# Grading Initial Public Offerings (IPOs) in India's Capital Markets A Globally Unique Concept

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## Abstract

*IPO grading assesses the fundamentals of the Initial Public Offerings (IPOs) and is reflected on a five-point point scale (1-5) with a higher score indicating stronger fundamentals of the IPO issuing firm. SEBI (India's capital market regulator) introduced the IPO grading as a mandatory requirement for all IPOs, and the requirement seems to have been borne by the fact that, in India, where institutions are less developed and retail participation in IPOs is significant, quality signal represented by an IPO grade yields discernible benefits to the market. We note that while SEBI and the rating agencies advocate the benefit of the IPO grade, not everyone in the industry and academia is convinced of the grade's merits.*

*To analyze the efficacy of IPO grading, we conducted regression analysis study of a total of 63 IPOs that have been graded. Through this study, we find that securities with higher IPO grades tend to exhibit under-pricing to a lesser extent. We also find that, with higher IPO grades, the subscription rate of the IPOs improves across all class of investors, including retail investors. We also find that IPO grades are inversely related to the short-term liquidity of the IPOs, i.e. at least in the short term, higher graded IPOs don't exhibit high turnover ratio. We further find that the IPO grade fails to explain with any significance the subsequent market performance of the issues in terms of capital gains.*

Key words: IPO, IPO grading

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# Introduction

As a first of its kind among securities market regulators in the world, the Securities & Exchange Board of India (SEBI) after much deliberation introduced a new requirement effective May 1, 2007 that a firm planning to be listed in the stock exchange obtain a grading of its Initial Public Offering (IPO), prior to the IPO issue, from at least one rating agency that is registered with SEBI.

Arriving at the decision was with a belief that the IPO grade represented a relative assessment of the fundamentals of that issue in relation to the other listed equity securities in India. Furthermore, SEBI believed that an IPO grade provided an additional input to investors, in arriving at an investment decision, based on independent and objective analysis. Hence, IPO grading can be seen as an endeavor to make additional information available to the investors in order to facilitate their assessment of equity issues offered through an IPO.

The decision to introduce the requirement recognized the specific needs of the Indian capital market and was the result of pressure from certain investor groups. However, the path to mandatory grading of IPOs has been rocky, with opposition from companies, investment bankers, fund managers, market experts and even the SEBI board members[2]. The parties that are in opposition want the grading to be an optional exercise. They argue that the mandatory grading has increased the cost of raising funds and also has led to delay in the IPO process, which SEBI was attempting to make faster and shorter with the help of grading. Given that the grading expenses have been as high as one percent of the total issue size in some cases, some of the concerns by the opposition deserve consideration.

The initial introduction of IPO grading requirement was launched was launched as an optional one. However, with the purpose of bringing additional transparency to the market, the requirement was further changed to a mandatory one.

The question that arises is whether a grading of this kind is needed given that the most efficient capital markets in the world such as in the United States and in Europe don't have a mandate for such a rating.

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[2] Retrieved from: http://www.financialexpress.com/news/Why-IPO-ratings-should-be-welcomed/127924/ on Nov 18, 2008

## IPO Grading and Criteria for Evaluation

SEBI's guidelines suggest that the grading of IPOs is a service aimed at facilitating assessment of equity issues offered to the public. The Grade assigned to any individual IPO is an assessment of the "fundamentals" of the issuer concerned on a relative grading scale, in relation to the other listed equity securities in India.[3] The grading is assigned on a five-point point scale with a higher score indicating stronger fundamentals and vice versa as below.

IPO grade **1**: *Poor fundamentals*

IPO grade **2**: *Below-average fundamentals*

IPO grade **3**: *Average fundamentals*

IPO grade **4**: *Above-average fundamentals*

IPO grade **5**: *Strong fundamentals*

The Grading exercise emphasizes on evaluating the prospects of the industry in which the company operates, and the company's competitive strengths that would allow it to address the risks inherent in the business(es). In case the IPO proceeds are planned to be used to set up projects, either Greenfield or Brownfield, the grading evaluates the risks inherent in such projects, the capacity of the company's management to execute the same, and the likely benefits accruing from the successful completion of the projects in terms of profitability and returns to shareholders.

Accordingly, IPO Grading methodology examines the following key fundamentals[4]:

♦ Business and Competitive Position -The alignment between industry opportunities, the company's strategy and objectives

♦ Financial Position and Prospects - Forward looking assessment of key financial indicators such as RoE, EPS, P/E, growth in profit, relevant for an equity investor

♦ Management Quality – An evaluation of the ability of the management to handle uncertainty in terms of capitalizing on future business opportunity and mitigating the impact of contingencies

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[3] Retrieved from http://www.sebi.gov.in/faq/ipo.html on November 21, 2008
[4] Retrieved from www.crisil.com/ on November 22, 2008

♦ Corporate Governance practices – An evaluation of the company's governance architecture to determine if it is structured such that the risks and rewards of business are equally available to all shareholders

IPO grading is a one time assessment done prior to the IPO issue and relies significantly on the draft prospectus filed with SEBI.  Normally, grading is done looking at roughly a three year time horizon and would involve an in-depth assessment of the various quantitative and qualitative parameters of the issuer.  While growth prospects of the industry and financial strength are some of the quantitative parameters, qualitative parameters such as management capability also provide critical input in determining a grade.[5]

It is worth noting that IPO grading is <u>NOT a recommendation to buy, sell or hold</u> the securities.  Similarly, it is <u>NOT a comment on the valuation or pricing of the IPO</u> nor is it an indication of the likely listing price of the securities.

## Is IPO Grading Necessary?

Given that no other capital market in the world practices such a grading scheme, what is unique about India's capital market that calls for IPO grading?  To assess the necessity, it is prudent to first look at the views of the various stakeholders.  The primary stakeholders in this context are SEBI, the rating agencies, the firms aspiring to issue an IPO, and the investors.

### SEBI's View

An investor may find it challenging to appropriately assess, on the basis of the information available on the prospectus, a firm's business prospects and risks.  SEBI's belief is that an IPO grade provides an additional input to investors, in arriving at an investment decision.  In recent times, with the stock market participation of new and foreign investors increasing in India, SEBI contends that there is need for greater value-added information on companies tapping the capital market and their intrinsic quality. In this context, IPO grades, being simple, objective indicators of the relative fundamental positions of the issuers concerned, helps in both widening and deepening the market.

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[5] Retrieved from http://www.careratings.com/ on November 22, 2008

SEBI has further said that as the IPO grading does not take into consideration the pricing of the security, it is not an investment recommendation. Rather it is only one of the inputs for the investor to aid in the decision making process. To that effect, SEBI's view is that all other things remaining equal, a security with stronger fundamentals would command a higher market price.

SEBI believes that it has taken a pioneering role in safeguarding investors' interest by increasing disclosure levels by entities seeking to access equity markets for funding. This has caused India to be amongst one of the more transparent and efficient markets in the world. A majority of retail investors do not read the offer document (prospectus) and even when they do, they may not fully disseminate or comprehend the implications of the disclosures made. Therefore, SEBI's belief is that there is a vital need to rate equity offerings, helping investors separate good floats from risky ones.[6]

## Grading Exercise - Optional to Mandatory

When first introduced in April 2006, SEBI kept the IPO grading as an optional exercise. This meant that issuers were not required to get their IPO graded, but in the event that they obtain a grading, they were required to disclose it in the prospectus. However, despite more than 40 IPOs expected to hit the market in the first half of 2006-07, only four companies approached the agencies for their rating. Incidentally, they did not accept the ratings awarded to them as the ratings did not match up to their expectations.[7] Additionally, there was no incentive for the companies to rate their IPOs. A tricky situation prevailed where in a good company would not go for the rating fearing that if it gets a bad rating, its issue might suffer despite strong fundamentals. Similarly, a bad company too would not go for the rating fearing that its cover ups might get exposed with a poor rating. Looking at these uncertainties, SEBI decided to make IPO grading a mandatory exercise effective as of May 1, 2007.

