CHAPTER-I

INTRODUCTION

1.1 INTRODUCTION

An initial public offering is one of the cardinal strategies devised by corporates to raise capital from the public. When a young, fast-growing firm sells its partnership for the first time to the general public and secures global exposure by becoming listed on a stock exchange, it is considered a monumental moment in its life cycle. The Dutch company, Verenigde Oostindische Compagnie (United East India Company), is known to have introduced the first modern IPO in the world and paved the way for share trading worldwide by listing itself on Euronext Amsterdam in March 1602 (Gounopoulos, 2012). An IPO is a proposal by an unlisted company to offer to sell a new issue of securities or existing stocks, or both. In such circumstances, the information available about the company's historical performance and track record is typically insufficient and may lack trust. The IPO prospectus is the primary source through which investors can obtain details about the issue and the history of the company, ownership information, its operating and past financial performance, and the risk factors involved in that investment (Bhabra & Pettway, 2003). It’s a legal document since it’s a written document that contains all of the relevant details about the offering. Both the issuers and the issuance agency have full responsibility for the accuracy of the document.

A prospectus's data is frequently considered as a potential investor's initial window for viewing the company's history and expected future success. Every prospectus for an IPO contains a broad list of items that warn investors about the risks associated with that particular IPO investment (Gleason et al., 2008). A prospectus is a lawful declaration and must meet transparency standards. Hence, the security regulators in most countries have mandated that IPO issuers unveil uncertainty and risk factors in their offer documents as well as serve as prospectus disclosure certifiers, ensuring that prospectus disclosures are clear and transparent (Wyatt, 2014).The Indian Companies Act 2013 and the Security Exchange Board of India have laid down stringent norms in the country. Sections 26 of the Indian Companies Act, 2013 as well as SEBI have listed out the contents which should be included in the prospectus, of which the “Risk Factors section” is the most important.

The risk factor portion of a prospectus is meant to outline important company risks that new issue investors should be aware of. It provides forward-looking and valuation-related information (Ding, 2016). This risk factor section is intended to give a clear and concise overview of the material risks associated with an investment in the issuers' securities that may affect investors' risk judgments and promote prudent investment decisions (Deumes, 2008). Moreover, in order to avoid any potential litigation, listed companies should disclose the risk factors in their prospectus as fully as possible (Beatty & Ritter, 1986). As the prospectus is a legal document, it plays an important function in eliminating information asymmetry between insider-owners and outside public investors. An in-depth examination of such prospectus material may aid in reducing investors' unfavourable selection risks (McGuinness, 2019). An investment decision can be described as a trade-off between expected return and market risk. There is a belief that the higher the risk, the higher the profit. Because of the risk-averse nature of investors, they generally intend to minimise the risk for the desired expected return. In the case of an IPO, investors may find the risk disclosure in the prospectus very useful. Ding (2016) analysed that a true and transparent picture of risk disclosures in the prospectus assists investors in assessing the risks and potential returns from the IPO. The investment decisions of risk-averse investors are skewed towards less risky and higher-return IPOs. IPO firms should provide investors with information not only about the risks involved, but also about the company's ability to control or influence these risks. Thus, investors may make correct and informed investment decisions, which may compensate for the risks they are expected to assume. This disclosure may affect the percentage of the discount to the offer price and, consequently, the IPO valuation. The returns on the first day could move to either the positive or negative side, but it is seen that, generally, IPOs provide very high returns on the first day.

It is empirically assessed that risk disclosure can change a firm’s risk premium and variance (Heinle et al., 2018). With the increase in risk disclosure, information asymmetry can be reduced, resulting in a reduction in the firm’s stock price crash risk (Au & Qiu, 2019), which further enables investors to be confident in the "fair price" of the stock, boosting their confidence to invest a larger amount in a particular firm (Nam et al., 2011).

1.2 THE IPO CONCEPT AND ITS IMPORTANCE

The primary securities market, also known as the "New Issue Market," deals with new securities or those that are being issued for the first time to the investing public. It acts as a gateway for businesses to raise funds for their financial demands. Both listed and unlisted companies use this route to generate funds for themselves. The first issue of shares or convertible securities by the new unlisted companies is known as the "initial issue" or "Initial Public Offer" (IPO). It is also known as an unseasoned new issue (Ule, 1937), whereas those by the existing listed companies are called ‘further issue’ or ‘Follow-on Public Offering’ (FPO). The first time a security is offered for sale to the general public with the expectation of a liquid market developing is termed an "Initial Public Offering" (Ritter, 1998). IPOs are usually offered by young, growing firms looking for funds for further operational or strategic expansion and diversification. Generally, a company decides to go public when its need for financing to satisfy its business demands surpasses its ability to raise additional capital on favourable terms through other channels. On the other hand, big privately held companies, on the other hand, can do so in order to become publicly traded. Hence, an IPO transforms a company from private to public. By listing itself on the stock exchange, a company gets worldwide exposure through an Initial Public Offer (IPO). Academic theory suggests four motivations or reasons for issuing an IPO. The first motivation is based on the literature on the cost of capital. According to the cost of capital theory, if external equity reduces the firm's cost of capital while increasing its value, the firm should consider a public offering (Miller & Modigliani, 1963). Internal equity comes first, followed by debt finance, and finally external equity. According to Myers and Majluf (1984), internal equity comes first, followed by debt finance, and finally by external equity. However, according to Brau & Fawcett (2006), the purpose of going public was to establish public shares that could be used in future acquisitions. The second motivation for IPOs is to cash out the holdings of insiders. Insiders opportunistically sell shares in the IPO for their personal gain (Ang & Brau, 2003). The third reason is that initial public offerings (IPOs) may make takeovers easier. Fourth, IPOs can be advantageous since they increase the company's ownership base (Chemmanur & Fulghieri, 1999). It boosts the firm's visibility or reputation of the company that is going public (Maksimovic & Pichler, 2001). It adds value to the company as investors, creditors, consumers, and suppliers, resulting in increased trust in the company, and it allows shareholders, employees, venture capitalists, and angle investors to convert a portion of their wealth into cash at the IPO or at a later date (Ritter & Welch, 2002). An IPO is viewed by high-tech companies as more of a strategic reputation-building move than a funding decision. An initial public offering, rights issue, or private placements are all ways for a company to raise money in the primary market. The inter-relationship among various types of issues can be shown in Figure-1.1.

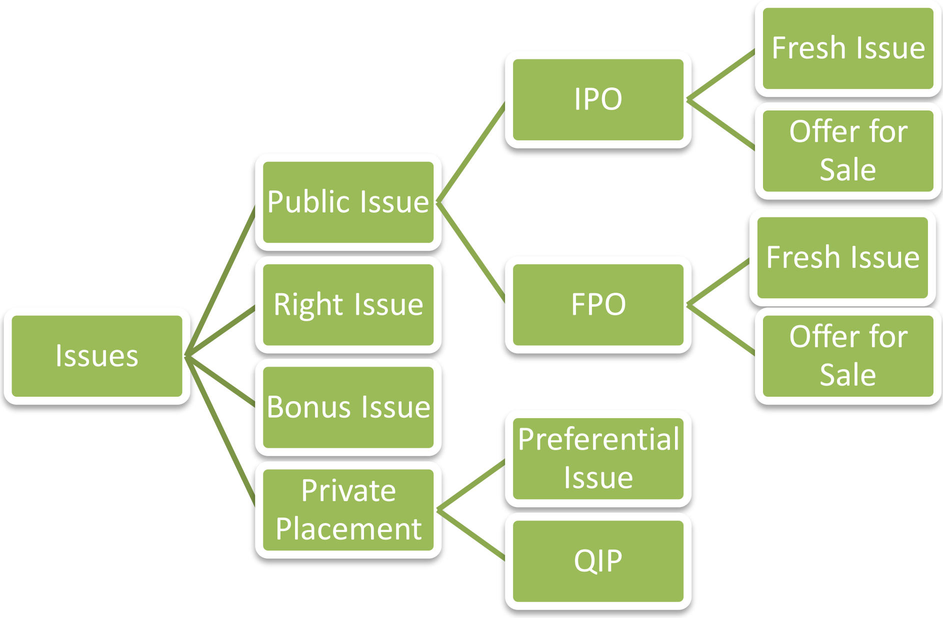

Figure 1.1: Inter-relationship among various types of issues (Author's own compilation)

As per Merriam-Dictionary Webster, "an initial public offering (IPO) is when a firm sells its stock for the first time on the open market. It's also referred as "going public."

