

Primary Market



Presented by: Ms Shailja Thakur
Designation: Assistant Professor
School of Management
Maharaja Agrasen University

Meaning



- The primary market is where securities are created. It's in this market that firms sell (float) new stocks and bonds to the public for the first time.
- The market where a company raises capital for the first time is known as the primary market.
- Companies issue IPO (initial public offering) in the primary market only.
- The market offers an opportunity for investors to buy securities directly from the issuing company.
- By buying securities or stock from the primary market, investors help companies to raise capital.

Advantages of Primary Market

Companies can raise capital at relatively low cost, and the securities so issued in the primary market provide high liquidity as the same can be sold in the secondary market almost immediately.

The primary market is an important source for mobilisation of savings in an economy. Funds are mobilised from commoners for investing in other channels. It leads to monetary resources being put into investment options.

Chances of price manipulation in the primary market are considerably less when compared to the secondary market. Such manipulation usually occurs by deflating or inflating a security price, thereby deliberately interfering with fair and free operations of the market.

The primary market acts as a potential avenue for diversification to cut down on risk. It enables an investor to allocate his/her investment across different categories involving multiple financial instruments and industries.

It is not subject to any market fluctuations. The prices of stocks are determined before an initial public offering, and investors know the actual amount they will have to invest.

Disadvantages of Primary Market



There may be limited information for an investor to access before investment in an IPO since unlisted companies do not fall under the purview of regulatory and disclosure requirements of the Securities and Exchange Board of India.

Each stock is exposed to varying degrees of risk, but there is no historical trading data in a primary market for analysing IPO shares because the company is offering its shares to the public for the first time through an initial public offering.

In some cases, it may not be favourable for small investors. If a share is oversubscribed, small investors may not receive share allocation.

Functions of Primary Market



New issue offer: The primary market organises offer of a new issue which had not been traded on any other exchange earlier. Due to this reason, it is also called a New Issue Market. Organising new issue offers involves a detailed assessment of project viability, among other factors. The financial arrangements for the purpose include considerations of promoters' equity, debt-equity ratio and requirement of foreign exchange.

Underwriting services: Underwriting is an essential aspect while offering a new issue. An underwriter's role in a primary marketplace includes purchasing unsold shares if it cannot manage to sell the required number of shares to the public. A financial institution may act as an underwriter, earning a commission on underwriting. Investors rely on underwriters for determining whether undertaking the risk would be worth its returns. It may so thus happen that an underwriter ends up buying all the IPO issue, and subsequently selling it to investors.

Distribution of new issue: A new issue is also distributed in a **primary marketing** sphere. Such distribution is initiated with a new prospectus issue. It invites the public at large to buy a new issue and provides detailed information on the company, issue, and involved underwriters.

Types of Primary Market Issuance



- There are 5 **types of primary market** issues.

- Public issue:** Public issue is the most common method of issuing securities of a company to the public at large. It is mainly done via Initial Public Offering (IPO) resulting in companies raising funds from the capital market. These securities are listed in the stock exchanges for trading. A privately held company converts into a publicly-traded company when its shares are offered to the public initially through IPO. Such public offer allows a company to raise funds for expansion of business, improving infrastructure, and repay its debts, among others. Trading in an open market also increases a company's liquidity and provides a scope for issuance of more shares in raising further capital for business. The Securities and Exchange Board of India is the regulatory body that monitors IPO. As per its guidelines, a requisite due enquiry is conducted for a company's authenticity, and the company is required to mention its necessary details in the prospectus for a public issue.

- Private placement:** When a company offers its securities to a small group of investors, it is called private placement. The investors can be both individual and institutional. Private placements are easier to issue than initial public offerings as the regulatory stipulations are significantly less. It also incurs reduced cost and time, and the company can remain private. Such issuance is suitable for start-ups or companies which are in their early stages.

- Preferential issue:** A preferential issue is one of the quickest methods available to companies for raising capital. Both listed and unlisted companies can issue shares or convertible securities to a selected group of investors. However, the preferential issue is neither a public issue nor a rights issue. The shareholders in possession of preference shares stand to receive the dividend before the ordinary shareholders are paid.

- **Qualified institutional placement:** Qualified institutional placement is another kind of private placement where a listed company issues securities in the form of equity shares or partly or wholly convertible debentures apart from such warrants convertible to equity shares and purchased by a Qualified Institutional Buyer (QIB). QIBs are primarily such investors who have the requisite financial knowledge and expertise to invest in the capital market. Some QIBs are –

1. Foreign Institutional Investors registered with the Securities and Exchange Board of India.
2. Foreign Venture Capital Investors.
3. Alternate Investment Funds.
4. Mutual Funds.
5. Public Financial Institutions.
6. Insurers.
7. Scheduled Commercial Banks.
8. Pension Funds.

Issuance of qualified institutional placement is simpler than preferential allotment as the former does not attract standard procedural regulations like submitting pre-issue filings to SEBI. The process thus becomes much easier and less time-consuming.