SEBI chairman M. Damodaran explains the decision to make IPO grading a mandatory exercise: "*When the market started going up suddenly a lot of people [companies] started coming to the market. It is not that only the best and the brightest continue to come to the*

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[6] The Chartered Accountant, July 2006
[7] Business Line, 20th March, 2006

*market, there are a lot of other people [companies] who started entering the market. One of our concerns is whether we are going to have another round of 'vanishing companies' which will raise money and never spend it for the intended purpose. I firmly believe that [IPO] grading, if made mandatory, will prevent vanishing companies in future.*"[8]

## Rating Agencies' View

Until now, research has been available to equity investors only in the form of investment advice (buy/sell/hold recommendations). Rating agencies contend that an IPO grade brings an independent, unbiased assessment of the fundamentals of the IPO issuing firm. The fundamentals, as stated earlier, can be looked at in terms of factors such as competence of management, competitive edge, operating efficiency and profile of promoters.

Although there are some reservations regarding the degree of unbiased nature of the IPO grade, which we shall look at later in the paper, the rating agencies believe that the assessment is in no way influenced by the issuer and therefore brings fresh perspective to the market.

Rating agencies further substantiate that the IPO grade summarizes the voluminous data in the prospectus and its implications, which a lay investor may not be able to comprehend. In response to the fact that there isn't a lot of clarity in the market as far as what an IPO grade indicates, the credit rating agencies point out that the investors should not misconstrue an IPO grading to be an investment decision. Rather, it is only one of the inputs to the investor decision making process. It needs to be read together with the disclosures made in the prospectus as well as the price at which the shares are offered.

One of the rating agencies, CRISIL, believes that grading helps if investors know where exactly it belongs in their investment decision process. CRISIL further states that the investment decision making is a three-step process as outlined in figure 1[9]:

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[8] Retrieved from http://www.hindu.com/2007/04/09/stories/2007040900921500.htm on November 27, 2008
[9] Money Today, August 21, 2008

**Figure 1**

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┌──────────────────────────────────────────────────────────────────────┐
│  ┌───────────────┐    ┌────────────────┐    ┌────────────────┐        │
│  │ Analysis of   │    │ Analysis of    │    │ Investor       │        │
│  │ fundamentals  │    │ Returns        │    │ Preference     │        │
│  │ (Addressed by │    │ (Is the        │    │ (Is this the   │        │
│  │ IPO Grade)    │    │ security being │    │ right          │        │
│  │               │    │ offered at the │    │ investment for │        │
│  │               │    │ right price?)  │    │ me?)           │        │
│  └──────┬────────┘    └───────┬────────┘    └───────┬────────┘        │
│         │                     │                     │                 │
│         └──────►  ┌───────────────────────┐  ◄──────┘                 │
│                   │  Investment Decision  │                           │
│                   └───────────────────────┘                           │
└──────────────────────────────────────────────────────────────────────┘
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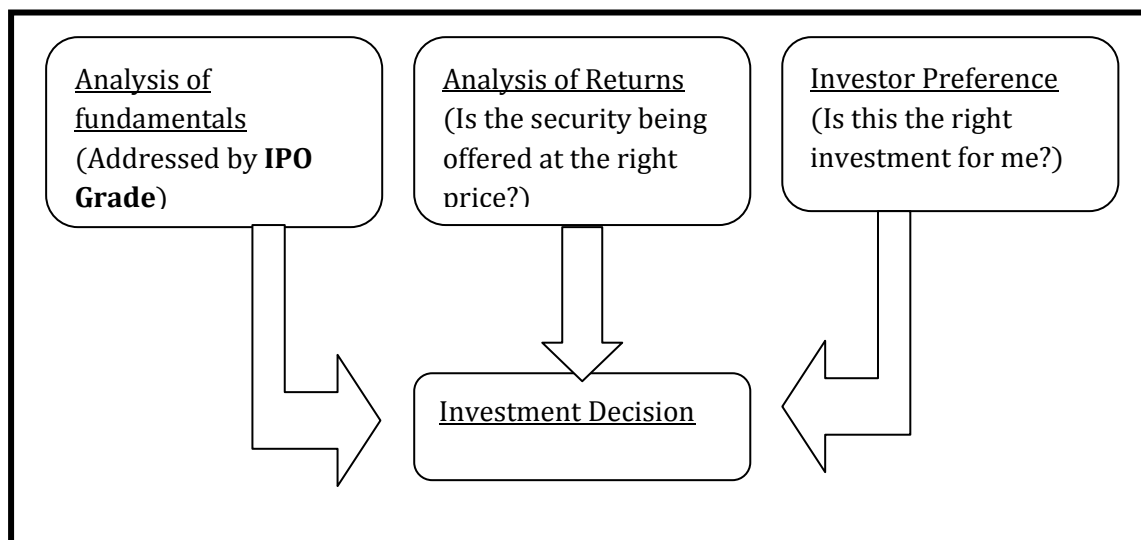
The decision matrix above further stresses that the IPO grade should not be used for assessing the price of the issue. For such information, other useful tools such as comparison of the price/earnings (P/E) ratio projections and growth with that of other companies in the same industry should be made.

The rating agencies compare the fundamentals of the IPO firm to those of other listed firms in the primary and the secondary market. This is done with an understanding that if IPO grading is to meet investors' needs, the relative comparison set of potential IPO companies must include all companies that are potential investment equity options for the investor.[10] Doing so benefits the issuer company by benchmarking itself with its peers.

Additional benefit of the IPO grade, in the eyes of the rating agencies, is particularly significant for the smaller firms. While the large and well-known companies would not find it difficult to raise funds, the middle rung companies would like their equity to be graded such that they could access funds without much track record of their performance.[11] "*Rating will certainly facilitate those companies which are not very well known, to tap the markets*" said Mr. Naresh Takkar, Managing Director, ICRA Ltd.[12]

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[10] Investors' FAQs on CRISIL IPO Grading
[11] Financial Express, April, 1996
[12] Business Line, Mar 24, 2007

## Other Stake holders' Views

Along with SEBI and the rating agencies who are advocates of the IPO grading system, there are other stakeholders, some of whom believe in the merits of the IPO grade, while others oppose it.

Initially, SEBI sources had disclosed that the cost of the grading would be borne by the Investor Protection Funds administered by the stock exchanges, or by Investor Education Protection Funds (IPF) administered by the Ministries of Companies Affairs. However, the onus of bearing the cost of obtaining the grade has since been transferred to the companies themselves. There does not seem to be any justification for having shifted the cost responsibilities from IPF to the companies. Due to lack of justification on this, some in the finance industry have suggested that the IPO grading has increased the cost of raising funds in the capital market.[13] Also, since payment would now be made by companies to rating agencies, would some level of biasness be involved in the equation? Would their be a conflict of interest in the hands of the rating agencies in that they would want to assign a high grade to a company in order to increase the likelihood of getting paid?

Some have argued that the term "IPO grade" is misleading, because if it were a true grading exercise, it would take into account the price at which the shares are offered. Mridul Sagar, chief economist, Kotak Securities says: "*Pricing of shares is the most critical factor in evaluating IPOs and by not taking the pricing into consideration, the usefulness of grading is diminished.*"[14] From an investment standpoint, a good company with an issue that is priced high can be a bad investment, regardless of the fundamentals. With the IPO grade not taking into cognizance the offer price, the intentional under-pricing of issues does not get addressed with the IPO grade, as some have argued.

The other argument is that given the details of the company's projections in terms of target growth, Price to Earning (P/E) ratio, already available in the prospectus, which is subject to SEBI's approval, the need for an IPO grade is not justified. Moreover, if a good company is given poor rating, the company's IPO plans might get shelved. Contrary to the rating agencies' view that small companies benefit from the IPO grade, some argue that vulnerable

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[13] The Economic Times, Nov 10, 2008
[14] Money Today, June 26, 2008

are the small and medium enterprises (SMEs) as most rating agencies are known to treat SMEs with little respect, and thus could assign them poor grades.

Even though the IPO grading process is to be carried out in parallel along with other pre-issue activities, there is belief that one more layer of deliverable has led to the delay in the overall IPO process. The IPO grading is required to be completed and disclosed in the final prospectus; therefore until the grading is complete, the filing of the final offer document to the registrar of companies (RoC) remains pending.