According to the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018**,** "Initial Public Offer means an offer of specified securities by an unlisted issuer to the public for subscription and includes an offer for sale of specified securities to the public by any existing holders of such specified securities in an unlisted issuer".

1.3 ELIGIBILITY NORMS FOR FLOATING AN IPO

The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 established the following eligibility criteria for companies launching an initial public offering (IPO):

Norm I (Profitability Route): This is the first entry norm. If an unlisted issuer meets the following criteria, it may undertake an IPO:

i. The issuer had at least ₹ 3 crore rupees in net tangible assets in each of the previous three fiscal years, with no more than 50% held in monetary assets. If the public offer is made in full in an offer for sale, the 50% cap does not apply.
ii. A company's average operational profit (before tax) for the prior five years was at least 15 crore rupees in at least three of those years.
iii. In each of the previous three years, the firm's net worth has been at least ₹ 1 crore.
iv. The issuance size cannot be more than five times the pre-issue net worth as recorded on the previous fiscal year's balance sheet.
v. If the company's name had changed, at least half of the previous year's revenue should have come from the activities specified by the new name.

Entry Norm II (QIB Route)

If an issuing firm is unable to meet any of the Entry Norm I standards, it may choose to offer the issue to the public through a book-building procedure, with a mandatory allotment of at least 75 percent of the net offer to qualified institutional buyers (QIBs). If the minimum number of QIBs is not reached, the company must return the subscription money (SEBI, 2018).

General conditions

(1) A company issuing an IPO should ascertain the following:

a) The company has applied to one or more stock exchanges for permission to list its specified securities on such exchanges, and has designated one of them as the designated stock exchange.
b) It has entered into an agreement with a depository for the proposed IPO's dematerlisation and has already issued specified securities.
c) All of the promoters' specified stocks are dematerialised prior to the filing of the offer document.
d) All of the promoters' specified stocks are dematerialised prior to the filing of the offer document.

e) Its existing partially paid-up equity shares should have been paid up in full or forfeited.)Its existing partially paid-up equity shares should have been either fully paid-up or forfeited.

f) It has made firm arrangements for the issue proceeds to fund 75 percent of the declared means of funding for a specific project, excluding the amount to be raised through the planned public offering or existing identified internal accruals, in verifiable ways.

(2) The amount set aside for general corporate purposes, as stated in the draft offer document and the offer document, shall not exceed 25% of the total amount raised by the issue.

1.4 INTERMEDIARIES ASSOCIATED WITH IPO ISSUE PROCESS

Intermediaries are those who facilitate the initial public offering (IPO) process. Merchant bankers for the issue (also known as Book Running Lead Managers), Registrars for the offer, Bankers for the offer, and Underwriters for the issue, are all SEBI-registered intermediaries who are associated with the IPO issue in various ways. Their addresses, phone/fax numbers, registration numbers, contact people, and email addresses are all included in the offer documents.

Those financial intermediaries involved in the business of transferring capital money to borrowers are known as merchant bankers. Merchant bankers may serve as issue managers, counsellors, consultants, underwriters, and portfolio managers, among other things. They are responsible for the issue management, prospectus preparation, financial structure determination, financial tie-up, and final allotment.

Registrars for the offer are intermediaries who perform activities related to the offer such as collecting IPO application forms, keeping a record of applications and money received from investors or paid to the seller of securities, assisting in determining the basis of allotment of securities, finalising the list of persons entitled to allotment of securities, and processing and dispatching allotment letters, refund orders, certificates, and other documents. The Bankers to the Issue facilitate the transfer of money which is related to applications, allotments, calls, refunds, etc., during the issue process and enable the registrars to settle the basis of allotment by providing them with clear financial status. In the event of an underwritten issuance, underwriters are intermediaries who agree to subscribe to the company's securities if they are not completely subscribed by the public.

1.5 IPO PROCESS

The process of launching an initial public offering (IPO) entails numerous actions and extensive planning on the part of the issuing business. The procedure begins long before the shares are actually issued. The sequence of events of IPO issue is figured below:

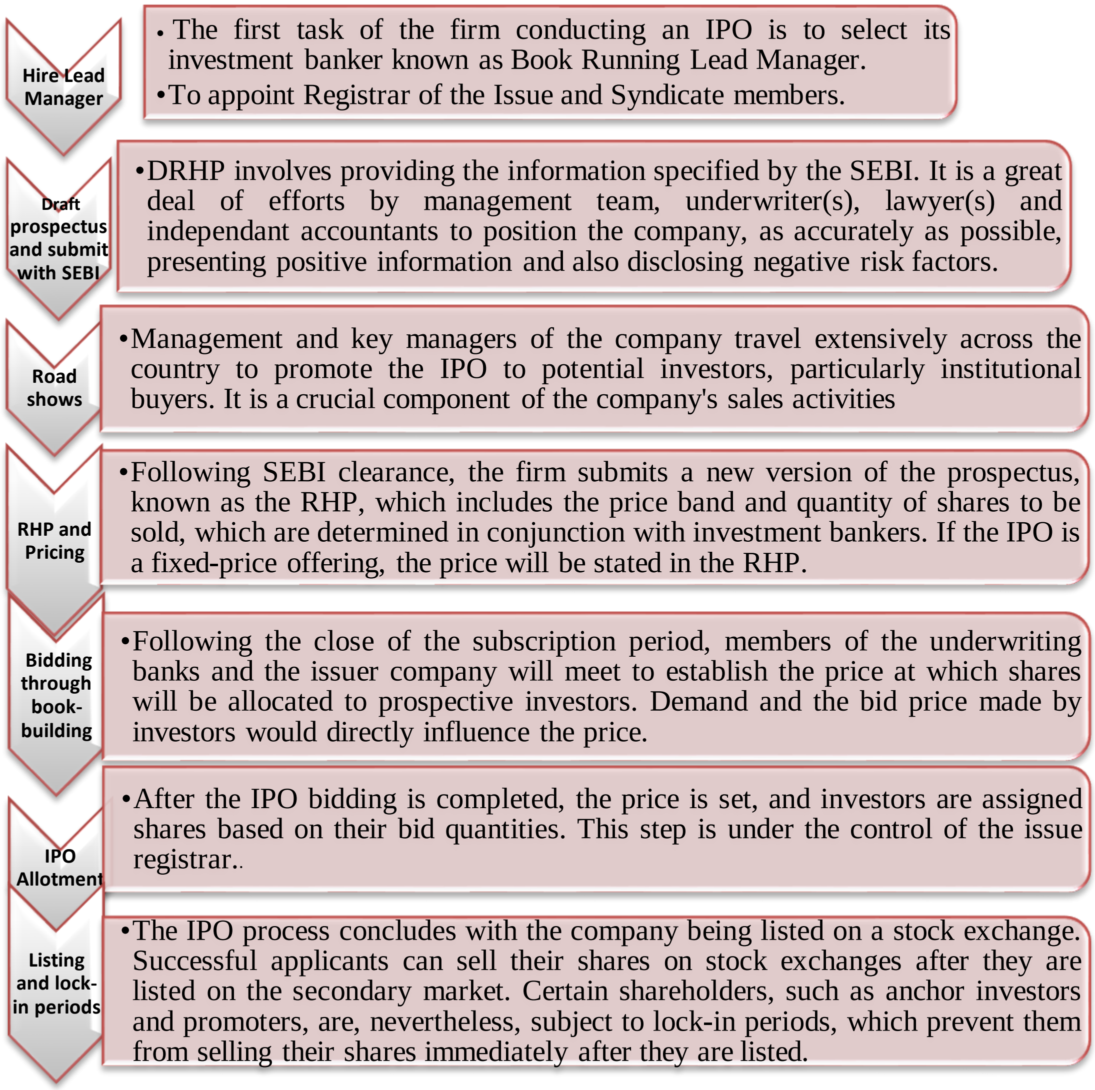

Figure-1.2: IPO Process

(Source: Author's own compilation)

