IPO Process

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Agenda

- Role of SEBI
- Factors to be considered for IPO
- Key terms
- Advantages of IPO
- IPO Process
- Metrics for IPO
- FPO Management

Role of SEBI

Role of SEBI

Registration and Regulation:

- SEBI mandates that any entity engaged in merchant banking activities must be registered with it. The registration process involves stringent criteria regarding capital adequacy, infrastructure, and professional expertise.
- SEBI regulates the conduct of merchant bankers to ensure transparency, fairness, and integrity in their dealings.

Code of Conduct:

- SEBI has laid down a comprehensive code of conduct for merchant bankers, which includes guidelines on professional integrity, confidentiality, disclosure of information, conflict of interest, and compliance with regulatory requirements.
- Merchant bankers are expected to adhere to these standards in their dealings with clients and other stakeholders.

Role of SEBI…

Issue Management:

- SEBI regulates the process of issuing securities to the public, including initial public offerings (IPOs), rights issues, and follow-on public offerings (FPOs).
- Merchant bankers are responsible for managing the entire process of issuing securities, including due diligence, drafting offer documents, pricing, marketing, and allotment of securities.
- SEBI ensures that the issuing process is fair, transparent, and in compliance with applicable laws and regulations.

Disclosure Requirements:

- SEBI mandates extensive disclosure requirements for companies making public offerings.
- Merchant bankers are responsible for ensuring that the offer documents contain all material information that investors need to make an informed decision about investing in the securities being offered.
- SEBI reviews offer documents to ensure compliance with disclosure requirements and may take enforcement action against issuers and merchant bankers for any violations.

Role of SEBI…

Monitoring and Enforcement:

- SEBI monitors the activities of merchant bankers through periodic inspections, audits, and surveillance mechanisms.
- SEBI has the authority to investigate and take enforcement action against merchant bankers for violations of securities laws and regulations.
- This may include imposing fines, penalties, or other disciplinary measures for misconduct or non-compliance.

Factors to be considered for IPO

Factors to be considered for IPO

- The historical record of the firm providing the Initial Public Offerings
- Promoters, their reliability, and past records
- Products offered by the firm and their potential going forward
- Whether the firm has entered into a collaboration with the technological firm
- Project value and various techniques of sponsoring the plan
- Productivity estimates of the project
- Risk aspects engaged in the execution of the plan

Key Terms

Key terms

Primary market

- It is the market in which investors have the first opportunity to buy a newly issued security as in an IPO.

Prospectus

- A formal legal document describing the details of the company is created for a proposed IPO, also making the investors aware of the risks of an investment. It is also known as the offer document.

Book building

- It is the process by which an attempt is made to determine the price at which the securities are to be offered based on the demand from investors.

Over-Subscription

- A situation in which the demand for shares offered in an IPO exceeds the number of shares issued.

Key terms…

Green shoe option

- It is referred to as an over-allotment option. It is a provision contained in an underwriting agreement whereby the underwriter gets the right to sell investors more shares than originally planned by the issuer in case the demand for a security issue proves higher than expected.

Price band

- Price band refers to the band within which the investors can bid. The spread between the floor and the cap of the price band is not more than 20% i.e. the cap should not be more than 120% of the floor price. This is decided by the company and its merchant bankers. There is no cap or regulatory approval needed for determining the price of an IPO.

Key terms...

Listing

- Shares offered in IPOs are required to be listed on stock exchanges for the purpose of trading. Listing means that the shares have been listed on the stock exchange and are available for trading in the secondary market.

Flipping

- Flipping is reselling a hot IPO stock in the first few days to earn a quick profit. The reason behind this is that companies want long-term investors who hold their stock, not traders.

Advantages of IPO

Advantages of IPO

- **Access to Capital**: One of the primary advantages of an IPO is access to a large pool of capital from public investors. By listing on a stock exchange, a company can raise funds to finance its growth initiatives, such as expanding operations, investing in research and development, or paying off debt.
- **Enhanced Visibility and Prestige**: Going public can enhance a company's visibility and prestige in the market. Being listed on a stock exchange can increase brand recognition and credibility among customers, suppliers, and business partners, potentially leading to new business opportunities and partnerships.
- **Liquidity for Existing Shareholders:** An IPO provides an opportunity for existing shareholders, such as founders, early investors, and employees with stock options, to monetize their investments and realize liquidity. Public markets offer liquidity through the ability to buy and sell shares freely, which may not be available in private markets.