However, not all in the industry are pessimistic. Siddhartha Sankar Saha, lecturer of Accounting & Finance at St. Xavier's College, in his article on --The Chartered Accountant--, argues that at certain times, a company may not know the extent of its own performance, and a grading by an independent rating agency would be useful. He suggests that IPO grading is particularly useful for companies with no track record of prior market performance. He suggests that IPO grading serves as an investment assistance device to enable more realistic pricing of shares. To that effect, he suggests, a high grade could allow issuing companies to demand a better premium on their offer.[15] He also argues that the IPO grade allows investors to understand the fundamentals of the company via a standard set of disclosures, rather than page through the voluminous prospectus.

Saha also suggests that the grading can be an impediment for weak companies. These companies will find it difficult to create speculative demand among investors. Therefore, IPO grading behaves as a deterrent for weak companies planning to come to the market to raise easy capital.[16]

## The Process of Obtaining an IPO Grade

The grading agencies that are approved by SEBI to carry out the grading are as follows:

♦ Credit Analysis & Research Ltd (CARE)
♦ Credit Rating Information Services of India Limited (CRISIL)
♦ FITCH Ratings
♦ ICRA Limited

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[15] The Chartered Accountant, July, 2006
[16] The Chartered Accountant, July 2006

To initiate the process of obtaining an IPO grade, the company first contacts one of the grading agencies.   The steps involved in the grading process are as follows:[17]

***Step I:*** The issuer shares the required information with the grading team of the rating agency

***Step II:*** Rating agency follows up with detailed management meetings with the CEO, CFO, and the board of directors, and further follows up with subsequent site visits

***Step III:*** The grading team prepares a detailed note and grading committee assigns the grade

***Step IV:*** Grading agency publishes a grading rationale outlining the reasons for the assigned grade

***Step V:*** Grading agency sends the grading report to SEBI, stock exchanges, and to the company

The issuing company then discloses the IPO grade on the prospectus that it files with the RoC (Registrar of Companies).  Please see Exhibit 1 for an example of a prospectus with a disclosed IPO grade.

The flow diagram in figure 2 below depicts the IPO grading process:

**Figure 2**



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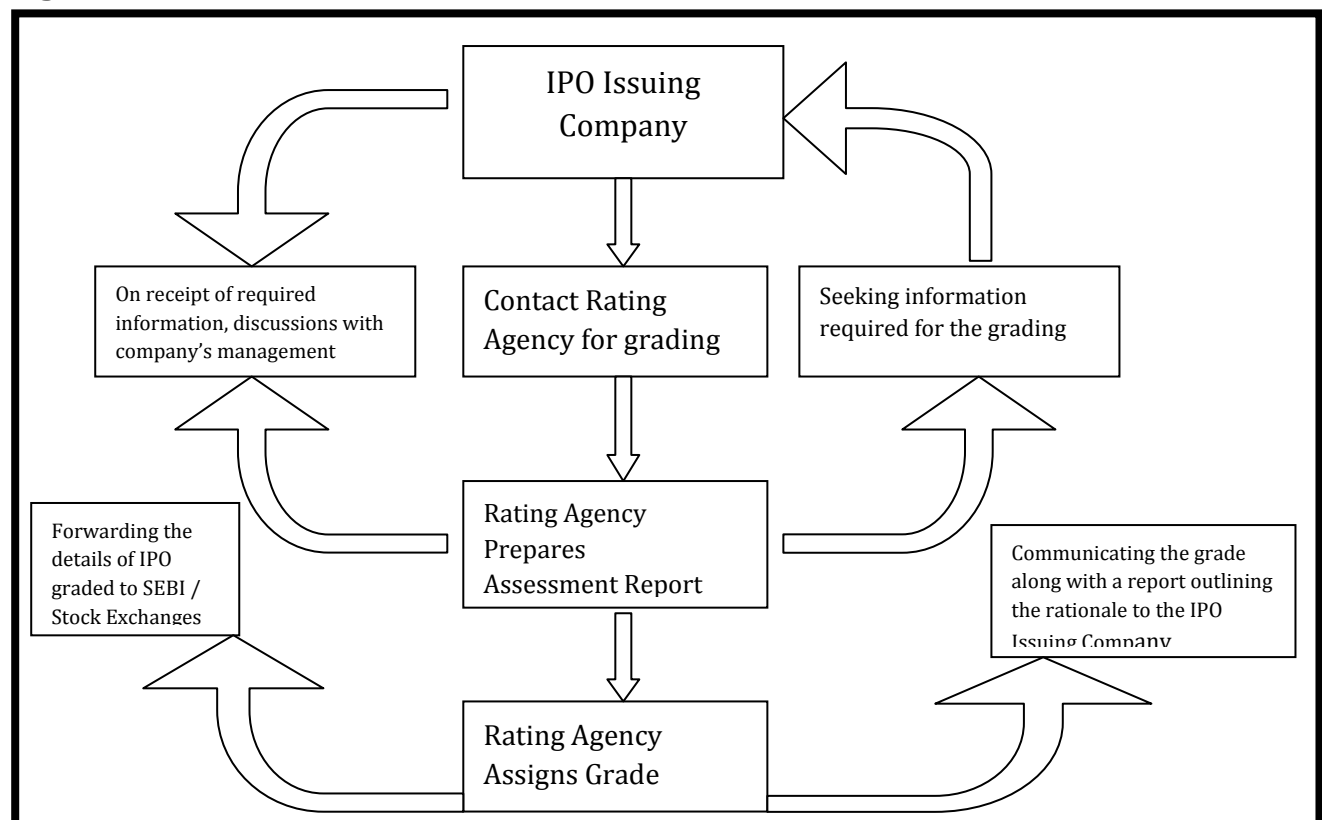
[17] The Investors' FAQs on CRISIL IPO Grading

The entire process depicted in figure 2 above is expected to take anywhere from 3 to 6 weeks.

## Rationale for Assigned Grades

In an effort to gauge what sort of firm characteristics the rating agencies look for before arriving at a particular grade, we look at the rating agencies' justification for some of the grades assigned.  We note again that the grades are assigned on a 5 point scale (1-5).  Out of the 63 graded IPOs that we have studied, the highest and the lowest grades assigned have been a 4 and 1 respectively.

## Rationale for Grade 4 (out of 5)[18]

CARE's justification in assigning a grade of 4 to a firm in the infrastructure sector:[19]

*"The grading factors in the long experience, **well entrenched position** in the construction industry."*
*"The rating takes into account the **improvement in the financial position** of the company."*
*"The company is leveraging strategic relationships with global infrastructure companies to **enhance their project bidding and development capabilities.**"*
*"Total income in FY06 has depicted a **quantum jump**."*
*"Consolidation coupled with low operational expenditure contributed to **healthy PBILDT** margins…."*
*"The company is currently enjoying a **debt free status**."*

CRISIL's justification in assigning a grade of 4 to a firm in the telecom sector:[20]

*"The grading reflects the firm's position as the **largest player** in the mobile value-added services (VAS) market in India…."*
*"The grading also reflects the firm's **ability to leverage** on the unique voice recognition capability…..and its ability to offer customer contact products to companies by virtue of having a voice channel **relationship with almost all telecom operators**."*
*"The grading also factors in the **management's strong understanding** of market dynamics, as reflected in the company's consistent track record in product innovation, and pro-activeness in setting up a corporate governance system…, as indicated by the appointment of independent directors."*
*"The firm plans to reduce its dependence on the Indian market by **expanding** into **international** markets.  In the last one year the company has made **two acquisitions**…"*

## Rationale for Grade 1 (out of 5)[21]

CRISIL's justification in assigning a grade of 1 to a firm in the mining sector:

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[18] This grade indicates that the fundamentals of the issue are above average in relation to other listed equity securities in India

[19] Retrieved from http://www.careratings.com/archive/1/2471.pdf on December 10, 2008

[20] Retrieved from http://www.crisil.com/research/research-ipo-grading.htm# on December 10, 2008

[21] This grade indicates that the fundamentals of the issue are poor in relation to other listed equity securities in India

*The grading reflects **weak management** capability of the firm and its present **uncertain business model**…."*

*"The company's financial returns are also **vulnerable** to spot price movements of the raw material..."*

*"The company management **lacks depth** since the key management personnel have a **limited understanding** of the business.*

*"The limited management capability is also reflected in its **significant dependence** on third-party consultants..".*

*"The grading also reflects the firm's **below-average corporate governance** structure."*

ICRA's justification in assigning a grade of 1 to a firm in the agrochemicals sector:[22]

*"The grade assigned by ICRA reflects the firm's **small scale of operations**, the high intensity of competition in the **fragmented** agrochemicals industry, the company's **extremely high working capital intensity**, the **vulnerability** of its earnings to agro-climatic conditions and its **below average corporate governance practices**."*

## Differences in IPO Grading and Credit Rating

The concept of IPO grading being a unique one, it is worthwhile to note a few underlying differences between IPO grading and credit rating.