1.6 OFFER DOCUMENTS

The issuer files a document with the ROC and Stock Exchanges called an offer document. It provides information about the company, its promoters, financial and operational facts, the reason for raising funds, and the terms of the issuance, among other things. It's used to invite people to subscribe to the issuer's current offering. An offer document contains all of the necessary information for an investor to make an informed investment decision. The "Offer Document" is referred to as "Prospectus" in the case of a public issue or offer for sale, but it is referred to as "Letter of Offer" in the case of a rights issue. Depending on the stage or type of issue and where the document is utilised, different terms are used for offer documents. The various terms for offer documents are as follows:

1.6.1 Draft Red Herring Prospectus (DRHP)

The DRHP is the first document submitted to SEBI by a company seeking to go public and have its shares listed on a stock exchange. It is an offer document which is in the draft stage, disclosing a company's past happenings and future plans also. It contains all the details about the company from the date of incorporation, including internal and external risks involved in that business, industry, and in the equity shares being offered. It does not, however, include issue-specific information such as the price band, the size of the issue, the number of shares being offered, and so on. SEBI reviews and checks this offer document and ensures whether adequate disclosure is made. This offer document is open for public comments and grievances (if any) on the SEBI and stock exchange websites where specified securities are planned to be listed for at least 21 days from the date of filing. However, within two days of filing the draft offer document, the issuer must publish a public announcement in two newspapers: one in English and Hindi national daily newspapers, and one in regional language newspapers with a large circulation. The lead manager must update the draught offer document with required suggestions and revisions after the specified time limit has expired.

1.6.2 Red Herring Prospectus (RHP)

RHP is the updated version of DRHP which is placed with SEBI incorporating its suggestions and other comments received from the public. In the case of a book-building issue, a RHP is submitted with the Registrar of Companies before the issue opens. After this, the issuer and lead managers can start road shows and advertising the issue but they are prohibited to use anything else which does not form part of the DRHP.

"Red Herring Prospectus" means a prospectus which does not include complete particulars of the quantum or price of the securities included therein. (*Explanation to Section 32, the Companies Act 2013*)

1.6.3 Final Prospectus

It's an offer document that contains all of the company's pertinent information, such as the price and quantity of shares being offered. In case of a fixed issue price, the issuer has to register it with the ROC before the opening of public issue whereas in case of a book built. The RHP is resubmitted to SEBI, this time using issue price figures determined following bidding at the time of the issue's close.

Definition of Prospectus

The prospectus is a document that is issued by a public corporation in order to raise funds. It is the basis of the contract between the company and those who invest in the company's securities. As per 'golden rule for making a prospectus' propounded by Justice V.C. Kindersley, the issuer of the prospectus should honestly project the image of the company from the right perspective, ensuring that no major information is left out which could influence the interest of the potential investors in the company's security. Section 26 of the Company Act, 2013, SEBI standards, and stock exchange procedures should all be followed when drafting a prospectus. The prospectus should be comprised of each and every piece of information about the company, like its historical background, the details of promoters, available opportunities, associated risks, and financial data, etc.

As per Section 2(70) of the Companies Act 2013, "Prospectus means any document described or issued as a prospectus and includes a red-herring prospectus referred to in Section 32 or shelf prospectus referred to Section 31 or any notice, circular, advertisement or other document inviting offers from the public for the subscription or purchase of any securities of a body corporate."

"Shelf prospectus" refers to a prospectus in which the securities or classes of securities mentioned in the prospectus are issued for subscription in one or more issues over a period of time without the need for a subsequent prospectus (*Explanation to Section 31, the Companies Act 2013).*

1.6.4 Abridged Prospectus

An abridged prospectus, as defined by Section 2(1) of the Act, is a memorandum embodying all of the salient aspects of the prospectus as stipulated by SEBI through regulations. It is also stated that no corporation can release a form for the sale of securities unless it is accompanied with an abridged prospectus.

1.6.5 Deemed Prospectus

When any company does not offer its securities to the public directly, but sells the securities to a third party or an issue house, with the understanding that the third party will present the same to the public, in such a case, a document known as a "deemed prospectus" is drafted in which an offer to sell is made to the general public. For all purposes, this document is assumed to be a corporate prospectus and all of the content and obligations of a prospectus will be applied to it *[Section 25(1), the Companies Act, 2013]*.

1.7 CONTENTS OF OFFER DOCUMENT/PROSPECTUS

The statute bound the company to disclose all material information, which may be positive or negative, in its prospectus and to make it accessible to the public, regulators, and other interested parties. A prospectus is a quite lengthy document with hundreds of pages, divided in different sections including tables, charts and graphs etc. The SEBI has suggested important sections of the prospectus, which are discussed below.

1. Cover Page: The cover page of the offer document/prospectus should be white in colour with adequate thickness. The backside of the cover page is kept blank, while the outside cover contains the following information:

i. On the right upper corner of the cover page, indicate the type of offer document - ‘Draft Red Herring Prospectus,' ‘Red Herring Prospectus,' ‘Shelf Prospectus,' ‘Prospectus,' or ‘Letter of Offer,' as appropriate.

ii. The offer document's date.
iii. Issuance type: book-built or fixed-price
iv. In the case of a public offering, mentioning “Please read Section 32 of the Companies Act, 2013” is required.
v. Information on the issuer company, including its name, logo, date and place of establishment, corporate identity number, registered and corporate offices' addresses, and contact information.
vi. Names of the issuer's promoters.
vii. The nature of the issue, the number of securities offered, the price of the securities offered, and the size of the issue, as applicable, including any offer for sale by promoters, members of the promoter group, or other shareholders.
viii. The total amount sought through all rounds of offer via the shelf prospectus.
ix. Risks associated with the First Issue—in the event of a public offering.
x. General Risks- Investors should read the risk part of the prospectus carefully, as indicated by the page numbers.
xi. The ‘Issuer's Absolute Responsibility' provision states that the issuer is solely responsible for all important material information and certifies its accuracy.
xii. All contact information for the lead manager (s), including logos, who are responsible for the due diligence certificate and the filing of the offer document with the SEBI.
xiii. Issue's registrar's contact information.
xiv. Issue Schedule: The start and end dates of the issue, as well as the anchor bid period (if any).
xv. A credit rating, if one has been obtained.
xvi. The name(s) of the stock exchange(s) on which the securities are proposed to be listed.

2. The table of contents: It is found immediately following the front inside cover page.

3. General: This is the first section of the offer document, and the number of pages starts with this section**.** This section identifies all of the document's essential issues and industry-specific key words. It discloses the following:

i. Term definitions and abbreviations used in the offer document, including (a) conventional or generic words, (b) issue-related terms, and (c) issuer and industry-related terms.

ii. Specific conventions for presenting currencies, financial data, and industry and market statistics.
iii. Forward-looking statements

4. Risk Factors: This portion summarises certain general and specific risk factors related to the project, offer and its objective; industry and issuer's on-going business activities; future proposals and material litigation risks etc. which can influence the business. The mentioned risk factors are identified according to their materiality and described in descending order. While describing the risk factors, the company should disclose their potential implications, including financial effects. Any positive speculative statement should not be mentioned regarding any matter or litigation etc. The issuer enlists the risks and uncertainties regarding the investment in the company, classifying them into three categories: internal risk factor, external risk factor, and the risks related to the offer. SEBI has suggested a long list of risk factors which must necessarily be disclosed in the prospectus, wherever applicable. This list of risk factors is described in Chapter-IV of this study.

