

# IPO Eligibility Norms: Outlived Utility



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## A. INTRODUCTION

Securities and Exchange Board of India (SEBI) has been issuing and modifying eligibility norms for IPOs ever since its inception in 1992. Over the recent years the primary capital market has undergone a sea change. Lots of developments in terms of its size, growth, disclosure requirements, vanishing companies and other characteristics such as IPO grading have taken place. In this context it appears that eligibility norms have lost their sanctity and have outlived their utility. This paper seeks to examine this issue.

Let us first understand what these eligibility norms are.

## B. ELIGIBILITY NORMS FOR IPOs

As per SEBI (Disclosure and Investor Protection) Guidelines the eligibility norms for IPOs are as under.

### Public Issue / Offer for Sale by Unlisted Companies:

No unlisted company can make a **Public Issue / Offer for Sale** of any **equity share** unless the company meets all the following requirements:

1. The company has **net tangible assets** of at least Rs. 3 crore in each of the preceding 3 full years (of 12 months each), of which not more than 50% is held in monetary assets. However if more than 50% of the net tangible assets are held in monetary assets, the company has made firm commitments to deploy such **excess** monetary assets in its business/project.
2. The company has a track record of **distributable profits** in terms of section 205 of the Companies Act, 1956, for at least three (3) out of immediately preceding five (5) years. Further, extra ordinary items are not considered for calculating distributable profits.
3. The company has a **net worth** of at least Rs. 1 crore in each of the preceding 3 full years (of 12 months each).
4. In case the company has **changed its name** within the last one year (reckoned from the date of filing of the offer document), at least 50% of the revenue for the preceding 1 full year is earned by the company from the activity suggested by the new name, and
5. The aggregate of the proposed issue and all previous issues made in the same financial year in terms of size (promoters plus public), does not exceed **five (5) times** its pre-issue net worth as per the audited balance sheet of the last financial year.

**Alternative:** An unlisted company not complying with any of the conditions specified above may make an IPO of equity shares or any other security which may be converted into or exchanged with equity shares at a later date, only if it meets both the conditions (a) and (b) given below:

**(a). (i).** The issue is made through the **book-building** process, with at least 50% of the issue size being allotted to the Qualified Institutional Buyers (QIBs), failing which the full subscription monies have to be refunded.

OR

**(a). (ii).** The "**project**", that is, the object for which the monies are proposed to be raised to cover the objects of the issue, has at least 15% participation by Financial Institutions/Scheduled Commercial Banks, of which at least 10% comes from the appraiser(s). In addition to this, at least 10% of the issue size shall be allotted to QIBs, failing which the full subscription monies shall be refunded.

AND

**(b). (i).** The **minimum post-issue face value** of capital of the company shall be Rs. 10 crore.

OR

**(b). (ii).** There shall be a **compulsory market making** for at least 2 years from the date of listing of the shares subject to the following:

- Market makers undertake to offer buy and sell quotes for a minimum depth of 300 shares.
- Market makers undertake to ensure that the bid-ask spread (difference between quotations for sale and purchase) for their quotes shall not at any time exceed 10%.
- The inventory of the market makers on each of such stock exchanges, as on the date of allotment of securities, shall be at least 5% of the proposed issue of the company.

6. W.e.f. 30-04-2007 all IPOs have to be mandatorily **graded** by a credit rating agency.
7. In addition to the conditions as above the **prospective allottees** should not be less than one thousand (1000) in number.

#### Specific Cases:

**Partnership Firms Converted into Companies:** In case of partnership firms which have since been converted into companies, the track record of distributable profits of the firm shall be considered for the purpose of eligibility requirements if, the financial statements for the respective years pertaining to partnership business conform to and are revised in a format identical to that required for companies in Schedule VI of the Companies Act, 1956.

**Spun-Off Companies:** In case of an unlisted company formed out of a division of an existing company, the track record of distributable profits of the division spun off shall be considered for the purpose of eligibility criteria if the requirements regarding financial statements as specified for partnership firms above are complied with.

#### C. A CRITIQUE OF THE NORMS

Now follows a critique of the major norms.

