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INITIAL PUBLIC OFFERING (IPO) - INVESTING IN CAPITAL MARKETS OF INDIA: A CRITICAL ANALYSIS

Author 1 - SONAL GUPTA

Designation- 4th Year Student, BA LLB Symbiosis Law School, Hyderabad.

Author 2 - SHIVANI KHAREEDI

Designation- 4th Year Student, BBA LLB Symbiosis Law School, Hyderabad.

ABSTRACT

The research paper aims to understand a part of the world of stock market- primary market. The author discusses the process of investment in the primary market, underpricing of the initial public offering and the survival of initial public offering at the time of the global economic crisis. Initial public offering or IPO is the process of "going public". A private company offers its shares to the public through issuance of IPOs where the company's shares are listed on a recognized stock exchange for the first time for the public to purchase. The issuance of IPOs is a popular method for the companies to acquire capital through the public. Such IPOs are issued by following a process as prescribed by law. The author discusses the process involved in such issuance and the risks involved in investing in such IPOs. Underpricing is a very common practice involved while dealing with IPOs, which affects the board members and owners of the company. Signaling is another important concept that helps the traders to estimate when to invest in such shares. These concepts are discussed in detail in the research paper. Further, the author discusses the relationship between IPOs and Non-Banking Financial Companies (NBFCs). This research helps one to understand how the primary market plays an important role in stock market and how it helps the companies and investors to make more money.

Key Words: *initial public offering, primary market, shares, company, capital, private, public, underpricing, signaling, NBFC*

INTRODUCTION

An initial public offering (IPO) implies the way toward offering shares of a private company or a private corporation to the public in stock issuance. Such issuance of shares to the general public permits an organization to raise capital from public speculators. In the meantime, it also gives a platform to the public financial specialists to carefully analyse and think about the said offering. The procedure of Initial Public Offering (IPO) changes an exclusively held organization into a public organization. This procedure likewise makes an open door for savvy financial specialists to acquire an attractive profit for their speculations. Putting resources into IPOs can be a brilliant move in the event that you are an educated financial specialist. Be that as it may, only one out of every odd up and coming IPO is an incredible chance. Advantages and dangers go connected at the hip. Before you join the temporary fad, it is essential to comprehend the fundamentals. Initial Public Offering is also known as "going public". Primary markets are the spot the associations offer their stocks to individuals when all is said in done or the primary go through honestly to the budgetary experts. Securities are made in the essential market. An instance of essential markets is IPO (first offer of stock, and so forth. Such stocks are sold at a pre-chosen or orchestrated expense. Associations or the organization can sell typical and supported stock, corporate and government protections, notes and bills right currently back or develop their business. They may require an IPO to meet working capital needs. Working capital is expected to maintain the business. Organizations additionally utilize IPOs by getting into new pursuits, extending activities and purchasing new hardware. At the point when you put resources into an IPO, the cost (or cost range) is fixed. The sum is plainly referenced in the organization's outline. Underwriters assume an extremely urgent job during the time spent IPO posting. Underwriters are agents of speculation banks which are engaged with the IPO. They perform due ingenuity, filings with SEBI, estimating, showcasing, roadshows even take out any hazard to the organization or rather ensure a specific measure of raised support (if the concurrence with the underwriter is purchased bargain). By putting resources into an IPO, you can enter the 'ground floor' of an organization with great potential for development. An IPO may be the chance benefit in a faster manner in a small timeframe period. It might also help to develop the organisation's wealth and assets in the long run. Suppose you put resources in a start-up dealing with or selling vexatious innovation. On the off chance that it figures out how to influence the market and rake in benefits, you would pick up from its prosperity as well. The cost per security gave is plainly referenced in the IPO request report. In this way, you approach a similar data as greater financial specialists. This would change in the post-IPO situation. The offer costs after the IPO would rely upon changing business sector rates and the best value that the stockbroker can offer. The research will deal with the process of investment, the risks of investment and other important topics such as under-pricing in the further sections.