The following risk considerations must be included in the prospectus:

i. Management-assumed risks
ii. Any recommendations for mitigating the risks.
iii. Prominent disclosures which the management decides to mention should appear immediately after the Risk factors.

5. Introduction: This section includes:

i. A brief summary of the industry and business in which the company operates.
ii. Specifics of the offer, such as the objects of issue, the basis for the offer price, the use of proceeds, and tax benefits, among other things.
iii. Consolidated financial information in summary form.
iv. Information about the company, including the names and corporate offices, directors, officials, legal advisors, underwriters, bankers of the issue, lead manager, auditors, etc.
v. The company's capital structure, mentioning authorized, issued capital, subscribed capital, and paid-up capital, as well as the size of the current issue, with the promoters' contribution, if any, mentioned separately.
vi. As per Regulation 33 of the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, the issuer's shareholding pattern in the required manner.

6. About the Company: This section includes the following information about the company:

i. Overview of the industry in which the issuer's business operates.
ii. Details of the issuer's business-its primary business, plant and machinery, technology adopted infrastructure, intellectual property rights, product, marketing, collaboration and business strategy etc.
iii. Policies and regulations
iv. The company's history and corporate structure.
v. Details about the company's management: the Board of Directors and their shareholdings, Managing Directors and other key managerial personnel, and so on.
vi. Information about the Promoters and the Promoters' Group
vii. If there are any group companies, give details.
viii. Deals involving related parties.
ix. Policy on dividends.

7. Financial Information: This section includes two types of information-

I. Financial information that has been restated and other financial information as per requirements either in terms of Indian Accounting Standards (IAS) or Indian GAAP, both with complete respect.

i. Consolidated Financial Statements for three years duly certified by the auditors along with their subsidiary companies, if any.
ii. Consolidated Financial Statements for the previous three years, duly certified by the auditors and their subsidiary companies, if any.
iii. A statement reconciling the differences between the audited CFS equity and profit (loss) and the restated consolidated financial statement.
iv. A list of all related parties and the transactions in which they are involved.

II. Other Financial Information as per the restated CFS for the past three years related to the following:

i. The EPS
ii. Net worth return
iii. NAV per share
iv. EBITDA

v. If the proceeds of the issue are to be used to purchase one or more significant businesses, the audited financial statements of the acquirer company for the previous three fiscal years.

III. According to the Consolidated Financial Statements, detailed information is disclosed in the MD&A Section, Analysis of Financial Position, and Results of Operations.

IV. Comparison of the profit and loss statement's principal headings over the last three years.

V. The Capitalization Statement that shows borrowings, total equity, and borrowing/equity ratios before and after the issuance.

8. Legal and Other Information: The following legal and other information are presented under this section-

I. Outstanding Litigations and Significant Developments:

i. Any criminal proceedings, pending legal cases related to the issuer/ its promoters / directors / subsidiaries, any action by regulatory authorities and statutory authorities, taxation authority or stock exchanges against company or the promoters in the last five financial years or any other pending litigation etc.

ii. Any outstanding dues to creditors related litigation.

iii. Any other related litigation which is not included in the above mentioned.

II. Approvals from the government and other authorities:

1. Government investment approvals, letters of intent, industrial licenses, and any declaration by the government or other controlling authority that they are not responsible for the financial soundness or accuracy of financial statements.
2. All approvals from the government and other authorities that are material and required for the issuer's and its subsidiaries' business and operations.

III. Information Related to Group Companies

IV. Other regulatory and required legal disclosures:

A. The issue's authority, as well as the specifics of the resolution(s) passed in relation to the issue.

B. A statement from the issuer stating that no regulatory body or court has barred the issuer, any promoter (s), promoter group, directors, or any other allied party from participating in the capital market.

C. Confirmation that the issuer, any of its promoters, promoter group, or selling shareholders abide by the Companies (Significant Beneficial Ownership) Rules, 2018.
D. A confirmation that none of the issuer's directors are involved in the securities market in any way, and, if so, whether the Board has taken any action against them in the last five years.
E. The issuer's eligibility to participate in the capital market under these regulations
F. If applicable, compliance with Part B of this Schedule.
G. Disclaimer clauses.

9. Offer Information:

i. Offer-Statement showing the number of shares issued in the current issue, existing shares in all respects including dividends, face value of share, issue price, floor price, price band, and rights of the security holders, market lot, and nomination facility available to investors and period of public issue subscription list etc.
ii. Offer structure
iii. Offer procedure- Process of book-building and application process, signing of underwriting agreement and prospectus filing with SEBI/ROC, statutory advertisement, issuance of confirmation of allocation note and allotment in the issue, designated date, general instructions, instructions for completing the bid form, payment instructions, use of proceeds, etc.
iv. Specifics on the restrictions on foreign ownership of Indian securities.

10. Main Provisions of the Articles of Association: The main provisions of the AOA deal with voting rights, dividends, liens on shares, and the mechanism for modifying such rights, forfeiture of shares, and any restrictions on the transfer and transmission of securities, as well as their consolidation or splitting.

11. Other relevant information:

Documents for inspection and a list of material contracts:

1. Material contract specifics
2. Documents in Support
3. From the date of the offer document until the date of the subscription list's closing, the contracts, along with papers, will be accessible for examination and its timing and locations.

4. If grades are received, its’ reports.
5. The issuer's Board of Directors must approve the draft offer document/letter of offer and offer document, which must be signed by all directors, including the Managing Director or Manager and the Chief Financial Officer (as defined in the Companies Act, 2013). The signatories should certify the truthfulness and correctness of the disclosures.

12. Declarations: Declarations as under:

We hereby declare that we have complied with all relevant provisions of the Companies Act, 2013, as well as the guidelines/regulations issued by the Government of India or the Securities and Exchange Board of India, established under section 3 of the Securities and Exchange Board of India Act, 1992, as the case may be, and that no statement made in the RHS. We also attest that all statements are correct and true.

1.8 DISCLOSURES IN THE OFFER DOCUMENTS AND THE DRAFT OFFER DOCUMENTS

While drafting the offer document the following point should be kept in mind:

(1) All material disclosures in the draft offer document and the offer document must be factual and adequate to allow the applicants to make an informed investment choice.

(2) The RHP and prospectus must include the following information, without limiting the scope of sub-regulation (1):

(a) Disclosures mandated by the Companies Act of 2013, as well as

(b) The disclosures set forth in Schedule VI Part A.

(3) The lead manager (s) must conduct due diligence on all aspects of the issue, including the accuracy and completeness of disclosure in the draft offer document and the offer document.

(4) The lead manager (s) should insist that the issuer, its promoters and directors, as well as the selling shareholders in the case of an offer for sale, fulfil their obligations as outlined in the draft offer document and the offer document, as well as as required by the regulations.

(5) The lead manager (s) must ensure that the information in the draft offer document and offer document, as well as the particulars in the restated audited financial statements contained in the offer document, are not older than six months from the issue opening date.

1.9 CATEGORIES OF INVESTORS

The following categories are used to categorise the investors:-

A) Retail Individual Investors (RIIs)

RIIs are investors those who invest in the equity market in much smaller amounts than large institutional investors. Retail individual investors include resident Indian individuals, NRIs, and HUFs. In a year, an investor can apply for or bid for any specified security worth up to two lakh rupees.

B) Non-Institutional Investors (NIIs)

The NII category includes residents of India, eligible NRIs, HUFs, corporations, corporate organizations, scientific institutes, societies, and trusts that apply for more than 2 lakh IPO shares. Non-Institutional Investors are investors who do not fall under the categories of RIIs or QIBs. High Net Worth Individuals (HNIs) and business entities are typically included under this category.