1. In the present day '**Buyer Beware**' and '**Disclosure Based Regulatory Regime**' the eligibility norms have hardly any utility in the investment decision making process of the investors. A 300 page offer document has become a common sight today.
2. The norms require a very **poor financial track record**: just Rs. 3 crore of net tangible assets, Rs. 1 crore of net worth and distributable profits without any minimum amount. Should such small companies be allowed to enter the capital market and later on become a drain on it?
3. Why should a '**not more 5 times the pre-issue net worth**' condition be imposed on the amount of the proposed issue?
4. Why should the **book building** mode be thrust upon the companies not complying with the eligibility norms? Why should they not be allowed the fixed price route as well?
5. The **market making** concept for small companies has not worked. It can not.
6. How can an issuer ensure **minimum 1000 allottees** in the IPO? Does not this mean promoting manipulation?

#### D. THE ISSUES THAT ARISE

In the above context two **major issues** arise:

1. Should there be the requirement of eligibility norms at all?
2. In any case, should small companies be allowed to raise IPOs?

Two **incidental issues** also arise:

1. If the present eligibility norms have to be maintained, should the book building mode be thrust upon non-compliant companies? and,
2. How can the non-compliant companies ensure institutional participation in project funding and allotment to QIBs?

These issues are examined hereunder.

#### Major Issues:

##### 1. Should there be the Requirement of Eligibility Norms at all?

The answer seems to be in negative in view of the following factors:

**Elaborate Disclosures and Buyer Beware:** SEBI's regulatory regime is today disclosure based. The offer document contains a plethora of disclosures on issues like objects of the issue, means of finance, history and background of the company, promoters and their background, quality of key executives, details about the project, progress of the project, description of business and industry, past financial performance of the issuer company, management's discussion and analysis, past financial performance of other group companies, basis for issue price, corporate governance, outstanding litigations, risk factors and investor grievances and redressal system etc. apart from statutory and other information. It is not uncommon now to find offer documents running into 300 plus pages. The red herring offer document of **Birla Cotsyn (India) Ltd.** contains **438 pages** (<http://www.sebi.gov.in/dp/birlacot.pdf>). Elaborate disclosures mean plenty of inputs for facilitating the investment decision making process. Based on the principle of 'Buyer Beware' where is the need then to prescribe eligibility norms?

**IPO Grading:** A recent development in the primary market has been the introduction of compulsory IPO Grading. IPO grading provides an independent relative assessment of **fundamentals of the IPO** in relation to the universe of other listed securities in India to aid comparative assessment that would prove useful as

an information and investment tool for investors. It is supposed to be particularly useful for facilitating the assessment of the offerings of companies accessing the equity markets for the first time, that is, where no track record of their market performance is available (**Gupta Ambrish 2007**). IPO grading service provided by the rating agencies like CRISIL and ICRA is an independent, reliable and consistent assessment of the fundamentals of IPOs that takes into account such issues as management quality, business prospects both of the industry and company, financial performance, corporate governance, project related factors, track record of legal and regulatory compliances, litigation history and capital history, etc (<http://www.crisil.com/research/research-ipo-grading-brochure.pdf>). IPO Grading is thus another tool in the hands of the investors, apart from the elaborate offer document, to make an informed investment decision. Is there a case any more now to impose eligibility conditions of net tangible assets, net worth and distributable profits, etc., for floating an IPO?

## 2. In any case should Small Companies be allowed to make IPOs?

The answer again seems to be in negative in view of the following factors:

**Vanishing Companies/ Unknown Category:** The eligibility norms cited earlier are as on date. However the requirements of past financial track record have been hovering more or less around the same figures ever since SEBI issued disclosure and investor protection guidelines for the first time in 1992. The miniscule past track record requirements led to a flood of small cap IPOs in the first five years of Post-SEBI era. Table 1 provides the details:

| Year         | Total IPOs  |                    |                      | IPOs Below Rs. 5 Crores |                           |                    |                      |
|--------------|-------------|--------------------|----------------------|-------------------------|---------------------------|--------------------|----------------------|
|              | No. of IPOs | Total Issue Amount | Average Issue Amount | No. of IPOs             | %age to Total No. of IPOs | Total Issue Amount | Average Issue Amount |
| 1992-93      | 448         | 1877.96            | 4.19                 | 355                     | 79%                       | 983.24             | 2.77                 |
| 1993-94      | 664         | 4007.91            | 6.04                 | 488                     | 73%                       | 1458.49            | 2.99                 |
| 1994-95      | 1215        | 7096.64            | 5.84                 | 956                     | 79%                       | 2420.70            | 2.53                 |
| 1995-96      | 1329        | 4739.11            | 3.57                 | 1167                    | 88%                       | 2846.05            | 2.44                 |
| 1996-97      | 659         | 4079.09            | 6.19                 | 562                     | 85%                       | 1500.86            | 2.67                 |
| <b>Total</b> | <b>4315</b> | <b>21800.71</b>    |                      |                         |                           |                    |                      |