This study shall seek to answer the questions mentioned hereinafter on the basis of the data collected-

i. Whether the performance of IPOs in Indian Capital Market helps in short-term returns or long-term results for raising the profits of the company?
ii. Whether the concept of 'Fixed Price' helps in evaluating the maximised returns to a company in investing in IPO?
iii. Whether investing in IPO helps in better performance of NBFCs?

UNDERSTANDING IPO

Initial Public Offering (IPO) is a process where the shares of a private corporation are offered to the public for the first time[1]. Such shares may be either new or existing. This type of issuance of shares allows the companies to raise capital from the public. This is an important process for a company to transition from a private to public company. Until the issuance of IPO, a company is privately owned. Post-IPO, it turns into a publicly traded company. Before issuing IPO, a company has very few shareholders, namely, the founders, directors, angel investors and venture capitalists. But when such IPO is issued, the invitation is given out to the public at large for investing in their company through purchase of shares through the stock market. This stock market is usually known as the primary market as this is where the first sale of stock or shares happen. Primary markets gained popularity in the country from the year 1992[2], in the era of liberalisation. Securities Exchange Board of India (SEBI) replaced the Controller of Capital Issues(CCI) in 1992 as an autonomous statutory authority regulating the capital markets which introduced free-pricing and intended only to regulate the capital markets and not control it. Buying shares from the IPO makes

[1] Adam Hayes, *Initial Public Offering (IPO)*, INVESTOPEDIA , https://www.investopedia.com/terms/i/ipo.asp .
[2] Initial Public Offerings Laws and Regulations | India | GLI, , GLI - GLOBAL LEGAL INSIGHTSINTERNATIONAL LEGAL BUSINESS SOLUTIONS , https://www.globallegalinsights.com/practice-areas/initial-public-offerings-laws-and-regulations/india.

a person a shareholder of the company issuing such shares. A company can decide to go public through this process due to various reasons some of which are listed as follows: (a)*RAISING CAPITAL FOR EXPANSION OR GROWTH:* a private company may issue shares for the purpose of acquiring capital to grow and expand its business. The capital put in by the shareholders, i.e., the founders, directors, angel investors and venture capitalists may not be enough for the further growth and expansion of the company. Company may also require additional capital for paying off existing debts or to produce new products into the market and increase their operations. To achieve this goal, the company may require additional finance. To do so, they may issue shares to the public to purchase which would help the company to gain capital and achieve these goals. (b)*GENERATE PUBLIC AWARENESS:* when a company lists itself on the stock market for IPO it is "star marked" in the stock market's calendar[3]. This creates awareness among investors who get to know more about the company. Such IPOs act as a great source of publicity and is a great way for the company to publicise its products and services. (c) *EXIT STRATEGY FOR EARLY INVESTORS:* sale of stocks through IPO means that the company is being liquidated. Early investors such as venture capitalists sell their share of the company through IPOs through which they get good returns and then they can leave the company. (d) *CREDIBILITY OF COMPANY:* when a company issues shares to the public, it has to get listed on the stock exchange. Such "listed companies" is listed on recognised stock exchanges and is obliged to follow the strict rules and regulations of corporate governance that is prescribed by SEBI and the Indian stock exchanges[4]. This increases the credibility of the company and helps in future investments and acquiring capital again whenever required. The process of IPO is as follows[5]:

A. Hiring a merchant banker: the company hires underwriters or investment banks to kickstart the process of IPO. An underwriter is a financial specialist working closely with the company that wishes to issue their share to the public through the stock markets and determine the price of the securities to be offered in this scheme by method of purchasing such shares from the issuing companies and selling it to the investors using the platform of

[3] What Is An IPO? - Meaning, Advantages & Disadvantages | Investology, , EDELWEISS , https://www.edelweiss.in/investology/introduction-to-primary-market-79a025/what-is-an-ipo-initial-public-offering-6a7c32.
[4] Initial Public Offerings Laws and Regulations | India | GLI, *supra* note 9.
[5] What is IPO – Introduction, Meaning, Pros & Cons | IndiaNivesh, , https://www.indianivesh.in/kb-blog/what-is-ipo
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stock exchanges[6]. This is done by assessing the current financial standing of the company, assess the company's assets and liabilities and formulate a plan to achieve the goals of the company. An underwriting agreement is signed between the issuing company and the underwriter or merchant banker which includes the details of the deal, securities being issued and the amount that is being raised.