1. While credit rating is assigned based on past responsibilities of debt payment along with future capabilities, IPO grade is assigned based solely on fundamentals and on assessment of the future performance

2. Companies that are likely to raise far more equity than they need in an IPO and hence suffer a depressed return on equity (RoE) are likely to be assessed unfavorably in the IPO grading exercise; However, they are likely to be assessed more favorably in a credit rating exercise, as more equity lowers the debt to equity (D/E) ratio and provides cushion to assume more debt[23]

3. The focus while assigning an IPO grade would be in projected RoE, EPS, and growth in profits, while the focus while assigning a credit rating would be on projected cash flows in relation to debt servicing

4. Credit rating is assigned based on a promise to pay a fixed sum at regular intervals regardless of the performance of the project for which the funds were borrowed; On the other hand, IPO grading constitutes an arrangement whereby the investors' returns are contingent on the performance of the project being financed[24]

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[22] Retrieved from http://www.icra.in/Files/PDF/Gradings/GradingNews/2008-Aug-Chemcelb.pdf on December 10, 2008
[23] The Investors' FAQs on CRISIL IPO Grading
[24] Financial Express, March 1995

5. Credit ratings are used for the valuation of buy/sell/hold recommendations on bonds, where as IPO grading has no bearing on buy/sell/hold recommendations of equity

## Analysis of IPO Grading

We now turn to the analysis of the IPO grading. Our motivation is to investigate the efficacy of the IPO grade, among other complex set of signals available to the investors at the time of IPO offerings by firms. We discuss the relative effectiveness of IPO grades in determining short term liquidity, under-pricing, short term market performance, and subscription rate (both overall and retail) of IPOs as dependent variables.

The data we have collected comprises of 63 companies that have issued IPOs from the period April 2005 to November 2008. The databases were screened for IPOs and only those IPOs, which were graded by at least one of the rating agencies.[25] Of the 63 graded IPOs, six were issued prior to May 1, 2007 (date as of when IPO grading became mandatory). Eleven out of 63 IPOs were issued using the fixed price underwriting method, while the rest were issued using the book built underwriting method.

We also note that in cases where an IPO has been graded by more than one rating agency (a total of three IPOs were rated by more than one rating agency), we have considered only the highest of the given grades in our analysis. .

Table 1 lists the companies, IPO list date, and the IPO grades.

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[25] Databases used: PROWESS (CMIE – Centre for Monitoring Indian Economy), CAPITALINE (http://www.capitaline.com), and INSIGHT (http://.insight.asiancerc.com)

## Table 1

| Company | IPO List Date | IPO Grades (Scale 1-5)* | Company | IPO List Date | IPO Grades (Scale 1-5)* |
|---|---|---|---|---|---|
| Alkali Metals Ltd | 6-Nov-08 | 2 | Cords Cable Industries Ltd | 13-Feb-08 | 3 |
| Chemcel Biotech Ltd | 13-Oct-08 | 1 | J Kumar Infraprojects Ltd | 12-Feb-08 | 2 |
| 20 Microns Ltd | 6-Oct-08 | 3 | Reliance Power Ltd | 11-Feb-08 | 4** |
| Austral Coke & Projects Ltd | 4-Sep-08 | 2 | Future Capital Holdings Ltd | 1-Feb-08 | 3 |
| Resurgere Mines & Minerals India Ltd | 1-Sep-08 | 1 | Porwal Auto Components Ltd | 14-Jan-08 | 3 |
| Nu Tek India Ltd | 27-Aug-08 | 3 | Precision Pipes & Profiles Company Ltd | 11-Jan-08 | 4 |
| Vishal Information Technologies Ltd | 11-Aug-08 | 3 | B G R Energy Systems Ltd. | 3-Jan-08 | 3 |
| Birla Cotsyn India Ltd | 30-Jul-08 | 3 | Brigade Enterprises Ltd | 31-Dec-07 | 3 |
| Somi Conveyor Beltings Ltd | 24-Jul-08 | 2 | eClerx Services Ltd | 31-Dec-07 | 3 |
| K S K Energy Ventures Ltd. | 14-Jul-08 | 3 | Transformers & Rectifiers India Ltd | 28-Dec-07 | 4 |
| Lotus Eye Care Hospital Ltd | 11-Jul-08 | 3 | Jyothy Laboratories Ltd | 19-Dec-07 | 4 |
| First Winner Industries Ltd | 8-Jul-08 | 1 | Renaissance Jewellery Ltd | 12-Dec-07 | 2 |
| Archidply Industries Ltd | 4-Jul-08 | 3 | Edelweiss Capital Ltd | 12-Dec-07 | 4 |
| Avon Corporation Ltd | 3-Jul-08 | 2 | Empee Distilleries Ltd | 26-Nov-07 | 3 |
| Sejal Architectural Glass Ltd | 1-Jul-08 | 1 | Allied Computers International (Asia) Ltd | 23-Nov-07 | 1 |
| Niraj Cement Structurals Ltd | 19-Jun-08 | 1 | Varun Industries Ltd | 22-Nov-07 | 1 |
| Bafna Pharmaceuticals Ltd | 7-Jun-08 | 2 | Religare Enterprises Ltd | 21-Nov-07 | 3 |
| Anu's Laboratories Ltd | 4-Jun-08 | 2 | Saamya Biotech (India) Ltd | 19-Oct-07 | 1 |
| Gokul Refoils and Solvent Ltd | 4-Jun-08 | 3 | Consolidated Construction Consortium Ltd | 15-Oct-07 | 3 |
| Aishwarya Telecom Ltd | 7-May-08 | 2 | Central Bank of India | 21-Aug-07 | 4 |
| Kiri Dyes & Chemicals Ltd | 22-Apr-08 | 2 | Surya Chakra Power Corporation Ltd | 23-Jul-07 | 2 |
| Titagarh Wagons Ltd | 21-Apr-08 | 3 | Celestial Labs Ltd | 17-Jul-07 | 1** |
| Sita Shree Food Products Ltd | 7-Apr-08 | 2 | Ankit Metal & Power Ltd | 10-Jul-07 | 1 |
| Gammon Infrastructure Projects Ltd | 3-Apr-08 | 4 | Hilton Metal Forging Ltd | 24-May-07 | 2 |
| V-Guard Industries Ltd | 13-Mar-08 | 3 | Bhagwati Banquets & Hotels Ltd | 17-May-07 | 2** |
| Rural Electrification Corporation Ltd | 12-Mar-08 | 3 | Orbit Corporation Ltd | 12-Apr-07 | 1 |
| Tulsi Extrusions Ltd | 25-Feb-08 | 3 | A M D Industries Ltd. | 19-Mar-07 | 3 |
| I R B Infrastructure Developers Ltd. | 25-Feb-08 | 4 | Evinix Accessories Ltd | 7-Mar-07 | 2 |
| Shriram EPC Ltd | 20-Feb-08 | 3 | Cambridge Technology Enterprises Ltd | 7-Feb-07 | 2 |
| Bang Overseas Ltd | 20-Feb-08 | 2 | Ramsarup Industries Ltd | 4-Jan-06 | 2 |
| OnMobile Global Ltd | 19-Feb-08 | 4 | Jaiprakash Hydro-Power Ltd | 18-Apr-05 | 4 |
| K N R Constructions Ltd. | 18-Feb-08 | 3 | | | |
| *Gradings Assigned by CARE, CRISIL, FITCH, ICRA* | | | | | |
| **Gradings Assigned by more than one rating agency, highest grade taken** | | | | | |
| Source for IPO Grades: http://www.careratings.com/ http://www.crisil.com/ http://www.fitchindia.com/index.jsp http://www.icra.in/ | | | | | |