**Source:** PRIME Database. 'Average Issue Amount' and '%age to Total No. of IPOs' derived from the primary data.

Figures are eye opening. Average size of the IPOs ranged between just Rs. 3.57 crore to Rs. 6.19 crore during 1992-93 to 1996-97. What is more is that 73% to 88% of the total IPOs during this period raised less than Rs. 3 crore on an average. It is common knowledge that such small cap companies have neither the willingness nor the capacity to serve the shareholders and comply with the rigorous listing and other regulatory requirements. Their liquidity in the stock exchanges is extremely poor. Many of them have vanished. As per 2007-08 annual report of Ministry of Corporate Affairs, SEBI had identified **229** companies by October 2000, which came out with IPOs during the period 1992-1998, as **vanishing** (<http://www.mca.gov.in/MinistryWebsite/dca/report/annualreport2008.html?year=2008>). BSE notes that correspondence in respect of certain companies with addresses (last known) are returned undelivered by the postal authorities for reasons such as "not known", "shifted" etc. The trading in the securities of these companies is already suspended by the Exchange. The list is drawn as on December 29, 2006. There are **319** companies in 'Unknown Category' ([http://www.bseindia.com/invdesk/unknown\\_cat.asp](http://www.bseindia.com/invdesk/unknown_cat.asp)).

**Latest Trends in IPOs in Terms of Numbers and Size:** Between 1997-98 and 2002-03 there was a lull in the primary market. The year 2003-04 witnessed a new trend: that of large amount IPOs of mostly well established companies in small numbers. The trend has continued. Table 2 provides the details:

| Year    | No. of IPOs | Total Issue Amount | Average Issue Amount |
|---------|-------------|--------------------|----------------------|
| 2003-04 | 19          | 3191.10            | 167.95               |
| 2004-05 | 23          | 14662.32           | 637.49               |
| 2005-06 | 76          | 10797.88           | 142.08               |
| 2006-07 | 76          | 23706.16           | 311.92               |
| 2007-08 | 84          | 41323.45           | 491.95               |

Source: PRIME Database.

Table 3 provides further break up of these IPOs in terms of issue amount:

| Year    | Below Rs.5 crore |                    | Rs.5 crore - Rs.10 crore |                    | Rs.10 crore - Rs.25 crore |                    | Rs.25 crore - Rs.50 crore |                    | Rs.50 crore - Rs.100 crore |                    |
|---------|------------------|--------------------|--------------------------|--------------------|---------------------------|--------------------|---------------------------|--------------------|----------------------------|--------------------|
|         | No. of IPOs      | Total Issue Amount | No. of IPOs              | Total Issue Amount | No. of IPOs               | Total Issue Amount | No. of IPOs               | Total Issue Amount | No. of IPOs                | Total Issue Amount |
| 2003-04 | 2                | 6.33               | 3                        | 25.50              | 3                         | 48.24              | 1                         | 27.13              | 2                          | 153.69             |
| 2004-05 | --               | --                 | 2                        | 15.50              | 3                         | 48.50              | 3                         | 91.28              | 5                          | 357.46             |
| 2005-06 | --               | --                 | --                       | --                 | 14                        | 240.53             | 16                        | 597.47             | 19                         | 1452.62            |
| 2006-07 | --               | --                 | 1                        | 10.00              | 10                        | 200.75             | 11                        | 428.37             | 22                         | 1687.14            |
| 2007-08 | --               | --                 | 1                        | 6.00               | 5                         | 98.97              | 16                        | 602.14             | 21                         | 1435.01            |