- **Rights and bonus issues:** Another issuance in the primary market is rights and bonus issue, in which the company issues securities to existing investors by offering them to purchase more securities at a predetermined price (in case of rights issue) or avail allotment of additional free shares (in case of bonus issue). For rights issues, investors retain the choice of buying stocks at discounted prices within a stipulated period. Rights issue enhances control of existing shareholders of the company, and also there are no costs involved in the issuance of these kinds of shares. For bonus issues, stocks are issued by a company as a gift to its existing shareholders. However, the issuance of bonus shares does not infuse fresh capital.

IPO

- An initial public offering (IPO) is the first time a company issues shares to the public. This is when a private company decides to go 'public'.
- In other words, a company that was privately-owned until then becomes a publicly-traded company.
- Before the IPO, a company has very few shareholders. This includes the founders, angel investors and venture capitalists. But during an IPO, the company opens its shares for sale to the public. As an investor, you can buy shares directly from the company and become a shareholder.
- There are two common types of IPOs: a fixed price and a book building offering. A company can use either type separately or combined.

Types of IPO

- **Fixed Price Offering**

Fixed Price IPO can be referred to as the issue price that some companies set for the initial sale of their shares. The investors come to know about the price of the stocks that the company decides to make public.

- The demand for the stocks in the market can be known once the issue is closed. If the investors partake in this IPO, they must ensure that they pay the full price of the shares when making the application.

- **Book Building Offering**

In the case of book building, the company initiating an IPO offers a 20% price band on the stocks to the investors. The interested investors bid on the shares before the final price is decided. Here, the investors need to specify the number of shares they intend to buy and the amount they are willing to pay per share. The lowest share price is referred to as floor price and the highest stock price is known as cap price. The ultimate decision regarding the price of the shares is determined by investors' bids.

DIFFERENCE BETWEEN FIXED PRICE ISSUES AND BOOK BUILDING ISSUES

Issue Type	Offer Price	Demand	Payment	Reservations
Fixed Price Issues	Price at which the securities are offered and would be allotted is made known in advance to the investors	Demand for the securities offered is known only after the closure of the issue	100 % Applications Supported by Blocked Amount	50 % of the shares offered are reserved for applications below Rs. 2 lakh and the balance for higher amount applications.
Book Building Issues	A 20 % price band is offered by the issuer within which investors are allowed to bid and the final price is determined by the issuer only after closure of the bidding.	Demand for the securities offered , and at various prices, is available on a real time basis on the BSE website during the bidding period..	100 % Applications Supported by Blocked Amount.	50 % of shares offered are reserved for QIBS, 35 % for Non Retail and 15% for Retail Investors

IPO Process Steps:

- **Step 1: Hiring Of An Underwriter Or Investment Bank**

To start the initial public offering process, the company will take the help of financial experts, like investment banks. The underwriters assure the company about the capital being raised and act as intermediaries between the company and its investors. The experts will also study the crucial financial parameters of the company and sign an underwriting agreement. The underwriting agreement will usually have the following components:

1. Details of the deal
2. Amount to be raised
3. Details of securities being issued

- **Step 2: Registration For IPO**

This IPO step involves the preparation of a registration statement along with the draft prospectus, also known as Red Herring Prospectus (RHP). Submission of RHP is mandatory, as per the Companies Act. This document comprises all the compulsory disclosures as per the SEBI and Companies Act. Here's a look at the key components of RHP:

1. **Definitions:** It contains the definitions of the industry-specific terms.
2. **Risk Factors:** This section discloses the possibilities that could impact a company's finances.
3. **Use of Proceeds:** This section discloses how the money raised from investors will be used.
4. **Industry Description:** This section details the working of the company in the overall industry segment. For instance, if the company belongs to the IT segment, the section will provide forecasts and predictions about the segment.
5. **Business Description:** This section will detail the core business activities of the company.
6. **Management:** This section provides information about key management personnel.
7. **Financial Description:** This section comprises financial statements along with the auditor's report.

8. **Legal and Other Information:** This section details the litigation against the company along with miscellaneous information.
9. This document has to be submitted to the registrar of companies, three days before the offer opens to the public for bidding. Alongside, the submitted registration statement has to be compliant with the SEC rules. Post-submission, the company can make an application for an IPO to SEBI.

- **Step 3: Verification by SEBI:**

Market regulator, SEBI then verifies the disclosure of facts by the company. If the application is approved, the company can announce a date for its IPO.

- **Step 4: Making An Application To The Stock Exchange**

The company now has to make an application to the stock exchange for floating its initial issue.

- **Step 5: Creating a Buzz By Road shows**

Before an IPO opens to the public, the company endeavors to create a buzz in the market by road shows. Over a period of two weeks, the executives and staff of the company will advertise the impending IPO across the country. This is basically a marketing and advertising tactic to attract potential investors. The key highlights of the company are shared with various people, including business analysts and fund managers. The executives adopt various user-friendly measures, like Question and Answer sessions, multimedia presentations, group meetings, online virtual road shows, and so on.