## Variables used in the Study

LIQUIDITY - Turnover ratio

IPO-GRADE - IPO Grade

UNDERPRICE – Under-pricing or Initial Excess Return

SUBSCRIBE – Subscription rate (Measure of over/under subscription)

PERFORM – Price performance of Issue post IPO

AGE – Age (in years) of company at the time of IPO issue

ISSUESIZE – IPO issue size in Rs. Crore (Rs. 10 million)

HOLDING – Portion of size that is floated i.e. not held by promoters

PROMOHOLDING – Portion of market capitalization that is held by promoters

RETAILSUBSCRIBE – Subscription rate by retail investors

METHOD – Dummy variable, 1 for Book Built IPO, 0 for Fixed Price IPO

PRICETOBOOK – Price to book ratio (Ratio of listed share price to book value of share reported in the company balance sheet)

## Regression Model Specification

## 1. Liquidity as a Dependent Variable

Here, we examine the effect of the IPO grade in predicting the turnover ratio of the issue. Liquidity in the market is measured through turnover ratio and it is calculated as:

Turnover ratio (LIQUIDITY) = Qty of shares traded / Qty of shares issued          (1)

We calculate the turnover ratio on the first day of listing, and day 2 to day 60 of listing. Since the sampling distribution of the turnover ratio (LIQUIDITY), age of the company (AGE), issue size (ISSUESIZE), and price to book ratio (PRICETOBOOK) exhibit excessive variability, we have log transformed these variables. The following multivariable regression model is used:

Log (LIQUIDITY) = $\beta_0$ + $\beta_1$IPO-GRADE + $\beta_2$Log (AGE) + $\beta_3$Log (ISSUESIZE) + $\beta_4$Log (PRICETOBOOK) + $\beta_5$METHOD + $\beta_6$HOLDING          (2)

Where,

$\beta_i$ (i=0,1,...6) are regression parameters to be estimated, while others are variables that are used to predict the liquidity. Table 2 reports the regression results with variable LIQUIDITY as the dependent variable.

## Table 2

Regression results with LIQUIDITY as dependent variable - Day 1 trading

| Predictor | Estimates of Coefficients | Standard Error | t-statistics | Significance Level |
|---|---|---|---|---|
| Intercept | 1.480 | 0.204 | 7.270 | 0.000 |
| IPO Grade (IPO-GRADE) | -0.052 | 0.040 | -1.280 | 0.206 |
| Method of Issue - Book built vs. Fixed Price (METHOD) | 0.383 | 0.086 | **4.46**\*\*\* | 0.000 |
| Non-Promoter Holding (HOLDING) | -0.002 | 0.002 | -0.830 | 0.410 |
| Log of Price to Book Ratio (PRICETOBOOK) | 0.084 | 0.158 | 0.530 | 0.597 |
| Log of Age (AGE) | -0.220 | 0.123 | **-1.8**\* | 0.078 |
| Log of Issue Size (ISSUESIZE) | -0.587 | 0.077 | **-7.64**\*\*\* | 0.000 |
| | F-statistic | Significance level | R-Sq | R-Sq(adj) |
| Overall significane of Regression Model | **21.23**\*\*\* | 0.000 | 71.00% | 67.70% |
| \*\*\* Significant at 1% | | | | |
| \* Significant at 10% | | | | |

The coefficient associated with the IPO grade has an unexpected underlined negative sign, and the explanatory power is weak. Given the weak explanatory power, we cannot confidently conclude that higher IPO grades predict less liquidity of the issues. However, in understanding the negative correlation, a plausible explanation might be that a high grade could allow issuing companies to demand a better premium on their offer, adversely reducing the demand in the market.

The issue size shows a strong negative correlation to the turnover ratio, at 1% significance, indicating that if the float is very large, the turnover ratio would be low either because large number of shares are issued, or because the list price is too high to induce strong investor demand.

Method of issuing IPO (book built vs. fixed price) shows a strong positive correlation to the liquidity of the IPO. We used the METHOD variable as a dummy indicator with book built issues taking the value of 1 and fixed price issues taking the value of 0. The model indicates with strong significance at 1% that IPOs issued via the book built method generate more

liquidity in the market, compared to the fixed price ones. One possible inference of this result is that book built method helps to appropriately price issues relative to fixed price method.

The age of the company shows a negative correlation to liquidity at 1% significance, indicating that newer companies are more attractive to investors in the short term.

We see that the overall significance of the regression model is strong at 1% significance and the explanatory power of the regression model is also strong in terms of $R^2$ at 71%.

Table 3 reports the regression results with variable LIQUIDITY from day 2 to day 60 of the IPO listing as the dependent variable.

## Table 3

Regression results with LIQUIDITY as dependent variable - Day 2 to 60 average daily trading

| Predictor | Estimates of Coefficients | Standard Error | t-statistics | Significance Level |
|---|---|---|---|---|
| Intercept | 0.034 | 0.297 | 0.110 | 0.910 |
| IPO Grade (IPO-GRADE) | -0.291 | 0.059 | **-4.97**\*** | 0.000 |
| Method of Issue - Book built vs. Fixed Price (METHOD) | 0.579 | 0.129 | **4.48**\*** | 0.000 |
| Non-Promoter Holding (HOLDING) | -0.007 | 0.003 | **-2.08**\** | 0.042 |
| Log of Price to Book Ratio (PRICETOBOOK) | 0.191 | 0.234 | 0.810 | 0.419 |
| Log of Age (AGE) | 0.053 | 0.180 | 0.300 | 0.768 |
| Log of Issue Size (ISSUESIZE) | -0.473 | 0.117 | **-4.05**\*** | 0.000 |
| | F-statistic | Significance level | R-Sq | R-Sq(adj) |
| Overall significane of Regression Model | **13.43**\*** | 0.000 | 62.20% | 57.60% |
| *** Significant at 1% | | | | |
| ** Significant at 5% | | | | |

Similar to the day 1 trading model in table 2, this model also shows a negative correlation between liquidity and the IPO grade. The difference here is that the IPO grade has a strong explanatory power at 1% significance. Similarly, issue size also shows a negative correlation to the liquidity of the IPO. Similar to table 2, book built method of issuing IPO shows a strong positive correlation to the liquidity of the IPO at 1% significance. We notice that the non promoter holding has a negative correlation to the short term liquidity of the issue at 10% significance indicating that investors are more attracted to companies with large promoter (insider) holdings.

We see that the overall significance of the regression model is strong at 1% and the explanatory power of the regression model is also moderately strong in terms of $R^2$ at 62.2%.

## 2. Under-Pricing as a Dependent Variable

Next, we examine the effect of the IPO grade in predicting the under-pricing (UNDERPRICE) of the issue. The measure of under-pricing, which is also the realized initial excess return, is calculated as the return on listing adjusted for the overall market index (SENSEX) performance during the corresponding period.

UNDERPRICE = $\underline{\text{Listing Price – Offer Price}}$ – $\underline{\text{Index on listing day – Index on offer day}}$ (3)
$\qquad\qquad\qquad$ Listing Price $\qquad\qquad\qquad$ Index on offer day

Where, offer price for book built IPOs are calculated on the last day of the offer, while offer price for fixed price IPOs are calculated on the first day of the offer. Similarly, the index on offer day for book built IPOs is on the last day of the offer, and index of offer day for fixed priced IPOs is on the first day of the offer.

