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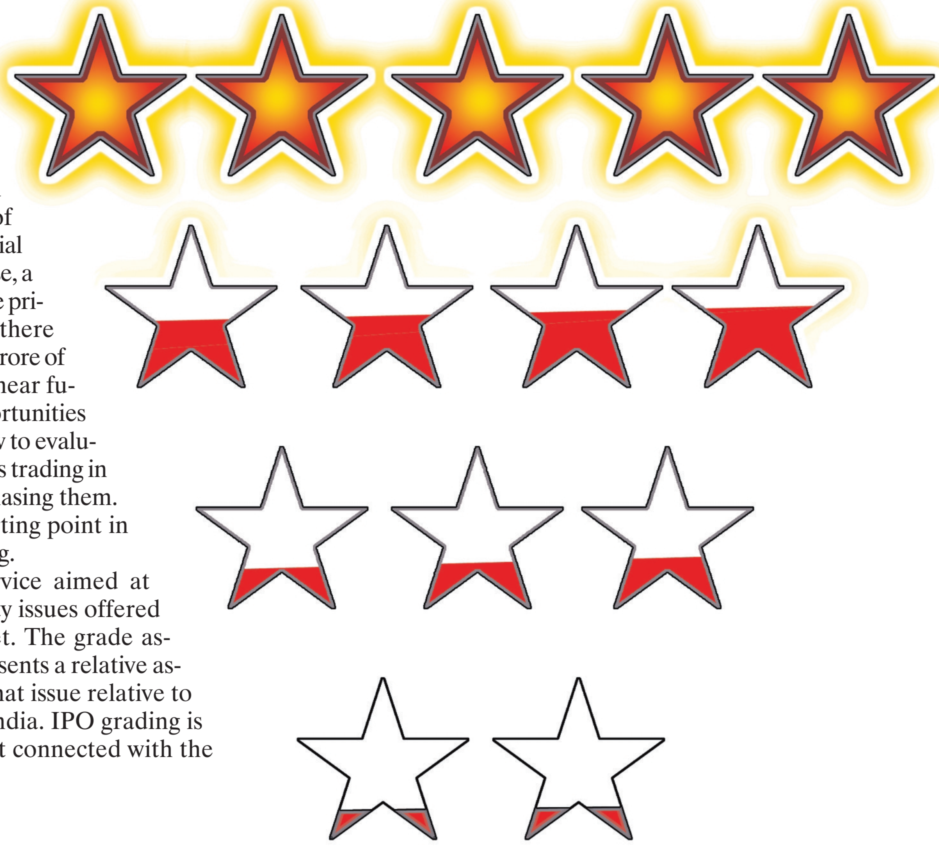
IPO RATING

LOOK BEYOND THE RATING

IPO ratings may add to investors' knowledge about companies, especially lesser-known ones. But investors must in addition do their own due diligence before arriving at an investment decision

NITI KIRAN



THE Sensex is up around 80 per cent from its March 2009 lows. With sentiments in the secondary market improving, the primary market has also perked up, especially after the success of Mahindra Holidays and Resorts' initial public offering (IPO). Prime Database, a consultancy that does research on the primary markets, has estimated that there are plans to raise nearly Rs 3,00,000 crore of capital through IPOs alone in the near future. With so many investment opportunities coming up, investors must learn how to evaluate IPOs, just as they evaluate shares trading in the secondary market before purchasing them. One tool that could serve as a starting point in their decision-making is IPO grading.

IPO grading or rating is a service aimed at facilitating the assessment of equity issues offered to investors in the primary market. The grade assigned to any individual issue represents a relative assessment of the fundamentals of that issue relative to the universe of listed equities in India. IPO grading is done by a rating agency that is not connected with the placement of the issue.

Rating methodology

The IPO rating process is qualitative. A relative assessment of the company is done based on parameters such as business fundamentals and prospects, financial position, management quality, corporate governance practices, project risk, and compliance and litigation history.

The rating procedure commences when the company planning to raise money in the primary market requests a rating agency to rate it. The company then submits all the relevant information and its offer document. The rating team analyses the information furnished by the client. It also interacts with the client. The latter responds to queries raised and provides additional data that might be required. The rating team also undertakes site visits. It interacts with the promoters and heads of strategic business units (SBU) to assess the strength of the management team. It also speaks to the company's independent directors to assess how robust are the company's corporate governance practices.