Advantages of IPO

- **Valuation Benchmark**: Going public can establish a transparent market valuation for the company's shares. The market price of the company's stock can serve as a benchmark for its valuation, which can be useful for future fundraising efforts, mergers and acquisitions, or employee stock incentive plans.
- **Currency for Acquisitions**: Publicly traded stock can be used as a currency for future acquisitions. By issuing shares as consideration for acquisitions, a company can conserve cash and use its stock as a means of financing strategic growth through mergers and acquisitions.
- **Employee Incentives**: Publicly traded stock can be an attractive incentive for employees. Stock options or equity grants tied to the company's publicly traded shares can align employees' interests with shareholders' interests and motivate them to contribute to the company's success.

Advantages of IPO

- **Enhanced Corporate Governance:** Going public typically requires companies to adhere to stricter regulatory and corporate governance standards. This can improve transparency, accountability, and oversight within the company, which may enhance investor confidence and trust.

- **Exit Strategy for Early Investors:** For venture capitalists, private equity firms, and other early investors, an IPO provides an exit strategy by allowing them to sell their shares to public investors. This can generate significant returns on their investments and enable them to redeploy capital into new opportunities.

Challenges of IPO

- Costs and expense
- Disclosure and transparency requirement
- Loss of control
- Market volatility
- Short-termism and pressure to perform
- Increased regulatory scrutiny
- Market perception

IPO Process

IPO Process

- Select a bank
- Due diligence and filings
- Pricing
- Stabilization
- Transition

Selection of Investment Bank

- Reputation
- The quality of research
- Industry expertise
- Distribution i.e. if the investment bank can provide the issued securities to more institutional investors or to more individual investors.
- Prior relationship with the investment bank

Due diligence and regulatory filing

Underwriting is the process through which an investment bank (the underwriter) acts as a broker between the issuing company and the investing public to help the issuing company sell its initial set of shares.

The following underwriting arrangements are available to the issuing company:

- **Firm Commitment**: Under such an agreement, the underwriter purchases the whole offer and resells the shares to the investing public. The firm commitment underwriting arrangement guarantees the issuing company that a particular sum of money will be raised.
- **Best Efforts Agreement**: Under such an agreement, the underwriter does not guarantee the amount that they will raise for the issuing company. It only sells the securities on behalf of the company.

Due diligence and regulatory filing…

- **Syndicate of Underwriters:** Public offerings can be managed by one underwriter (sole managed) or by multiple managers. When there are multiple managers, one investment bank is selected as the lead or book-running manager. Under such an agreement, the lead investment bank forms a syndicate of underwriters by forming strategic alliances with other banks, each of which then sells a part of the IPO. Such an agreement arises when the lead investment bank wants to diversify the risk of an IPO among multiple banks.

Due diligence and regulatory filing…

Engagement Letter: A letter of engagement typically includes:

- **Reimbursement clause**: This clause mandates that the issuing company must cover all out-of-the-pocket expenses incurred by the underwriter, even if the IPO is withdrawn during the due diligence stage, the registration stage, or the marketing stage.
- **Gross spread/underwriting discount**: Gross spread is arrived at by subtracting the price at which the underwriter purchases the issue from the price at which they sell the issue.

- *Gross spread = Sale price of the issue sold by the underwriter – Purchase price of the issue bought by the underwriter*

Due diligence and regulatory filing…

Letter of Intent:

- The underwriter‵s commitment to enter an underwriting agreement with the issuing company
- A commitment by the issuing company to provide the underwriter with all relevant information and thus, fully co-operate in all due diligence efforts.
- An agreement by the issuing company to provide the underwriter with a 15% overallotment option.
- The letter of intent does not mention the final offering price.

Due diligence and regulatory filing…

Underwriting Agreement:

- The letter of intent remains in effect until the pricing of the securities, after which the Underwriting Agreement is executed.
- Thereafter, the underwriter is contractually bound to purchase the issue from the company at a specific price.

Registration Statement:

- The registration statement consists of information regarding the IPO, the financial statements of the company, the background of the management, insider holdings, any legal problems faced by the company, and the ticker symbol to be used by the issuing company once listed on the stock exchange.
- The SEC requires that the issuing company and its underwriters file a registration statement after the details of the issue have been agreed upon.

Due diligence and regulatory filing…

Parts of registration statement:

- The Prospectus – this is provided to every investor who buys the issued security
- Private filings – this is comprised of information which is provided to the SEC for inspection but is not necessarily made available to the public

Red herring document

- In the cooling-off period, the underwriter creates an initial prospectus which consists of the details of the issuing company, save the effective date and offer price.
- Once the red herring document has been created, the issuing company and the underwriters market the shares to public investors.
- Often, underwriters go on roadshows (called the dog and pony shows – lasting for 3 to 4 weeks) to market the shares to institutional investors and evaluate the demand for the shares.