Since the sampling distribution of the initial excess return (UNDERPRICE), the subscription rate (SUBSCRIBE), company (AGE), issue size (ISSUESIZE), and price to book ratio (PRICETOBOOK) exhibit excessive variability, we have log transformed these variables. The following multivariable regression model is used:

Log (UNDERPRICE) = $\beta_0$ + $\beta_1$IPO-GRADE + $\beta_2$Log (SUBSCRIBE) + $\beta_3$Log (AGE) + $\beta_4$Log (ISSUESIZE) + $\beta_5$Log (PRICETOBOOK) + $\beta_6$METHOD + $\beta_7$PROMOHOLDING $\qquad$ (4)

Where,

$\beta_i$ (i=0,1,...7) are regression parameters to be estimated, while others are variables that are used to predict the extent of under-pricing. We expect a negative relationship between under-pricing and IPO-GRADE, i.e. we expect higher graded IPOs to exhibit lesser degree of under-pricing such that the value of $\beta_1$ is negative. Table 4 below reports the regression results with variable UNDERPRICE of the IPO as the dependent variable.

## Table 4

Regression results with UNDERPRICE (adjusted over SENSEX) as dependent variable

| Predictor | Estimates of Coefficients | Standard Error | t-statistics | Significance Level |
|---|---|---|---|---|
| Intercept | 0.075 | 0.033 | 2.300 | 0.026 |
| IPO Grade (IPO-GRADE) | -0.023 | 0.008 | **-2.74**\*\*\* | 0.009 |
| Log of Subscription Rate (SUBSCRIBE) | 0.099 | 0.011 | **8.67**\*\*\* | 0.000 |
| Method of Issue - Book built vs. Fixed Price (METHOD) | -0.033 | 0.020 | -1.620 | 0.111 |
| Promoter Holding (Prom HOLDING) | 0.000 | 0.000 | -1.000 | 0.321 |
| Log of Price to Book Ratio (PRICETOBOOK) | 0.016 | 0.039 | 0.420 | 0.679 |
| Log of Age (AGE) | 0.014 | 0.027 | 0.500 | 0.619 |
| Log of Issue Size (ISSUESIZE) | 0.002 | 0.016 | 0.150 | 0.883 |
|  | F-statistic | Significance level | R-Sq | R-Sq(adj) |
| Overall significane of Regression Model | **19.91**\*\*\* | 0.000 | 73.20% | 69.50% |
| \*\*\* Significant at 1% | | | | |

As expected, table 4 above indicates that the coefficient associated with the IPO grade has a negative sign. This indicates that the extent of under pricing is negatively correlated to the IPO grade, i.e. higher the IPO grade, lesser the extent of under-pricing. The IPO grade shows a strong significance at 1%, indicating a high explanatory power. There are a couple of observations that can be made of this relationship. Firstly, firms with high IPO grades have strong management capabilities and therefore are equipped to do proper research to help them rightly price their issues. The other observation is that a firm having obtained a high grade might decide to add a premium to its issue (pre-list) price, thus reducing the chances of initial excess return to the investors. This observation conforms to SEBI's view that all other things remaining equal, a security with stronger fundamentals would command a higher market price.

We note that if the lag period (number of days elapsed between the offer close date and the issue list date) is not substantial, then initial excess returns can be more confidently attributed to intentional under-pricing. The average lag period of the 63 IPOs in our study is 22 days, with minimum at 8 days and maximum at 31 days. These numbers indicate a minor lag period compared to IPOs in the mid 1990s in India, when lag periods would be measured in months.

The other notable observation from table 4 is the high positive correlation of under-pricing to the subscription rate. This indicates that under pricing results in high over subscription

of the issue. The subscription rate captures the effect of most of the signals related to under-pricing to the extent that other variables, with the exception of the IPO grade, used in this model don't appear to show much correlation to under-pricing.

We see that the overall significance of the regression model is strong at 1% significance and the explanatory power of the regression model is also strong in terms of $R^2$ at 73.2%.

## 3. Price Performance as a Dependent Variable

Now, we turn to examining the effect of the IPO grade in predicting the price performance (PERFORM) of the issue, 30, 60, and 90 days after the list date. The measure of price performance, in terms of capital gains, is calculated as the performance of the stock adjusted for the overall market index (SENSEX) performance during the corresponding period.

$$\text{PERFORM} = \frac{\text{Listing Price}_{\text{day 30,60,90}} - \text{Listing Price}_{\text{day 0}}}{\text{Listing Price}_{\text{day 0}}} - \frac{\text{Index}_{\text{day 30,60,90}} - \text{Index}_{\text{day 0}}}{\text{Index}_{\text{day 0}}} \quad (5)$$

Where, day 0 corresponds to the issue list date, and day 30, 60, and 90 correspond to 30, 60, and 90 days after the issue list date.

Since the sampling distribution of the age of the company (AGE), issue size (ISSUESIZE), and price to book ratio (PRICETOBOOK) exhibit excessive variability, we have log transformed these variables. The following multivariable regression model is used:

PERFORM = $\beta_0$ + $\beta_1$IPO-GRADE + $\beta_2$Log (AGE) + $\beta_3$Log (ISSUESIZE) + $\beta_4$Log (PRICETOBOOK) + $\beta_5$METHOD + $\beta_6$HOLDING

(6)

Where,

$\beta_i$ (i=0,1,...6) are regression parameters to be estimated, while others are variables that are used to predict price performance. Table 5 reports the regression results with variable PERFORM from day 2 to 30 of the IPO listing as the dependent variable.

## Table 5

Regression results with PERFORM (adjusted over SENSEX) as dependent variable

| Predictor | Estimates of Coefficients | Standard Error | t-statistics | Significance Level |
|---|---|---|---|---|
| Intercept | -12.180 | 13.170 | -0.930 | 0.360 |
| IPO Grade (IPO-GRADE) | -2.543 | 2.825 | -0.900 | 0.373 |
| Method of Issue - Book built vs. Fixed Price (METHOD) | 16.153 | 5.550 | **2.91**\*** | 0.005 |
| Non-Promoter Holding (HOLDING) | -0.068 | 0.139 | -0.490 | 0.627 |
| Log of Price to Book Ratio (PRICETOBOOK) | -7.850 | 10.170 | -0.770 | 0.444 |
| Log of Age (AGE) | -3.983 | 7.713 | -0.520 | 0.608 |
| Log of Issue Size (ISSUESIZE) | 5.691 | 5.023 | 1.130 | 0.263 |
| | F-statistic | Significance level | R-Sq | R-Sq(adj) |
| Overall significane of Regression Model | **2.41**\*\* | 0.041 | 23.20% | 13.60% |
| \*\*\* Significant at 1% | | | | |
| \*\* Significant at 5% | | | | |

As table 5 indicates, the IPO grade does not show significant correlation to the subsequent market performance of the issue. The t-statistic of -0.9 and the significance level of 0.37 associated to the IPO grade are both weak. However, even though insignificant, the model shows the sign of the IPO grade as negative, indicating an inverse relationship between a high IPO grade and positive market performance. Equity, by nature, is 'risk investment' and the relative limitation of the IPO grade is evident in its difficulty to capture all of the risks involved. To account for cases like this, SEBI and rating agencies argue that even if an investor were to lose money during volatile market conditions, if the fundamentals of the stock (exhibited by the IPO grade) are strong, the investor is likely to hold on to the stock.

As the IPO grade does not recommend whether to buy, sell or hold the securities, it might not be appropriate drawing a correlation between the grade and the market performance of the securities. This is where the IPO grade can improve its usefulness – by taking pricing into cognizance.

The model indicates with strong significance at 1% that IPOs issued via the book built method result in better price performance in the market, compared to the fixed price ones. This indicator is a natural extension to our earlier observation, in which the book built issues also exhibited more liquidity.

The $R^2$ value of 23.2% indicates relatively low predictability in the overall model. Similarly, we could not depict any explanatory power in the IPO grade and other variables in

predicting the 60 day and 90 day price performance of the issue adjusted over SENSEX performance and have thus omitted the tables to reduce redundancy.