  

| Year    | Rs.100 crore - Rs.500 crore |                    | Rs.500 crore - Rs.1000 crore |                    | Rs.1000 crore - Rs.5000 crore |                    | Above Rs. 5000 crore |                    | TOTAL       |                    |
|---------|-----------------------------|--------------------|------------------------------|--------------------|-------------------------------|--------------------|----------------------|--------------------|-------------|--------------------|
|         | No. of IPOs                 | Total Issue Amount | No. of IPOs                  | Total Issue Amount | No. of IPOs                   | Total Issue Amount | No. of IPOs          | Total Issue Amount | No. of IPOs | Total Issue Amount |
| 2003-04 | 7                           | 1936.87            | 1                            | 993.33             | --                            | --                 | --                   | --                 | 19          | 3191.10            |
| 2004-05 | 6                           | 885.39             | 1                            | 376.00             | 1                             | 1899.35            | 2                    | 10788.64           | 23          | 14662.32           |
| 2005-06 | 24                          | 4996.58            | 1                            | 642.11             | 2                             | 2868.58            | --                   | --                 | 76          | 10797.88           |
| 2006-07 | 22                          | 4550.44            | 5                            | 3739.79            | 4                             | 7300.86            | 1                    | 5788.79            | 76          | 23706.16           |
| 2007-08 | 27                          | 5809.34            | 8                            | 5958.83            | 4                             | 8102.46            | 2                    | 19310.70           | 84          | 41323.45           |

Source: PRIME Database.

Data is quite revealing. As against average size of IPOs ranging between Rs. 3.57 crore to Rs. 6.19 crore during 1992-93 to 1996-97 it has shot to Rs. 142.08 crore to Rs. 637.49 crore during 2003-04 to 2007-08. Average size of 2007-08 is Rs. 491.95 crore. IPOs up to Rs.10 crore have demised during 2003-04 to 2007-08. Major concentration during the last three years is on IPOs between Rs. 50 crore to Rs. 500 crore. There are IPOs beyond this amount also going up to well over Rs. 5000 crore per IPO. For example, **Reliance Power Ltd.** raised **Rs. 10123.20 crore** through its IPO during 2007-08. Interestingly during 2007-08 just 2 IPOs raised Rs. 19310.70 crore as against just Rs. 21800.71 crore raised by a whopping 4315 IPOs during 1992-93 to 1996-97. Clearly the dynamics of the primary market have changed. There is no space for small cap IPOs. Quality is the hallmark now.

**Listing Requirements of NSE:** As per the requirements of NSE, the premier and trend setting stock exchange of India, a company to be eligible for listing of its IPO should have paid up equity capital of not less than Rs. 10 crore post issue and the capitalisation of the company's equity, that is, the product of the issue price and the post issue number of equity shares should not be less than Rs. 25 crore ([http://www.nseindia.com/content/equities/eq\\_ipolisting.htm](http://www.nseindia.com/content/equities/eq_ipolisting.htm)). Clearly the exchange is not in favour of small cap companies.

#### **Incidental Issues:**

**1. If the Present Eligibility Norms have to be maintained, should the Book Building Mode be thrust upon Non-Compliant Companies?**

Certainly not. It may not be possible for an issuer to tie up with the QIBs for many reasons. Issuers therefore need to be given the choice of fixed price route. Primary market has become matured enough. Further, elaborate disclosures and IPO grading are supposed to provide enough efficiency to the market where all investors can make independent investment decisions. Therefore, is mandating the book built issue and the reservation for the QIBs still relevant? Why should other investors be still made to look to QIB response as a guide to their decision?

**2. How can the Non-Compliant Companies ensure Institutional Participation in Project Funding and Allotment to QIBs?**

This is again beyond their control. And for that matter beyond the control of compliant companies as well. Also in view of the reasons cited in 3 above there seems to be no need for such requirements.

#### **E. POLICY IMPLICATIONS**

The thrust of this paper is on advocating, on the basis of facts and figures, that the capital market regulator SEBI should consider dispensing with the eligibility norms for IPOs as they have outlived their utility and in any case the eligibility norms should not be such as to permit small cap companies come out with IPOs. Some other incidental issues have also been raised. These issues have serious policy implications for SEBI. It is suggested that SEBI may consider these issues, and if convinced, remove/revamp its policy on IPO eligibility norms in tune with the changing times.

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