading in the aftermarket.

Fixed Price

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Issue Type	Offer Price	Demand	Payment	Reservations
Fixed Price Issues	Price at which the securities are offered and would be allotted is made known in advance to the investors	Demand for the securities offered is known only after the closure of the issue	100 % advance payment is required to be made by the investors at the time of application.	50 % of the shares offered are reserved for applications below Rs. 1 lakh and the balance for higher amount applications.
Book Building Issues	A 20 % price band is offered by the issuer within which investors are allowed to bid and the final price is determined by the issuer only after closure of the bidding.	Demand for the securities offered , and at various prices, is available on a real time basis on the BSE website during the bidding period..	10 % advance payment is required to be made by the QIBs along with the application, while other categories of investors have to pay 100 % advance along with the application.	50 % of shares offered are reserved for QIBS, 35 % for small investors and the balance for all other investors.

Advantage of Book building over Fixed Price method

- More flexible than fixed price method of issue as issuer company has flexibility to revise price band during the bidding period.
- Issuer Company has the freedom to determine the issue size based on demand in the market.
- Risk of failure of security can be avoided as issuer can withdraw from the market if demand does not exist.
- Comparatively cost effective than fixed price.

3. Conclusion

Pricing of IPOs is of great importance in deciding the issue price of security to be traded in capital market. There are different pricing mechanisms followed in different capital market around the globe. The pricing mechanisms used are Auction, Book Building and Fixed price method. From the work of different researcher about IPOs pricing mechanisms it is clear that book building method is adopted by most of the companies at global level and it shows that book building is popular pricing mechanism than fixed price method. The reason for company choosing the book building over fixed price is the advantage that book building have over fixed price method such as flexibility and short of freedom that is there in book building method. Also different researchers work support the fact that book building method of pricing is more preferred by company to issue IPOs rather than Fixed price method.

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