## 4. Subscription Rate as a Dependent Variable

Next, we study the effect of the IPO grade in predicting the subscription rate (SUBSCRIBE) of the issue. Subscription rate is defined as:

Subscription rate (SUBSCRIBE) = Qty of shares demanded / Qty of shares to be issued

$$(7)$$

Since the sampling distribution of the subscription rate (SUBSCRIBE), initial excess return (UNDERPRICE), turnover ratio (LIQUIDITY), age of the company (AGE), issue size (ISSUESIZE), and price to book ratio (PRICETOBOOK) exhibit excessive variability, we have log transformed these variables. The following multivariable regression model is used:

$$Log\ (SUBSCRIBE) = \beta_0 + \beta_1 IPO\text{-}GRADE + \beta_2 Log\ (UNDERPRICE) + \beta_3 Log\ (AGE) + \beta_4 Log\ (ISSUESIZE) + \beta_5 Log\ (PRICETOBOOK) + \beta_6 METHOD + \beta_7 PROMOHOLDING \qquad (8)$$

Where,

$\beta_i$ (i=0,1,…7) are regression parameters to be estimated, while others are variables that are used to predict the subscription rate. We expect a positive relationship between subscription rate and IPO-GRADE, i.e. we expect the value of $\beta_1$ to be positive, indicating that IPOs graded higher should demand higher subscription. Table 6 reports the regression results with variable SUBSCRIBE as the dependent variable.

## Table 6

Regression results with SUBSCRIBE as a dependent variable

| Predictor | Estimates of Coefficients | Standard Error | t-statistics | Significance Level |
|---|---|---|---|---|
| Intercept | -0.698 | 0.240 | -2.900 | 0.005 |
| IPO Grade (IPO-GRADE) | 0.247 | 0.066 | **3.76**\*** | 0.000 |
| Log of Excess Initial Return (UNDERPRICE) | 5.673 | 0.643 | **8.83**\*** | 0.000 |
| Method of Issue - Book built vs. Fixed Price (METHOD) | -0.262 | 0.152 | **-1.72**\* | 0.091 |
| Promoter Holding (Prom HOLDING) | 0.004 | 0.003 | 1.100 | 0.278 |
| Log of Price to Book Ratio (PRICETOBOOK) | 0.707 | 0.275 | **2.57**\*\* | 0.013 |
| Log of Age (AGE) | 0.254 | 0.198 | 1.280 | 0.206 |
| Log of Issue Size (ISSUESIZE) | -0.068 | 0.123 | -0.550 | 0.586 |
| | **F-statistic** | **Significance level** | **R-Sq** | **R-Sq(adj)** |
| Overall significane of Regression Model | **28.05**\*** | 0.000 | 79.70% | 76.90% |
| \*\*\* Significant at 1% | | | | |
| \*\* Significant at 5% | | | | |
| \* Significant at 10% | | | | |

Table 6 indicates that IPO grade as a predictor shows a strong significance at 1%, indicating a high predictability of IPO grade to subscription rate of the issue. In other words, the higher the IPO grade, the better the subscription rate tends to be. If subscription rate is viewed as an indicator of quality, then the positive relationship between the IPO grade and the subscription rate suggests that IPO grade correctly indicates the fundamentals, and therefore the quality of the issuing firm.

We also notice from table 6 that subscription rate has a significant positive correlation to under-pricing of an issue, at 1% significance. In table 4, we noted the high predictability of under-pricing when using subscription rate as a predictor variable. Here we see that the relationship is mutually strong as under-pricing, when used as a predictor, offers a significant prediction of the subscription rate. This conforms to historical market behavior that under-priced offers are typically heavily oversubscribed. For firms, under-pricing provides for an insurance against under-subscription and excess demand affords the issuer the opportunity to choose a shareholder base of its liking. However, economists argue that in efficient markets, companies should not 'leave money on the table' by intentionally under-pricing. It is this efficiency that the IPO grade appears to be bringing to the market, thus relieving the highly graded issuers from having to underprice their issues in order to attract investors.

The model indicates with 10% significance that IPOs issued via the book built method exhibit less subscription when compared to the fixed price ones. This observation seems to contradict earlier ones for no obvious reasons. Another surprising observation is the positive correlation of subscription rate to the price to book ratio significant at 5%. Intuitively, we would expect that issues priced higher than their book value would generate less demand, but the model indicates otherwise.

We see that the overall significance of the regression model is strong at 1% and the explanatory power of the regression model is also strong in terms of $R^2$ at 79.7%.

## 5. Retail Subscription as a Dependent Variable

After examining the predicting power of the IPO grade to the overall subscription, we now turn to the effect of the IPO grade in predicting the retail investor subscription rate (RETAILSUBSCRIBE) of the issue. This study allows us to examine whether SEBI's objective to make retail investors better informed via the implementation of IPO grade has been as desired. Subscription rate is defined as:

Retail Subscription rate (RETAILSUBSCRIBE) = Qty of shares demanded by retail investors/ Qty of shares allotted to retail investors          (9)

Since the sampling distribution of the retail subscription rate (RETAILSUBSCRIBE), initial excess return (UNDERPRICE), and issue size (ISSUESIZE), exhibit excessive variability, we have log transformed these variables. The following multivariable regression model is used:

$\text{Log (RETAILSUBSCRIBE)} = \beta_0 + \beta_1 \text{IPO-GRADE} + \beta_2 \text{Log (UNDERPRICE)} + \beta_3 \text{Log (ISSUESIZE)}$

        (10)

Where,

$\beta_i$ (i=0,1,...3) are regression parameters to be estimated, and others are predictor variables. Similar to the overall subscription behavior, we expect a positive relationship between variable RETAILSUBSCRIBE and IPO-GRADE, i.e. we expect the value of $\beta_1$ to be positive.

Table 7 reports the regression results with variable RETAILSUBSCRIBE as a dependent variable.

**Table 7**

Regression results with RETAILSUBSCRIBE as a dependent variable

| Predictor | Estimates of Coefficients | Standard Error | t-statistics | Significance Level |
|---|---|---|---|---|
| Intercept | -0.077 | 0.186 | -0.420 | 0.679 |
| IPO Grade (IPO-GRADE) | 0.108 | 0.057 | **1.88**\* | 0.066 |
| Log of Excess Initial Return (UNDERPRICE) | 6.314 | 0.552 | **11.44**\*\*\* | 0.000 |
| Log of Issue Size (ISSUESIZE) | -0.175 | 0.105 | -1.670 | 0.102 |
| Promoter Holding (Prom HOLDING) | 0.006 | 0.003 | 1.830 | 0.073 |
|  | F-statistic | Significance level | R-Sq | R-Sq(adj) |
| Overall significane of Regression Model | **33.81**\*\*\* | 0.000 | 73.40% | 71.20% |
| \*\*\* Significant at 1% |  |  |  |  |
| \* Significant at 10% |  |  |  |  |

The IPO grade predicts retail subscription at 10% significance, which is less than the significance at which it predicted the overall subscription rate. Nonetheless, the correlation is positive indicating that higher IPO grades attract more retail investment. The rating agencies state that the grade does not indicate whether the IPO is likely to oversubscribe or under-subscribe as these are scenarios that depend on factors such as market sentiments and macroeconomic situation, which are unrelated to the fundamentals of the company. However, this model, along with the previous model in which we examined the overall subscription, tells us that issues with higher IPO grades are better subscribed. To that effect, it appears to be bringing better information symmetry to the market.

A worthy notation is that of the strength (1% significance) at which the initial excess return (UNDERPRICE) is able to predict retail subscription. The model shows that the retail subscribers place high demand on IPOs that exhibit under-pricing.

We see that the overall significance of the regression model is strong at 1% and the explanatory power of the regression model is also strong in terms of $R^2$ at 73.4%.

**Conclusion**

While studying the IPO grade's ability in predicting the short term liquidity of the issue, we observed that the coefficient of the IPO grade carried a negative sign indicating that higher graded equities exhibit lower turnover ratio. This result questions our intuitive understanding that higher graded IPOs would tend to be more liquid.

When we studied the IPO grade's ability to predict market performance in terms of capital gains, we noticed that the IPO grade correlates negatively to the subsequent market

performance of the issue in terms of capital gains, although at a very low significance level. One inference we make to this result is that equity being a "risk investment", the IPO grade is not able to capture all of the risks involved.

When we studied the correlation of the IPO grade to the phenomena of initial excess return or under-pricing, we noticed a strong significance in IPO grade's ability to predict the extent of under-pricing. We saw that securities with higher IPO grade are less likely to be under-priced. On this front, the IPO grade does seem to be bringing about more information symmetry to the market.