B. Filing IPO with SEBI[7]: an application for IPO must be filed with the SEBI which has to include the documents listed for the IPO vetting process[8]. Vetting is a process of thorough investigation by verifying information and may also be known as due diligence[9].
C. Preparing DHRP: Draft Red Herring Prospectus[10] or DHRP as popularly known is nothing but offer document. It is prepared by the underwriter or the merchant banker. It includes all possible information about the company's operations and also specifies the reason for raising money through the public and how it will be used as well as the risks involved in investing in the company but does not include the prices or the number of shares that are being listed on the stock exchange.
D. IPO roadshow: in this step, the listed IPO is promoted. This is done to create awareness among the public that an IPO of the issuing company is on the stock exchange and people interested can purchase the shares and become a shareholder in the company. This is usually done through advertisements.
E. Price band fixing and book building: price band is in auction pricing technique where the issuing company notifies the upper and lower amount for the shares and interested buyers bid for the shares in between these amounts. The merchant bank or the underwriter sets the prices of the shares based on this price band. After setting of the price, the shares are listed on the stock exchange for the public to subscribe to them. On the opening day, the shares are available for subscription for a period of 3 days after which it is finally offered.

[6] Caroline Banton, *Why Underwriters Are the Risk Experts of the Financial World*, INVESTOPEDIA , https://www.investopedia.com/terms/u/underwriter.asp (last visited Oct 30, 2020).
[7] All you need to know about IPO process, , MONEYCONTROL , https://www.moneycontrol.com/news/business/markets/all-you-need-to-know-about-ipo-process-2918911.html .
[8] NSE - National Stock Exchange of India Ltd., , https://www1.nseindia.com/getting_listed/content/listing_process.htm .
[9] Carol M. Kopp, *The Vetting Process Defined*, INVESTOPEDIA , https://www.investopedia.com/terms/v/vetting.asp .
[10] What is DHRP: What is draft red herring prospectus? - The Economic Times, , https://economictimes.indiatimes.com/markets/ipos/fpos/what-is-draft-red-herring-prospectus/articleshow/75005637.cms .

F. Listing day/final offering day: On the basis of market demand for the shares of the company, the issuing company starts trading on the stock exchange at the listed price.

INVESTING IN IPO

When a private company decides to go public by the issue of shares through initial public offering, it is a decision taken after thorough consideration to ensure that the exit of the early investors is smooth and is also profitable. When such decision is taken, most likely, there is scope for future growth of the company. IPOs are generally at a discounted rate to attract as many public investors as possible and helps the issuing company to generate maximum number of buyers from the initial issue of shares itself. Though the discounted low prices are very attractive, any person looking to purchase shares through IPO must keep in mind a few things before investing his money into the company. Some of the important points to look-into before investing in IPO are as follows:

1. It is very important to look into the prospectus given out by the company as it includes lot of important details about the business, its market standing in financial terms, its track record and the prospectus also clearly states why the company is issuing IPO. Usually, a person can take an informed decision whether investing in the IPO of a company is beneficial to him in the future by closely looking into the prospectus. If he sees any red flags in the same or sees any important information is missing, he can make an informed decision whether he wants to go ahead with his decision of investing in the said company.
2. Determining priorities[11]: before diving into the world of IPO, an individual investor must assess a few things to choose the perfect IPO to invest in to get maximum results. Along with perusal of the prospectus, one must also look into his own goals. In this scenario, goals would mean what he would like to expect from such investment. For this, one must be aware of his investment budget, upto what level can he afford taking a risk and his financial goals. By determining these 3 points, one can choose the best suited IPO for his portfolio and invest in it for maximum profits.

[11] Is it Good to Invest in IPO in India?, , ANGEL BROKING , https://www.angelbroking.com/knowledge-center/ipo/is-it-good-to-invest-in-ipo-in-india .