C) Qualified Institutional Buyers (QIBs)/ Institutional Investors

According to SEBI, a "institutional investor" is defined as either (i) a qualified institutional buyer; or (ii) a family trust or intermediary registered with the Board, with a net worth of more than five hundred crore rupees as per the most recent audited financial statements, for the purposes of listing and/or trading on an institutional trading platform. For the purposes of engaging in the main issuance process, any entity that falls under the criteria listed below is considered a QIB, and these entities are not required to be registered with SEBI as QIBs. SEBI norms forbid QIBs from withdrawing their bids after the deadline for the closing of IPOs.

i. Any public financial organization, as defined in Section 4A of the Companies Act of 1956;
ii. Any regularly scheduled commercial bank;
iii. Any mutual fund that is registered with the SEBI;

iv. Any foreign institutional investor and sub-account registered with SEBI, excluding sub-accounts owned by a foreign corporation or individual.

v. Any multinational or bilateral development financing institution;

vi. Any venture capital fund registered with SEBI;

vii. Any international venture capital investor who is a SEBI-registered entity;

viii. Any public corporation established to promote the development of industry in the state;

ix. Any insurance company registered with the Insurance Regulatory and Development Authority;

x. Any provident fund with a minimum corpus of ₹ 25 crores;

xi. Any pension fund established with a corpus of at least ₹ twenty-five crores;

xii. The National Investment Fund established by the Government of India by Resolution No. F. No. 2/3/2005-DDII dated November 23, 2005, which was published in the Indian Gazette.

D) Anchor Investors

The anchor investors are those who can subscribe to the issue before it goes public by paying a 25% margin on application and the remaining 75% within two days of the public issue closing. The anchor mechanism requires the issuing firm to offer a portion of the IPO to "anchor" institutional investors before making this allocation available to public bidders. The offer price for anchor investors is also decided separately. They have to hold the shares for at least one month. It boosts confidence among retail investors regarding the issue. A QIB would be the anchor investor, and the issuer might allocate up to 30% of its institutional quota to them. The general conditions specified for anchor investors are as under:

i. Through the book-built process, an anchor must submit an application for a minimum of 10 crore rupees or more.

ii. Anchor Investors are eligible for up to 60% of the QIB Category.

iii. A third of the anchor investor proceeds must be set aside for domestic mutual funds.

iv. Anchor investors have different Anchor Investor Bid/Offer Periods.

v. Each anchor investor's minimum application size should be 10 crore rupees. Under the anchor investor category, no merchant banker, promoter, or their family are eligible to apply for shares. There can be a maximum of 15 anchor investors if the offer size is less than 250 crore rupees, but there is no limit on the number of anchor investors if the offer size is greater than 250 crore rupees.

vi. Anchor investors are barred from bidding at the cut-off price.

vii. Applications from QIBs in the anchor investor and non-anchor investor categories are not considered multiple applications.

1.10 METHODS OF ISSUE PRICING

The new securities can be issued either through a fixed pricing method or through a book building method that decides their offer price. It's the price at which a company sells its stock to the general public. The offer price plays a vital role in measuring the market performance as it ultimately decides the under-pricing or overpricing of the stock on the initial listing day.

1.10.1 Fixed Price Method

The companies offering their shares by using a fixed price method have to mention the specific issue/offer price in the offer document before making their issue publically available. The fixed price was decided on the basis of a set formula suggested by the CCI (Controller of Capital Issues) during the pre-liberalization period. Only when the issue is closed, the exact demand for the securities can be determined. This mechanism allocates 50% of the net offer to RIIs and the remaining 50% to other investors such as corporations or institutions.

1.10.2 The Book Building Method

In India, book-building was introduced in 1999 with the concept of price band, and now the issuers have the opportunity to choose between the fixed price and the book-building methods. However, the fixed price offerings were the preferred mechanism up to 2003, though later the book building pricing method overpowered the IPOs. The book building method added the option of "anchor" investors at the initial stage prior to the public offering, in the year 2009 (Bubna & Prabhala, 2013).

The issuer specifies the floor price or the price band in the RHP in the book building method. If this price band is not specified, then the issuing company shall announce it at least two working days prior to the opening of the bid for an IPO. The difference between the floor price and the cap price should not be more than 20%. This method provides the investors the opportunity to decide their own price by bidding for the shares. After the closure of the issue, the issuer decides the cut off price of the IPO, keeping in view the demand and supply of the shares, after consulting with the merchant bankers. This method favours the issuer in minimising the variance in the extent of information asymmetry among different classes of investors by allowing potential investors to make flexible bids within a pre-determined price range (Katti & Phani, 2016). Successful bidders who bid at a higher price than the issue price receive a refund, while those who bid at a lower price than the issue price must pay the difference. The money is refunded to all unsuccessful bidders. The following norms for allocation in the net offer are reserved under the book building method:

1) If an entry norm I issue is raised in accordance with Regulation 6(1)

a) 35 percent to retail individual investors.
b) 15% allocated to non-institutional investors;
c) Fifty percent to qualified institutional buyers, with five percent going to mutual funds [Regulation 32(1), SEBI (ICDR) Regulations, 2018].

2) In the case of Regulation 6(2) Entry norm II

a) 10% to retail individual investors.
b) 15% allocated to non-institutional investors;
c) Seventy-five percent to qualified institutional buyers, with five percent going to mutual funds [Regulation 32(2), SEBI (ICDR) Regulations, 2018].

3) Subject to the restrictions set forth in Schedule XIII, the issuer may allocate up to 60% of the portion available for allocation to qualified institutional buyers to anchor investors. Qualified institutional buyers filing an application for a value of 10 crore rupees or more through the book building procedure are referred to as anchor investors *[Regulation 32(3) SEBI (ICDR) Regulations, 2018].*

1.11 SECURITIES LISTING ON STOCK EXCHANGE

A public firm must have its securities listed on at least one of the country's stock exchanges. The process of admitting an issuer's securities to trading privileges on a stock exchange through a formal agreement is known as listing. The primary goal of listing is to provide securities with liquidity and marketability, as well as a framework for effective control and supervision of trading. It not only secures the interests of shareholders and investors but also offers free negotiability to securities. Following the listing of securities, the issuer must comply with the stock exchange's requirements.

A stock exchange is a trading platform for existing securities. Trading transactions can take place both physically on the trading floor and electronically via a network of computers on virtual stock exchanges. There are 23 stock exchanges in India, but the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) are the major trading exchanges.

According to the Securities Contracts (Regulation) Act 1956, "Stock exchange means anybody of individuals, whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities". Regulation 2 (1) (ggg), Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018, has defined a stock exchange as "Any recognised stock exchange having nationwide trading terminals chosen by the issuer, on which securities of an issuer are listed or proposed to be listed for the purpose of a particular issue of specified securities under these regulations, other than an SME exchange." This trading terminal is known as 'main board'.

'SME exchange' refers to a trading platform of a recognised stock exchange with national trading terminals that has been granted recognition by the Board to list the required securities issued in accordance with Chapter IX, but does not include the Main Board [Regulation 2(1)(ddd), SEBI (ICDR) Regulations, 2018].

In India, the first exchange designed specifically for SMEs was established in 1990 which was known as the OTC Exchange of India. But the trading on OTCEI was below expectations. As a result, the need for a new stock exchange or a separate platform on recognised stock exchanges for SMEs arose, and the SEBI issued a circular in this regard on April 26, 2010.This platform helps new, infant ventures and small quality companies raise the required capital to grow themselves enough to move to the main board of the stock exchange.