- **Step 6: Pricing of IPO**

The company can now initiate pricing of IPO either through Fixed Price IPO or by Book Building Offering. In the case of Fixed Price Offering, the price of the company's stocks is announced in advance. In the event of Book Binding Offering, a price range of 20% is announced, following which investors can place their bids within the price bracket. For the bidding process, the investors have to place their bids as per the company's quoted Lot price, which is the minimum number of shares to be purchased. Alongside, the company also provides for IPO Floor Price, which is the minimum bid price and IPO Cap Price, which is the highest bidding price. The booking is typically open from three to five working days and investors can avail the opportunity of revising their bids within the stipulated time. After completion of the bidding process, the company will determine the Cut-Off price, which is the final price at which the issue will be sold.

- **Step 7: Allotment of Shares**

Once the IPO price is finalised, the company along with the underwriters will determine the number of shares to be allotted to each investor. In the case of over-subscription, partial allotments will be made. The IPO stocks are usually allotted to the bidders within 10 working days of the last bidding date.

- **Other Factors That The Company Consider Before The Initial Public Offering Process Is Complete:** Yes, any company will endeavour to prevent company insiders or internal investors from participating in the IPO process. Remember, company insiders trading in their own shares can disrupt the demand and supply balance. Not only does this measure protect retail investors from manipulated offer prices but also prevents fraudulent company officials to fob off overpriced stocks at the expense of general investors. This measure also helps to fend off additional selling pressure from inside, and thus sustain the market price of shares.

Meaning of book building

- Book Building is essentially a process used by companies raising capital through Public Offerings-both Initial Public Offers (IPOs) or Follow-on Public Offers (FPOs) to aid price and demand discovery. It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices, which are within the price band specified by the issuer. The process is directed towards both the institutional as well as the retail investors. The issue price is determined after the bid closure based on the demand generated in the process.

PROCESS OF BOOK BUILDING

- The Issuer who is planning an offer nominates lead merchant banker(s) as 'book Runners'.
- The Issuer specifies the number of securities to be issued and the price band for the bids.
- The Issuer also appoints syndicate members with whom orders are to be placed by the investors.
- The syndicate members input the orders into an 'electronic book'. This process is called 'bidding' and is similar to open auction.
- The book normally remains open for a period of 5 days.
- Bids have to be entered within the specified price band.
- Bids can be revised by the bidders before the book closes.
- On the close of the book building period, the book runners evaluate the bids on the basis of the demand at various price levels.
- The book runners and the Issuer decide the final price at which the securities shall be issued.
- Generally, the number of shares is fixed, the issue size gets frozen based on the final price per share.
- Allocation of securities is made to the successful bidders. The rest get refund orders.

Eligibility Criteria for IPO Application As Mandated By SEBI

- **Profit Norms:** SEBI has mandated the following criteria based on the company's profitability for any company desirous of issuing an IPO.
 1. The company should have at least Rs 3 crore in net tangible assets in each of the previous three years. Out of this 3 crore amount, not more than 50% should be cash or cash equivalent like money in an account, cash receivable or investment accounts. However, if the Initial Public Offer is being made through offer through sale, this restriction of 50% on monetary assets is not applicable.
 2. The company should have a net worth of at least one crore rupees in each of the previous three years.
 3. The company should have an average operating profit of at least fifteen crore rupees (pre-tax) in each of any three years among the previous 5 years.
 4. If the company has taken a new name, then 50% of the total revenue earned in the previous one year should have come from the activity performed by the company after assuming the new name.
 5. The total value of the issue size of the IPO by the company should not be more than 5 times the net worth of the company before the issue of the IPO.
- **Non-Profitability routes:** SEBI ensures that legitimate companies are not held back due to the stringent profitability norms, thus to provide the necessary flexibility to these companies to access the primary market, SEBI provides the QIB route.
 1. In the QIB route, the IPO must be issued through the book building method and out of the entire offer, a minimum of 75% of the issue size should be allotted to the QIBs (Qualified Institutional Buyers). The company issuing the IPO would be required to refund the entire IPO subscription money if this minimum allotment requirement is not attained.

Allotment of shares

- Allotment is the process of allocating shares to shareholders, based on prior agreements, most commonly seen in an IPO. This allotment of shares is based on conditions which must be satisfied before the shares are issued.
- After the closures of the issue, the bids received are aggregated under different categories i.e., firm allotment, Qualified Institutional Buyers (QIBs), Non-Institutional Buyers (NIBs), Retail, etc.
- The over subscription ratios are then calculated for each of the categories as against the shares reserved for each of the categories in the offer document.
- Within each of these categories, the bids are then segregated into different buckets based on the number of shares applied for.
- The over subscription ratio is then applied to the number of shares applied for and the number of shares to be allotted for applicants in each of the buckets is determined. Then, the number of successful allottees is determined. This process is followed in case of proportionate allotment. In case of allotment for QIBs, it is subject to the discretion of the post issue lead manager.