3. Investing in business[12]: investing in an IPO means investing in the business of the company. One should closely assess the performance of the company and not invest solely on the popularity of the brand name of the company. Your investment will be affected by the performance of the business. Hence, one must invest in an IPO after close consideration of the fortune and the business performance of the company.
4. Stock market reliability: the stock market fluctuates within seconds. It is important to understand that there is a risk factor involved when investing in shares and stocks on the stock market. It is subject to change. Investments made can boom to great levels and give a lot of profits but at the same time it can also cause erosion of the invested amounts. Vigilance is key while investing in the stock markets and IPOs.

There are various risks involved while investing in IPOs some of which are listed below:

1. No guaranteed shares[13]: in the pre-IPO share distribution process, any number of persons can subscribe to the shares; there is no cap on how many persons can subscribe to the shares of the issuing company. But at the time of allotment of shares this may pose to be a problem to smaller investors as there is a possibility that very few of no shares are allotted to them. This is because such allotment happens on a proportional basis and hence the smaller investors may not stand a chance of getting the shares of the company due to the allotment mechanism if there are too many subscribers to the shares.
2. Risk of losses: as a listing gain, it is an available option to invest in the IPOs of new businesses. But here, the risk of not knowing how the business will perform can prove to be a loose end. It is advised that adequate research about the company and its credentials and financials is looked into before investing to avoid losses. Even as the older businesses put up IPOs, it is always to have a thorough check of the company and its credentials and financials in order minimise the risk of losses of the invested money in the shares of such company.

[12] What is IPO – Introduction, Meaning, Pros & Cons | IndiaNivesh, *supra* note 12.
[13] 5 Risk Factors Involved in Applying for an IPO, , https://www.ekvity.com/5-risk-factors-involved-in-applying-for-an-ipo.php .

3. Repayment of broking house loans[14]: a lot of broking houses give out loans for the purchase of shares in IPOs. The dynamic of this system is such that the investor can take a loan from a broking house if the investor does not have sufficient money to purchase the shares. He can put in a fraction of the amount and the broker puts in the rest and the IPO is purchased. This is a good option to dive into if there are high chances of the business going well and getting profits. In case the business does not go well and the shares are going downhill, it can cause huge losses to the investor as he may not be able to repay the loan as the broking houses charge high interest rates on the loan taken.

UNDERPRICING AND SIGNALLING

Signalling essentially means following market trends and signals for initiation of trading positions[15]. Technical analysis is used to facilitate such signalling. Such signalling can be done by closely observing company insiders. This is because they have better knowledge of the company's business and hence observing their trading can prove to be beneficial for an outside investor to make better decisions regarding investment in the company's IPO. But using such insider information to manipulate the stock market is illegal and can attract serious legal consequences. The outside investors may watch the insiders to gain insight on the company's performance and business and can figure out the company's stock price's overall trend. By doing such close observation and gaining insights, one can make an informed decision whether to invest in such company and also whether such investment will be profitable or not in the future.

Underpricing is when the IPO is listed at a price below its real value in the stock market. When after the first day of trading, when the IPO closes above the set price, the stock is considered to be underpriced[16]. When the stocks are underpriced, it directly affects the initial or early investors of the company as they suffer losses and hence, they discourage this practice as it is not beneficial for their exit. But the investment banks prefer such underpricing strategy as it would mean that a

[14] IPO Investing: Is It Worth the Risk?, , CLEARTAX CHRONICLES (2020), https://news.cleartax.in/ipo-investing-is-it-worth-the-risk/ .

[15] Gordon Scott, *Signaling Approach Definition*, INVESTOPEDIA , https://www.investopedia.com/terms/s/signallingapproach.asp .

[16] Julia Kagan, *What Is Underpricing an IPO?*, INVESTOPEDIA , https://www.investopedia.com/terms/u/underpricing.asp .

greater number of stocks are sold. When a company applies the underpricing strategy it can be seen as a sign of credibility. This is because such underpricing would mean that the company cares about its investors and only good firms can be expected to recoup such loss after their performance is realized. Such underpricing conditions the interpretation of the investors that said firm will give them good dividends. Any company's IPO whose price increase after the first day of trading is considered to be underpriced. Such underpricing may be done on purpose to boost the demand or may be accidental because the underwriter may not have anticipated such demand for the company's IPO.