In March 2012, BSE floated its 'SME Platform" while the NSE launched its platform named "Emerge" in September 2012. SMEs with a post-issue paid-up capital of less than or equal to 25 crores are eligible to join the SME Platform. The significant listing requirements for the Main Board and SME Platform are demonstrated in table 1.1

Table -1.1: Regulations for Listing of IPOs on Main Board and SME Exchange

Particulars	Main Board	SME Platform
Post-issuance paid-up capital	A minimum of INR 10 crore is required for an IPO and for FPOs INR 3 crore	Minimum INR 3 crore Maximum INR 25 crore
Minimum number of allotees in the IPOs	1000	50
Trading lot size	INR 10000 – INR 15000 Min.	Min. INR 1 lakh
Underwriting of IPOs	Non Mandatory (Under fifty percent compulsory subscription to QIB's)	Mandatory (hundred percent underwritten with MB underwriting 15%)
Offer Document vetting	By SEBI	By Exchange
Track Record of Distribution Profits	Stringent track record norms like Operating Profit of 15 Crore rupees. There must have been profit last year, as well as distributable profits in three of the previous five years.	Track record norms have been relaxed. There must have been distributable profits in two of the previous three years, or the company's net worth must be at least Rs. 5 crores.
IPO Time frame	6 months-1 year	2-3 months
Market- making	Non- obligatory	It is obligatory for the Merchant bankers to undertake market making for a period of three years.
Corporate governance requirements	Clause 49	Clause 52
Report Requirement	Quarterly	Half yearly

Source: https://www.abhipra.com/sme-listing/110-sebi-guidelines

[Chapter IX, Regulation 228 of SEBI (ICDR) Regulations, 2010]

1.12 IPO PRICING

The day, when IPO opens for the first time for its trading, is known as the listing day and the closing price on this day may vary from the issue price. The initial returns could move to either positive or negative side but in some cases it can be fairly priced. If the IPO's listing day price is significantly more than the issue price, the stock is considered to be under-priced; while if the IPO's initial price is less than the issue price, the stock is thought to be overpriced. The IPO is known as 'fairly priced' if the listing day price remains same as the offer price which signifies that market is perfect. Under-pricing as well as Over-pricing denote market imperfections may be due to investors' ignorance, information asymmetry, uninformed investors and market players etc. (Ljungqvist & Wilhelm, 2003). Generally, IPO investors make high returns on listing day, which is known as short-run under-pricing.

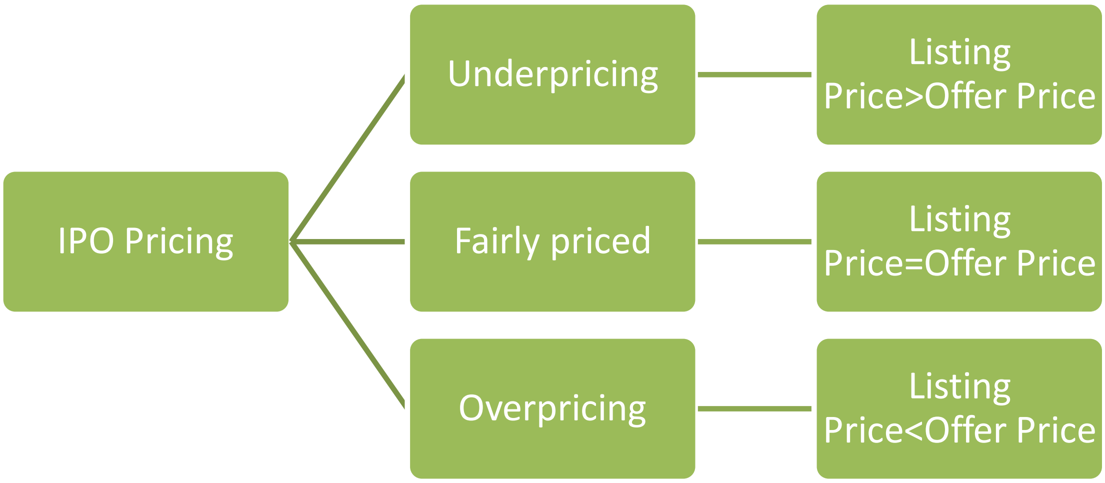

Figure-1.3: IPO Pricing

(Source: Author's own compilation)

1.13 THEORIES OF UNDER-PRICING

The under-pricing is one of the anomalies related to IPO pricing. This anomaly happens when an IPO's initial offering price is determined lower than its intrinsic worth (Beatty & Ritter, 1986). Under-pricing occurs when the offer price at which IPO is offered to the public is lesser than the prices at which it happens to trade on the stock exchange on its first day of listing. It's regarded an opportunity cost for companies going public since issuers are "leaving money on the table" by selling shares at a lower offer price than their potential market value (Loughran & Ritter, 2002)

Number of theoretical models around the anomaly of under-pricing has been developed to describe the causes of under-pricing phenomenon. Any single theory cannot provide a valid exhaustive explanation of IPO under-pricing. However, the most of the theories explaining under-pricing are based on the notion of information asymmetry. Ritter & Welch (2002) has suggested the categorization of theories of under-pricing based on the assumption of whether information is asymmetric or symmetric. Theories based on asymmetric information include signaling hypothesis, winner's curse, market feedback hypothesis, agency hypothesis, Ex-ante Uncertainty model and bandwagon effect etc. while symmetric information theories include the lawsuit avoidance hypothesis, internet bubble and trading volume etc. Other models assume that under-pricing is the result of investors' behavioural biases [Welch (1992) and Ritter (1998)] which can be categorized as Behavioural Theories. Significant theories of under-pricing are discussed as below:

1.13.1 Asymmetric Information Theory

The study of decisions in transactions where one party has more or better information than the other, resulting in a power imbalance in economic transactions, is known as information asymmetry. Under-pricing theories based on asymmetric information assume that participants in the IPO process are not equally well informed about the underlying value of the issue. As per Asymmetric information models, the investors, the investment banker and the issuers are not equally informed as one of them has more relevant information than that of the other. The following models were developed on the basis of information asymmetry theory:

A. Information asymmetry between investors

Rock (1986), a noted theorist, developed a significant model of under-pricing namely the winner's curse. His model defines that there exists wide information asymmetry among investors. IPO market comprises two major groups of investors-uninformed investors and informed ones. The informed investors have more information about the fair value of the shares than uninformed investors. Being more acquainted with market information, the aware investors bid only for attractively priced IPOs whereas unaware investors bid randomly for any IPO due to the lack of proper market knowledge (Rock, 1986). As per the winner's curse model, in attractive offerings, the uninformed investors obtain less shares as the informed investors bid more while in unattractive IPOs, the unaware investors obtain larger number of shares in overpriced IPOs because the aware investors don't invest in such IPOs hence leave them with return lesser than the average under-pricing return. Rock stated that under-pricing is required to boost the participation of uninformed investors in the stock market so that they may not face the 'winner's curse' during trading in a competitive age.

Previewing the model of Rock, Beatty & Ritter (1986) further assumed that the winner's curse problem will intensify with the increase in ex-ante uncertainty as more uncertainty means more risk, especially for unaware investors. When the issuers do not provide detailed information, the investors have to spend more to get the required information. In such cases, the risk is mitigated by a higher expected return as a result of the lower offer price.

B. Asymmetry of information among investment bankers, as well as between investment bankers and investors

Baron (1982) introduced a model, based on the principal-agent relationship known as agency theory, mentioning the situation where the issuer, the principal, is less informed in comparison to the investment banker (underwriter), the agent. Often the issuer has to depend upon the advice of the investment bankers and even the offer price is virtually decided by the investment bankers. Baron's model describes that the investment bankers are compensated by the under-pricing for his better guidance and information. The higher is the uncertainty regarding the demand for the issue, the higher will be the under-pricing to encourage the banker to perform his utmost to sell the stock.

Benveniste and Spindt (1989) propounded the 'information gathering theory', based on the market feedback hypothesis It presumes that client investors can be encouraged to disclose their information related to the firm consequently determining a low offer price and preferring allocations in future IPOs. Thus underwriters make them sure that their future offerings will also be sold out. As an extension in Baron's model and Benveniste and Spindt's model Loughran and Ritter (2002) state that 'leaving money at the table' is another type of underwriters' compensation, whereas Ljungqvist (2003) affirms that underwriter compensation and under-pricing are supplements of each other. A bigger gross spread is associated with lower under-pricing.