Pricing

- After the IPO is approved by the SEC, the effective date is decided.
- On the day before the effective date, the issuing company and the underwriter decide the offer price (i.e. the price at which the shares will be sold by the issuing company) and the precise number of shares to be sold.
- Deciding the offer price is important because it is the price at which the issuing company raises capital for itself.
- After the stock starts trading on the secondary market, money is raised through the sale of shares the company, not the underwriter.
- The following factors affect the offering price:
  - the success/failure of the roadshows (as recorded in the order books)
  - the company‘s goal
  - condition of the market economy

Stabilization

- After the issue has been brought to the market, the underwriter has to provide analyst recommendations, after-market stabilization, and create a market for the stock issued.
- The underwriter carries out after-market stabilization in the event of order imbalances by purchasing shares at the offering price or below it.
- Stabilization activities can only be carried out for a short period of time – however, during this period of time, the underwriter has the freedom to trade and influence the price of the issue as prohibitions against price manipulation are suspended.

Transition to Market competition

- The final stage of the IPO process, the transition to market competition, starts 25 days after the initial public offering, once the ―quiet period‖ mandated by the SEC ends.
- During this period, investors transition from relying on the mandated disclosures and prospectus to relying on the market forces for information regarding their shares.
- After the 25- day period lapses, underwriters can provide estimates regarding the earning and valuation of the issuing company. Thus, the underwriter assumes the roles of advisor and evaluator once the issue has been made.

IPO Process - Metrics

Metrics for IPO

- **Market Capitalization**: The IPO is considered to be successful if the company‛s market capitalization is equal to or greater than the market capitalization of industry competitors within 30 days of the initial public offering.
- Market capitalization = Stock Price x Total Number of Company‛s Outstanding Shares
- **Market Pricing:** The IPO is considered to be successful if the difference between the offering price and the market capitalization of the issuing company 30 days after the IPO is less than 20%.

FPO Management

FPO Management

- FPO is an issue of stocks that is released by a company that has previously issued an Initial Public Offering (IPO) and already listed on stock exchange.
- A company intending to offer additional shares to the public registers the offering with regulators, which includes releasing fresh prospectus of the investment.
- As the company is already publicly listed in exchanges and its existing shares are consistently being valued by investors, its shares already having a defined valuation. Hence, any investment banks or underwriters working on the FPO of that company tends to focus on the current market price rather than doing the entire valuation.
- Usually, the price of a follow-on public offering (FPO) is usually offered at a small discounted rate (lower price) from the closing market price on the day of the transaction.

IPO vs FPO

Timing:

- **IPO**: An IPO occurs when a company issues shares to the public for the first time, transitioning from a privately held company to a publicly traded one. It is the initial sale of stock by a private company to the public.
- **FPO**: A FPO occurs when a company that is already publicly traded issues additional shares to the public. It is a subsequent offering made by a company that has already completed its IPO.

Purpose:

- **IPO**: The primary purpose of an IPO is for a company to raise capital to fund its growth initiatives, repay debts, or provide liquidity to existing shareholders. It also allows existing shareholders, such as founders, early investors, and employees, to monetize their investments.
- **FPO**: The purpose of a FPO is typically to raise additional capital for the company after its IPO. Companies may use the proceeds from a FPO to finance acquisitions, expansion projects, research and development, or other strategic initiatives.

IPO vs FPO…

Regulatory Requirements:

- **IPO:** An IPO involves an extensive regulatory process, including filing a registration statement with the Securities and Exchange Commission (SEC) or relevant regulatory authority, undergoing a review process, and obtaining approval before the shares can be offered to the public.
- **FPO**: While FPOs also involve regulatory compliance, they may be subject to fewer regulatory requirements compared to IPOs since the company is already publicly traded and has an established regulatory framework in place.

IPO vs FPO…

Market Conditions:

- IPO: The success of an IPO is often influenced by market conditions, investor sentiment, and the company's growth prospects. Companies typically choose to go public during favorable market conditions to maximize investor demand and pricing.
- FPO: The success of a FPO may also be influenced by market conditions, but companies that are already publicly traded may have more flexibility in timing their offerings based on market conditions and shareholder demand.

IPO vs FPO...

Offering Size and Pricing:

- **IPO:** The offering size and pricing of shares in an IPO are typically determined based on factors such as the company's valuation, financial performance, market demand, and pricing negotiations with underwriters.
- **FPO:** In a FPO, the offering size and pricing are determined based on similar factors as an IPO, but the company's existing stock price and market conditions may also influence the pricing of the additional shares being offered.

THANK YOU