Evidence suggests that underpricing can signal favourable prospects for the firm[17].

IPO, BANKS AND NBFC'S RELATIONS

IPO has a relationship with banks and non-banking financial company (NBFC) that helps in the functioning and facilitation of the IPO. First, the relationship between banks and IPO is discussed as follows:

After nationalisation of banks in 1969[18], the Government of India, banks were used to implement national policies and sometimes even political agendas with the explicit expectation from the Government of India that regularly, capital would be infused to support any losses incurred due to loans. With progression in time, the Government of India has kept the promise of capital infusion but at the same time, it requires the banks to also raise money from the markets. Such bank IPOs affect the financial system to a great extent. All the money or capital acquired from the public through IPO is a source of income for the banks and this amount is used for growth and expansion of banks across the nation. The liberalisation, privatisation and globalization that took place in this time period, allowed the banks and other NBFCs to flourish with capital generation through IPO. In the late 2000s when the global economic crisis occurred, the Indian capital markets and the

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[17] Franklin Allen & Gerald R. Faulhaber, *Signalling by underpricing in the IPO market*, JOURNAL OF FINANCIAL ECONOMICS (1989), https://scinapse.io/papers/2089858078

[18] Indian Banking Sector - IPO Scenario and its Impact.pdf, , https://www.icsi.edu/media/webmodules/publications/Indian%20Banking%20Sector%20-%20IPO%20Scenario%20and%20its%20Impact.pdf .

issue of IPO was affected to a great extent. But the Indian markets picked up pace soon after and managed to keep afloat the IPOs, which resulted in minimal damage to the IPO system.

Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956[19]. It undertakes the business of advances and loans as well as acquiring stocks or shares or bonds or debentures or any other type of securities or any other marketable securities. NBFCs compete for similar kinds of businesses as the two are in the similar sector of finance. NBFCs offer services that include corporate loads, IPO funding, nonconvertible debentures and venture capital among others. Seeing the growing competition among the banks and NBFCs, the Reserve Bank of India placed certain restrictions on the NBFCs and allowed the banks to finance certain activities including finance for NBFCs for further lending to individuals for subscription of IPOs[20]. These NBFCs give loans and act as broking houses to individuals wishing to invest in IPOs where the individual pays a minimal amount, and the rest is paid by the lender[21]. Some popular NBFCs involved in such activities are Edelweiss, Sharekhan, Aditya Birla Money etc. Sometimes, the NBFC themselves are listed on stock exchange for raising capital to meet the needs of the business operations.

SUGGESTIONS AND CONCLUSION

When a company is at the right stage of its development, the best decision it can take is to go public by the issue of initial public offering. It is the best method to include the public and make them shareholders in the company. This can be beneficial for the company's goals by helping it to earn more capital to conduct more business and flourish in the tremendously growing market. It is important to understand how the IPO helps not only the company but also the public investing in it. In the above discussion, the author has elaborately explained the meaning, characteristics and functioning of initial public offerings and its process. The author has further pointed out how investing in IPOs is risky but after careful consideration, such investment can yield good returns.

[19] Reserve Bank of India - Frequently Asked Questions, , https://www.rbi.org.in/Scripts/FAQView.aspx?Id=92.
[20] Reserve Bank of India - Non Banking Financial Companies(NBFCs), , https://www.rbi.org.in/Scripts/BS_NBFCNotificationView.aspx?Id=3207 .
[21] IPO Funding in India (IPO Loan Process) Explained, , https://www.chittorgarh.com/article/ipo-funding-in-india-explaned-ipo-loan-process/205/

Further, the author has discussed a major concept in the IPO world, i.e., underpricing and how it helps the company itself, the investors, and its impact on the initial shareholders of the company. Emphasis is also laid upon the global economic crisis that took place in the late 2000s which affected the performance of IPOs worldwide. It is crucial to note that the IPOs can prove to be a turning point in the performance of a company and in turn it affects the investments made by the public in the said company.