C. Asymmetry of information between issuers and investors:

The information asymmetry between issuers and investors is the basis for the signaling hypothesis. In this model, Allen & Faulhaber (1989)and Welch (1989) have stated that the issuers of high quality, being more-informed, use the under-pricing as a tool to signify their better quality to investors. High-quality issuers intentionally under-price their shares to enhance their goodwill and enable themselves to get higher returns from their subsequent offerings. These higher returns will recoup the loss of earlier under-pricing. The lower quality issuers are not in such a position to copy the high quality firms' attributes as the cost of imitating them will be beyond their limits. The issuers and promoters can use the prospectus as a vehicle to signal significant insider information. Assuming that the company and their sponsor have a greater understanding of the firm's valuation than most market players, the IPO signaling hypothesis claims that successful companies use certain factors to communicate value, and that the prospectus is an excellent medium for doing so.

1.13.2 The Lawsuit Avoidance Theory

Tinic (1988) assumes that firms, in order to lessen the possibility of litigations by investors, underprice their IPOs. Under-pricing is regarded as an ex-ante insurance against upcoming litigations. To give the benefit of under-pricing, the issuers intentionally fix the offer price lower to avoid any future litigation for their wrongdoings and material omissions in prospectus. In this way, the frequency and expenditure on future lawsuits can be minimized. Ritter (1998) is of the view that such under pricings are too expensive to avoid the possibilities of future litigations.

1.13.3 The Information Cascades Theory

The information cascade theory is widely used in the area of behavioral economics and also has vital implications for financial markets. When a person makes a decision based purely on the decisions of others rather than their own unique knowledge, an information cascade occurs. The investor wants to do what the other investors doing rather than using their own information and decision are making capability. Such behavior of investors is known as herd behavior and this psychological biasness leads to bandwagon effect. Welch (1992) documented that bandwagon effect or informational cascade may influence the investors to great extent in the IPO market. The bandwagon effect is visible when the potential investors make their investment decisions according to the plans of other investors instead of their own information about the IPO. Even after having favourable IPO information, such investors will not invest as other investors are not interested in investing in that IPO. Thus issuers, making use of bandwagon effect, underprice their shares to influence the initial few potential investors to purchase their IPOs so that other investors may also get interested in purchasing without considering their own information. Further, this bandwagon effect was also experienced by Ritter (1998).

1.13.4 The Fads (impresario) Hypothesis

Aggarwal & Rivoli (1990) assumed that there exist fads in the IPO market as investors behave irrationally in the early aftermarket due to optimism. It induces the underwriters to under-price their IPOs intentionally to gain publicity and to encourage the investors (Shiller, 1990). The optimism of investors motivates the underwriters to set a higher offer price than the intrinsic value of security to make the investors buy more shares in the aftermarket. However, as the price gets back to its basic value 4in the long run, underperformance is evident. According to Ritter (1991), anomalous initial returns for IPOs are due to investor overvaluation of IPOs rather than systematic under-pricing. The impresario hypothesis ascertains that in the primary market IPOs can be fairly priced, however, due to the effect of fads investors may overvalue the IPOs in the early aftermarket. As a result, under the premise of efficient markets, the price of initial public offerings (IPOs) may indicate a negative connection between initial returns and long-term performance (Shiller, 1990).

1.13.5 Speculative Bubble Theory

Generally, investors have the tendency to adhere to market trends; they invest in upward trend markets and sell their securities when the market has downward trend. The speculators capture the trend as they buy the IPOs with opening of offerings and immediately sell them in the aftermarket. Thus the law of demand and supply play a vital role in such a situation, the higher demand of securities even before opening of the IPO creates a speculative natured bubble in the market enabling the issuers to decide a higher offer price. This speculative bubble remains in the early aftermarket which enables the speculators to get more returns (Douglas, 1997).

1.16.6 Prospect Theory

A 'Prospect Theory' was suggested by Loughran and Ritter (2002), which explains why issuers should not object to the money left on the table in the initial public offerings. Most IPOs leave a fairly small sum of money on the table. The cash situation left on the table arises when the IPO's offer price and market price are more than the planned. As a result, a small percentage of issuers lose money. At the same time, such issuers normally find that they are wealthier than they planned and left satisfied by balancing their losses with the profits, even though they have already been victimized. This theory emphasizes the covariance of money left on the table and changes the wealth of decision-makers of the issuing company.

1.13 MAJOR RISKS CONCERNED WITH INVESTING IN INITIAL PUBLIC OFFERINGS (IPOs)

Risk is an inevitable element of any business venture. Risk, in a general sense, is used to signify hazard, threat, or harm (Toisktillio, 2000). In the seminal state, risk was generically associated with the act of nature and viewed as unmanageable. It is basically described as ―variability around expected value or expected losses (Harrington & Niehaus, 2003). Risk can be characterised as a circumstance where the potential outcomes of the decision are not known. Risk incorporates either the positive and negative outcomes of events (Linsley & Shrives, 2005) or the uncertainty associated with both a potential gain and a loss. In the finance literature, 'risk refers to the possible loss of income or capital or unavailability or variability of expected return', Besides financial risk, a firm has to face business risk and economic climate changes that can also affect the performance of its securities (Abdel-azim & Abdelmoniem, 2015). 'Business risk' refers to the inability of a company to maintain its competitive position and the growth or stability of its earnings. Business risk can be divided into two broad categories: internal and external risk. Internal risk is largely associated with the operational efficiency of a firm. External risk is the result of operating conditions imposed upon the firm by circumstances beyond its control. Some of the external factors like the business cycle, demographic changes, political policies, monetary and fiscal policies of the government, and the general economic environment of the economy influence the costs and revenues of the firm. Typical risk factors include a company's lack of operating history, lack of profitability, financial position, business or lack of a market for the company's securities. Other risk factors include those dealing with possible litigation, competition, future capital needs, and dependence on key personnel, government regulation and other factors unique to the company or its industry. Though the risk factors are abundant but some significant risk factors are being discussed here:

(i) Lack of Operating History of Issuer – An issuer, going to be public, may be in its infant stage with little operating history having meagre revenue or even at a loss as during its initial stage a company has to invest a huge amount in the establishment of the infrastructure and developing its product or service and market share. Such issuers have to face various risks related the setting up a new business viz developing its manufacturing capacity, limited product, inexperienced marketing experts, intense competition, and dependence on limited suppliers or customers.

(ii) Lack of Prior Market for the issuers' stock- There is any public trading for the company's share before the launching of IPO and also there is no surety of developing and retaining of active trading following the IPO. Furthermore, the prices of the shares are subject to market fluctuations resulting due to numerous factors like market volatility, lack of liquidity and other external variables.

(iii) Additional Financing – The IPO issuer suffering from loss have to raise additional finance for funding its operation. The additional equity shares issuance results in dilution of the existing shareholding and interests of existing shareholders. If it is financed through debts, indebtedness will occur as well as the issuer has to face certain risks such as interest rate fluctuations and inadequate cash flow generation for scheduled payments. The issuers may be unable to raise additional finance on desired covenants or they have to curtail their operations due to the shortage of funds.

(iv) Inexperienced Management Team- A Company may face problems due to unavailability of experienced management personnel. Their hasty and immature decisions may land the company in a difficult situation.

(v) More Dependence on Key Personnel – Generally the issuers have to depend on the services provided by the key technical and managerial personnel and their inability to retain them may affect adversely the issuer's operating and financial condition.

(vi)Proprietary Rights and Licenses – As some of the issuers rely on others' proprietary rights in their business hence their success depend on their capability to get and protect intellectual property rights. There is also possibility of infringement of intellectual property rights and counterfeits by competitors which may result in litigation and substantial costs.