Thereafter, the rating agency's internal committee previews the analysis. The rating committee then awards a rating to the client.

According to D.R. Dogra, deputy managing director, Credit Analysis & Research (CARE), "The client may ask for a review of the grading assigned and may furnish additional information for that purpose. However, clients do not have the option of not accepting the final grading." He adds: "The company may opt for multiple ratings by applying to more than one rating agency, but it must disclose all these ratings."

WHAT THE GRADES INDICATE

Grades	CRISIL Research	Fitch Ratings	CARE
1	Poor	Poor	Poor
2	Below average	Below average	Below average
3	Average	Average	Average
4	Above average	Above average	Good
5	Strong	Strong	Strong

Illustration: ANIRBAN BORA

Rating scale

Companies are assigned grades on a five-point scale where the highest grade of 5/5 signifies that the fundamentals of the company are strong relative to other listed securities in India. A grade of one, on the other hand, indicates that the fundamentals of the company are poor relative to that of other listed securities. The grades of some rating agencies such as CRISIL Research, CARE and Fitch Ratings India, and their interpretation, are given in the table.

Additional info at website

Apart from the grade which is there in the red herring prospectus (RHP) of the company, a detailed grading rationale covering all the grading parameters is also available on the rating agency's website. If an investor needs additional information or clarification on a particular case, he can contact the rating agency.

Limitations of IPO grading

Any investment decision has three components: one, is it a good company (evaluation of the company's fundamentals)? Two, is it available at the right price (valuation decision)? And three, is it the right investment for me (assessment of the investor's own risk appetite)?

IPO grading addresses only the first component of the investment decision-making process (analysis of the company's fundamentals). According to Chetan Majithia, head-equities, CRISIL Research, "IPO grading does not solicit investors to subscribe to the issue. It also does not convey the appropriateness of the pricing of the IPO issue." The grading does not even comment on the future market performance and earning prospects of the issuer.

Valid for a fixed period only

Some rating agencies define a fixed period for which their IPO ratings remain valid. It is six months in the case of CRISIL Research and four months in the case of CARE. "In case of delays and if the validity period has expired, the company can ask for a re-rating of its IPO," says Dogra. According to Rakesh Valecha, senior director, Fitch Ratings India, "The IPO grading is a point-in-time assessment. The company is not monitored after the initial assignment."

Positives and negatives

Many of the companies that tap the IPO market are small and mid cap companies. The market may not have complete information about their management's track record in conducting the business. Information about the company's corporate governance practices may also be incomplete. In such a scenario, IPO grading does add to investors' knowledge about the company.

The drawback of IPO ratings is that they do not offer a complete answer to the investor's question — whether to invest in the IPO or not. "It does not capture the link between fundamentals and price. So the decision whether to buy or not cannot be taken on the basis of IPO grading alone," says Veer Sardesai, a Pune-based financial planner.

The other concern relates to the validity of the rating. "From the point when the rating is assigned to the time the company goes for listing, there can be material changes in the business environment and fundamentals of the company. The rating won't factor in the changes during the interim period," points out Vishal Dhawan, a Mumbai-based financial planner.

Bottomline

Gradings do add to investors' knowledge in case of companies that are not very well known. Says Majithia: "The grades are meant to be used by investors in conjunction with their personal risk appetite, price and return considerations."

In addition to looking up the ratings of an IPO, some additional due diligence needs to be exercised by investors. They should learn about the company from the prospectus. Further, according to Sardesai, "Look at other companies in the same industry and compare their price-to earnings ratio (PE) and growth prospects. Thereafter, see whether the fundamentals justify the pricing of the IPO. If one finds that other companies have higher growth prospects and are available at a more attractive price, then invest in the secondary market where more information is available on stocks," says Sardesai.

Thus, IPO grading should be used by investors only as a guidance tool. If investors go merely by the grading, they will have cause to regret in future. ♦

niti.kiran@expressindia.com

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D.R. DOGRA, CARE

"IPO gradings do not convey the appropriateness of pricing. They should be used in conjunction with investors' risk appetite, and their price and return considerations"

CHETAN MAJITHIA, CRISIL Research

"From the time ratings are assigned to the time the company goes for listing, there can be changes in the business environment and fundamentals. Watch out"

VISHAL DHAWAN, Financial Planner