

CASE

Section 3.1.1 of SEBI's (Securities and Exchange Board of India) DIP (Disclosure and Investor Protection) guidelines says, "The standard of due diligence shall be such that the merchant banker shall satisfy himself about all the aspects of offering, veracity and adequacy of disclosure in the offer documents." The rules say that the "liability of the lead manager will continue even after the completion of issue process." The investment banker is required to provide a due diligence certificate along with the red herring prospectus as well as the final prospectus. He is also required to certify different stages of compliance before the opening of the issue and after it has opened. These certificates are to be issued in SEBI's prescribed format. They make the investment banker specifically responsible for price justification, no-complaints certification, underwriting commitments and the appointment of all other intermediaries in the issue process.

Markets change, products evolve, and investors come and go but the financial markets remain the same. This keeps happening in cycles. Let us examine how IPOs fared in the past 15 years. The biggest IPO mania of the past few decades occurred between mid-1994 and early 1995. Thanks to extremely lax primary and secondary market regulations, almost anybody could raise money by mis-stating facts or artificially increasing prices. A grey market flourished and conveyed wrong price signals to investors. The SEBI also remained silent at that time. After a steady rush to raise money throughout the second half of 1994, the market reached an absolute frenzy in January and February 1995. In those two months, a spate of mega issues like Reliance Capital, Essar Oil, Jindal Vijaynagar, Hindustan Petroleum, MS Shoes and others hit the market. In January 1995, 145 equity issues opened for subscription. In one frenzied week in February 1995, 78 companies hit the market, crowning a financial year (1994–95) of as many as 1,400 IPOs! However, in 2007, which was a very good year for IPOs, there were only 90 issues.

After the MS Shoes issue, the primary market went bust. Until then, it was exhibiting all the symptoms of the worst IPOs: poor track record, huge asset growth, borrowings, price rigging, lack of due diligence, a manic market, and poor regulation. Such were the excesses of this period that the most high-profile companies and their aggressively marketed IPOs quickly sank below their offer price and fell steadily until some had lost as much as 80% of their initial value. The market then remained dead for almost a decade. It revived in 2005 to another cycle of excess that was the dotcom bubble.

There are three things to learn from this experience. First, the cycles of boom and bust will keep happening. There was one IPO boom in 1988, another in 1995, then in 2005, and one in 2007, and 2008. Second, once the primary market turns bullish with an initial IPO listing at a premium in a booming secondary market, we quickly move into a late-stage IPO mania that starts when investment bankers collude with company managements to plan issues that are primarily meant to enrich themselves. Projects planned at this stage of an IPO rally often propose expansion plans that are much larger than the existing business; many are shaky to begin with because due diligence tends to be lax during a euphoria. Third, investors are more willing to take chances, since they have seen prices double and treble over short periods and their neighbours and colleagues seem to have made easy money while they were left behind. Those who taste success in one IPO are also prepared to try their hand at the next hot one.

Discussion Questions

1. Did SEBI not learn any lesson from the mid-1990s when it was found wanting in its regulatory role? Explain the current role of SEBI in this regard.
2. Discuss the role of companies, investment bankers and regulators in fetching poor IPO returns which has made the market comatose.