We also noticed that the IPO grade has a strong positive correlation (1% significance) to the IPO subscription rate, i.e. the higher the IPO grade, the higher the subscription rate. This result seems to indicate that the investor response to the quality of signals that an IPO grade provides has been positive. Therefore, it can be said that contrary to some of the views in the industry, mandatory grading has yielded discernible benefits.

We saw that the retail subscription also has a positive correlation to the IPO grade. In light of the fact that retail investors may not fully disseminate or comprehend the implications of the disclosures made in the prospectus, SEBI's belief that there is a vital need to rate equity offerings, helping investors separate good floats from risky ones, appears to be holding true.

We have looked at the efficacy of the IPO grade from several angles. The qualitative arguments along with the quantitative regression analysis reported on this paper provides for some useful insights in deciphering the usefulness of this initiative to market transparency. With further time, the IPO grade has the potential to become the flagship criterion in evaluating the fundamentals of an IPO issue. However, if attaining a flagship status is the goal, would doing so shift the responsibility of bringing out good IPOs from merchant bankers to the rating agencies? What would happen if a highly graded IPO turns out to be a fraud and is floating its shares just to raise the funds, only to disappear afterwards? Would the rating agencies be held accountable? In addition, in institutionalizing the IPO grading as a mandatory exercise, would investors perceive rating as SEBI's approval of the issue? To take it one step further, would SEBI's approval itself depend on the rating outcome? Internationally, S&P and Moody don't grade IPOs and these are perhaps the questions that they asked themselves and decided against such a scheme.

However, in looking at the regression results, we can conclude that the IPO grade has helped bring more transparency and information symmetry to the market. IPO grading has impacted the way all classes of investors allocate their funds in the capital markets.

## Exhibit 1 – A Prospectus with IPO Grade Disclosed[26]

### AISHWARYA TELECOM LIMITED[TM]

(The Company was incorporated as Aishwarya Telecom Private Limited on June 2, 1995 with the Registrar of Companies, Andhra Pradesh, Hyderabad and took over the business of the partnership firm named 'Advanced Electronics & Communications System'. Subsequently, it was converted into a Public Limited Company on July 12, 2005 in terms of Section 31(1)/44 of the Companies Act, 1956 and the name of the Company was changed to Aishwarya Telecom Limited and a fresh Certificate of Incorporation obtained from the Registrar of Companies, Andhra Pradesh, Hyderabad). (For details of changes in Registered Office of the Company, please refer to page no. 7 of this Prospectus).

Registered Office: 3-C Samrat Commercial Complex, Opp. A G Office, Saifabad, Khairatabad, Hyderabad, Andhra Pradesh, India, Pin - 500 004
Telephone: +91 40 2323 6019, 2323 5439; Fax: +91 40 2329 6282, E-mail: ipo@aishwaryatelecom.com
Website: www.aishwaryatelecom.com, Contact Person/Compliance Officer: Mr C N Bhavani Prasad, Company Secretary

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INITIAL PUBLIC ISSUE OF 40,00,000 EQUITY SHARES OF RS. 10 EACH FOR CASH AT A PRICE OF RS. 35/- PER EQUITY SHARE (INCLUDING SHARE PREMIUM OF RS. 25/- PER EQUITY SHARE) AGGREGATING RS. 1400 LAKHS (HEREINAFTER REFERRED TO AS "THE ISSUE"). THE ISSUE COMPRISES A RESERVATION FOR ELIGIBLE EMPLOYEES OF UPTO 1,00,000 EQUITY SHARES OF RS. 10 EACH ("THE EMPLOYEE RESERVATION PORTION") AGGREGATING RS. 35 LAKHS AND THE NET ISSUE TO THE PUBLIC OF 39,00,000 EQUITY SHARES OF RS. 10 EACH ("THE NET ISSUE") AGGREGATING RS. 1365 LAKHS

THE ISSUE WOULD CONSTITUTE 37.53% OF THE FULLY DILUTED POST ISSUE PAID-UP CAPITAL OF THE COMPANY. THE NET ISSUE TO THE PUBLIC WOULD CONSTITUTE 36.59% OF THE FULLY DILUTED POST ISSUE PAID-UP CAPITAL OF THE COMPANY.

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ISSUE PRICE is RS. 35/- PER EQUITY SHARE OF FACE VALUE OF RS 10/-

THE ISSUE PRICE IS 3.5 TIMES OF THE FACE VALUE

In case of revision in the Price Band, the Bidding/Issue Period shall be extended for three additional working days after such revision, subject to the Bidding/Issue period not exceeding ten working days. Any revision in the price band, and the revised Bidding/Issue period, if applicable, will be widely disseminated by notification to Bombay Stock Exchange Limited ("BSE") and the National Stock Exchange of India Limited (NSE) by issuing a press release and also by indicating the change on the website of the respective Book Running Lead Managers (BRLMs) and at the terminals of the Syndicate Member(s).

The Issue is being made through the 100% Book Building Process wherein up to 50% of the Net issue shall be allocated on proportionate basis to Qualified Institutional Buyers (QIBs) out of which 5% will be available for allocation on a proportionate basis to Mutual Funds. The remaining QIB portion shall be available for allotment on a proportionate basis to QIB bidders including Mutual Funds, subject to valid bids being received at or above the Issue Price. Further, not less than 15% of the Net issue would be allocated to Non-Institutional Bidders on proportionate basis and not less than 35% of the Net issue would be allocated to Retail Individual Bidders on a proportionate basis, subject to valid bids being received from them at or above the Issue Price.

#### RISK IN RELATION TO THE FIRST ISSUE

This being the first issue of the Company, there has been no formal market for the Equity Shares of the Company. The face value of the Equity Shares is Rs. 10 and the Issue Price is 3.5 times of the face value. The Price (as been determined by the Company in consultation with the Book Running Lead Managers (BRLMs) on the basis of assessment of market demand for the Equity Shares by way of Book Building) should not be taken to be indicative of the market price of the Equity Shares after the Equity Shares are listed. No assurance can be given regarding an active and/or sustained trading in the Equity Shares of the Company or regarding the price at which the Equity Shares will be traded after listing.

#### GENERAL RISKS

Investments in Equity and Equity related securities involve a degree of risk and investors should not invest any funds in this Issue unless they can afford to take the risk of losing their investment. Investors are advised to read the risk factors carefully before taking an investment decision in this Issue. For taking an investment decision, investors must rely on their own examination of the Company and the Issue including the risks involved. The Equity Shares offered in the Issue have not been recommended or approved by the Securities and Exchange Board of India (SEBI) nor does SEBI guarantee the accuracy or adequacy of this Prospectus. Specific attention of investors is invited to the section titled 'Risk Factors' beginning on page no. x of this Prospectus.

#### ISSUER'S ABSOLUTE RESPONSIBILITY

The Company having made all reasonable inquiries, accepts responsibility for, and confirms that this Prospectus contains all information with regard to the Company and the Issue, which is material in the context of the Issue, that the information contained in this Prospectus is true and correct in all material aspect and is not misleading in any material respect, that the opinions and intentions expressed herein are honestly held and that there are no other facts, the omission of which makes this Prospectus as a whole or any of such information or the expression of any such opinions or intentions misleading in any material respect.

#### LISTING

The Equity Shares offered through this Prospectus are proposed to be listed on the Bombay Stock Exchange Limited ("BSE"). The in-principle approval from BSE for the listing of Equity Shares has been received vide their letter no. DCS/IPO/SLRO-IP/98/4/2007-08 dated September 4, 2007. For the purposes of this Issue, BSE is the Designated Stock Exchange.

#### IPO GRADING

CARE has assigned "IPO Grade 2 out of 5" to the proposed Public Issue of the Company indicating 'below average fundamentals', vide its letter dated August 30, 2007 and the Grading has been subsequently revalidated vide its letter dated January 29, 2008. For more information on IPO grading and CARE's disclaimer, refer to page no. 12 of this Prospectus.

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#### BID/ISSUE PROGRAMME

| BID/ ISSUE OPENED ON : TUESDAY, APRIL 15, 2008 | BID/ISSUE CLOSED ON: THURSDAY APRIL 17, 2008 |
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[26] Retrieved from http://www.sebi.gov.in/Index.jsp?contentDisp=Department&dep_id=1 on November 27, 2008