

IPO Basics

An initial public offering, or IPO, is the first sale of stock by a company to the public. A company can raise money by issuing either debt or equity. If the company has never issued equity to the public, it's known as an IPO.

Companies fall into two broad categories: **private and public**.

Private Company is defined as:

(a)	has a minimum paid-up share capital of Rs.1 Lakh or such higher capital as may be prescribed; and
(b)	by its Articles Association:
	1. restricts the right of transfer of its share;
	2. limits the number of its members to 50 which will not include:-
	A. members who are employees of the company; and
	B. members who are ex-employees of the company and were members while in such employment and who have continued to be members after ceasing to be employees;
	3. prohibits any invitation to the public to subscribe for any shares or debentures of the company; and
	4. Prohibits any invitation or acceptance of deposits from persons other than its members, directors or their relatives.

It usually isn't possible to buy shares in a private company. You can approach the owners about investing, but they're not obligated to sell you anything. Public companies, on the other hand, have sold at least a portion of themselves to the public and trade on a stock exchange. This is why doing an IPO is also referred to as "going public."

Public Company is defined as:

The Company defined under Section 3(1)(iv) of the Companies Act, 1956 is a public company which-

	1. is not a private company;
	2. has a minimum paid-up capital of Rs. 5 lakhs or such higher capital as may be prescribed;
	3. is a private company but subsidiary of a public company.

Public companies have thousands of shareholders and are subject to strict rules and regulations. They must have a board of directors and they must report financial information every quarter. From an investor's standpoint, the most exciting thing about a public company is that the stock is traded in the open market, like any other commodity. If you have the cash, you can invest.

Primary market: The market in which investors have the first opportunity to buy a newly issued security like in an IPO.

Prospectus: A formal legal document describing the details of the company is created for a proposed IPO. It is the document that makes investors aware of the risks of an investment.

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

Book Building: The process by which an attempt is being made to determine at what price the securities to be offered based on demand from investors. An electronic book is being built by accepting orders from the investors who indicate the number of shares they desire and the price they are willing to pay.

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

What is a price band?

Price band in the book building process refers to the band within which the investors can bid. The spread between the floor and the cap of the price band is not be more than 20%. In other words, it means that the cap should not be more than 120% of the floor price. It is up to the company and its merchant bankers to decide on the price or the price band of the public issue. There is no cap or regulatory approval needed for determining the price of an IPO. The only requirement is that the issuing company is required to disclose in detail about the qualitative and quantitative factors justifying the issue price.

How is the Retail Investor defined as?

Retail individual investor' means an investor who applies or bids for securities of or for a value of not more than Rs.1,00,000.

Can a retail investor also bid in a book-built issue?

A retail investor can bid in a book-built issue for a value not more than Rs.1,00,000. Any bid made in excess of this will be considered in the HNI category.

What is "online bidding"?

A company bringing out an IPO can use the infrastructure of a stock exchange for on-line system offer of securities. An investor desirous of making the application may place his bids through the online terminals offered by some of the brokers. This is the easiest way of investing in IPO, where broking houses such as ICICIdirect.com, Kotak Securities, Geojit securities etc, offer their clients to invest in IPOs through click of the button.

What is listing?

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

How long will it take after the issue for the shares to get listed?

The listing on the stock exchanges is done within 14 days from the finalization of the issue. Ideally, it would be around 3 weeks after the closure of the book built issue. In case of fixed price issue, it would be around 37 days after closure of the issue.

How can an investor trade after listing?

An investor can trade by opening a broking account with a registered stock broker. He can place an order for sale of the number of shares he wants to sell and also fix the price at which he wants to sell at. Remember on the day of listing, there are huge volatility generally witnessed in the price of shares as the price discovery mechanism come into place for arriving at the fair price in the secondary market.

Whether listing price will be higher than the offer price?

It is not necessary that the price discovered in the secondary market after listing of shares would be higher than the IPO price. That is the price risk that you have to assume for investing in IPOs.

Why Go Public?

Going public raises cash, and usually a lot of it. Being publicly traded also opens many financial doors:

- Because of the increased scrutiny, public companies can usually get better rates when they issue debt.
- As long as there is market demand, a public company can always issue more stock. Thus, mergers and acquisitions are easier to do because stock can be issued as part of the deal.
- Trading in the open markets means liquidity. This makes it possible to implement things like employee stock ownership plans, which help to attract top talent.

The Underwriting Process

Getting a piece of a hot IPO is very difficult, if not impossible. To understand why, we need to know how an IPO is done, a process known as underwriting.

When a company wants to go public, the first thing it does is hire an investment bank. A company could theoretically sell its shares on its own, but realistically, an investment bank is required. Underwriting is the process of raising money by either debt or equity (in this case we are referring to equity). You can think of underwriters as middlemen between companies and the investing public. The biggest underwriters are Goldman Sachs, Credit Suisse First Boston and Morgan Stanley.

The company and the investment bank will first meet to negotiate the deal. Items usually discussed include the amount of money a company will raise, the type of securities to be issued and all the details in the underwriting agreement. The deal can be structured in a variety of ways. For example, in a firm commitment, the underwriter guarantees that a certain amount will be raised by buying the entire offer and then reselling to the public. In a best efforts agreement, however, the underwriter sells Securities for the company but doesn't guarantee the amount raised. Also, investment banks are hesitant to shoulder all the risk of an offering. Instead, they form a syndicate of underwriters. One underwriter leads the syndicate and the others sell a part of the issue.

Once all sides agree to a deal, the investment bank puts together a registration statement to be filed with the SEBI. This document contains information about the offering as well as company info such as financial statements, management background, any legal problems, where the money is to be used and insider holdings. The SEBI then requires a cooling off period, in which they investigate and make sure all material information has been disclosed. Once the SEBI approves the offering, a date (the effective date) is set when the stock will be offered to the public.

During the cooling off period the underwriter puts together what is known as the red herring. This is an initial prospectus containing all the information about the company except for the offer price and the effective date, which aren't known at that time. With the red herring in hand, the underwriter and company attempt to hype and build up interest for the issue.

As the effective date approaches, the underwriter and company sit down and decide on the price. This isn't an easy decision: it depends on the company, the success of the road show and, most importantly, current market conditions. Of course, it's in both parties' interest to get as much as possible.

Finally, the securities are sold on the stock market and the money is collected from investors.