(vii) Dependence on limited Suppliers – For product components or materials many issuers depend on a certain number of suppliers. Their Inability to get adequate supplies of goods and materials, leads to non-production of goods as per the customers' specifications, delay in deliveries or reductions in shipments. This may bring adverse effects on their business.

(viii) Reliance on Small Number of Customers – If the primary customer base of any issuer is restricted, the loss of even a small number of customers may cause adverse effect on the business and financial position.

(ix) Cut throat Competition – The issuers have to encounter with big companies having sound financial position and better technical resources. Thus they cannot take the risk of investing much to maintain their competitive position in the market.

(x) Product Obsolescence and Rapid Technological Change –In this hi-tech age, the issuers have to face the problem of technological changes as their product may become obsolete. Due to limited resources the issuers may be unable to develop new products or make necessary and timely changes in their technology to maintain their position in the competitive market.

(xi) History of Loan Default- The issuer may have the history of default in payment of loans which indicates issuers' poor financial position as well as their poor cash management ability. It also increases the possibilities of bankruptcy. Hence the investor remains more aware while making investment in such type of companies.

(xii) Negative Gross Margins and cash flows- If any issuer is incurring losses and negative cash flows in the past, such situation means that in the near future, if ever or it is probable that such a business will never be profitable, the company is not likely to make money for quite some time. The investor should therefore consider before investing in such a company.

(xiii) Legal Proceedings- Significant litigation pending against the company is another risk factor worth considering while investing. Such litigation cases are difficult to quantify as it is almost impossible to determine how the court of law will decide a case or how much harm it will grant to a company.

(xiv) Prior Unsuccessful Public Offering Attempt- If any issuer had filed its RHP to go public earlier, but have to withdraw due to poor market response and under subscription. This may had happened due to various reasons such as weak operating performance, financial condition of the company, non-compliance with rules and regulations, poor reputation of promoters or directors etc. In such situations, even after the IPO was floated on the second attempt, the stock could be exchanged at a very low rate because of the issuer's weak fundamentals. The investors treat such investment as risky.

(xv) Technology Risk- Occasionally, the IPO firm may be using an out-dated technology in its business/production process, or other companies in the same industry may be using better, more sophisticated technology in their operations, giving them a cost advantage or allowing them to provide higher-quality products in the market. In other cases, the government may be considering banning the technology already in use, because of environmental concerns or the effect on the health of workers and consumers etc. In such situations, investing in the company's initial public offering (IPO) shares could be highly risky in terms of long-term success.

1.15 RISK FACTOR DISCLOSURE IN IPO PROSPECTUS

Due to liberalisation and globalization, the business world has now turned into a boundary less field where businesses have to face various types of risks. It's tough to anticipate all of the risks. So, the most ideal way, in such a situation, may be to disclose known risks in the most complete and exact manner as could reasonably be expected. Risk factor narrated by issuers in their offer documents are meant to play a vital role in the capital markets by providing investors with a knowledge of the risks that specific companies face. Corporate finance theory suggests that more disclosure can reduce a company’s cost of capital. The choice to purchase, sell, or keep a company's stock is based on an investor's expectations for future cash flow and return distributions.

According to Beretta & Bozzolan (2004) risk disclosures can be defined as "a communication of information concerning firms’ strategies, characteristics, operations, and other external factors that have the potential to affect expected results."

Risk disclosure sentences are those that could inform the readers of any prospect, opportunity, exposure, hazard, threat, or harm that has already impacted the operation of the company or may pose an impact in the future. A sentence will be coded as a risk disclosure sentence if it complies with any part of the risk disclosures as described above (Linsley & Shrives, 2006). The risk factors section of any prospectus, however, requires greater judgement regarding what to say and what to include. This rule specifies that companies should "set forth each risk factor under a sub caption that adequately describes the risk," but it is not necessary that the word "risk" appear in every sentence that was defined as a risk disclosure sentence (Arnold et al., 2010).

The Risk Factors Section of the prospectus contains a number of risk disclosure statements which give a brief outline of risk factors associated with the investment in new issue securities. These statements concentrate on a number of the foremost internal and external risk factors related to the issuer's business and industry such as operational, financial, managerial, technological, economic and political and IPO initiatives etc. Investors should adjudge these risk factors keeping in view their own investment objectives, risk forbearance and financial condition.

The government and security exchange regulator of every country has mandated the issuer of securities to include a specific risk factors section in its prospectus. The firm identifies and discusses the specific risks that are associated with an investment in the firm in this section. Risk factors present the summary of risks facing the company. Every initial public offering (IPO) prospectus has a long list of elements that expose investors to risk when they invest in an IPO. Generally, IPO prospectuses are drafted using language borrowed from the disclosure of other, similar companies. As a result, the Risk Factors section is sometimes misunderstood as merely legal boilerplate, but a well-designed risk factors discussion that is carefully tailored to the company can provide significant liability protection. Complete and clear risk factor disclosure proves to be a prophylactic gesture against legal liability under the "bespeaks caution" doctrine, which protects issuers from litigation if they have sufficiently warned about the risks that may cause a fall in security prices if subsequently materialised (Spindler, 2009). Risks disclosed can include such items, if applicable and important to the company's business, as the company's early stage of development, its short history or lack of profitability in past periods, potential volatility of the company's operating results, special risks in the company's industry, the status of product development and need for follow-on products, competition, litigation, reliance on certain customers, dealers or suppliers, the need for additional funds, as well as any other significant business risks. In addition, if the company is foreign or has a significant international presence, then there may be other specific risks, including fluctuation in currency exchange rates, enforce-ability of different court judgments and different stockholder rights in foreign jurisdictions.

The company should use various plain English principles to make the risk factors easier to read and each risk factor should be concise and focused. The Securities and Exchange Commission of the US has suggested six basic principles of plain English as:

1. Short Sentences
2. Definite, concrete, everyday words
3. Active Voice
4. Tables or bullet points, whenever possible.
5. There is no legal jargon or highly technical business terms.
6. No multiple negatives.

1.15.1 SEBI GUIDELINES ON RISK DISCLOSURE

The Securities and Exchange Board of India (SEBI) has also mandated that the outside front cover page of the prospectus should contain a cross-reference to the risk factors section, including the page number where it appears in the offer document/prospectus under the heading of 'General Risks'. The following general risk clause must be included:

"Stock and equity-related securities are risky investments, and investors should only participate in this offer if they can afford to lose their money. Investors are advised to read the risk factors carefully before taking an investment decision in this offering. Investors must undertake their own due diligence on the issuer and the offer, including the risks involved, before making an investing decision. The Securities and Exchange Board of India (SEBI) has neither advised nor approved the securities, nor does it guarantee the accuracy or completeness of this document." [Clause 6.4.2.2 (a) (v), Securities and Exchange Board of India (Disclosure and Investor Protection) guidelines, 2000]

One more clause on ‘Risks in relation to the first issue’ (wherever applicable) shall also be incorporated in a box format in case of an IPO:

"There has been no established market for the company's securities because this is its maiden offering. The issue price/floor price/price range is 'X-times' the face value of the shares, and the face value is (——-). The issue price/floor price/price range (as decided and justified by the Lead Merchant Banker and the issuing firm in the Justification of Premium paragraph in the case of a premium issue) should not be considered indicative of the market price of the equity shares after they are listed. There can be no guarantee of active or sustained trading in the company's shares, or of the price at which the equity shares will be traded." [Clause 6.4.2.2 (a) (iv), Securities and Exchange Board of India (Disclosure and Investor Protection) guidelines, 2000]

The prospectus should provide all the required information, including risk factors, to potential investors, which they should consider while making an informed decision on the firm and its shares. Besides the information about the offer, the prospectus should also cover general information about the firms, the industry, forward-looking statements, MD&A and the audited financial statements for a minimum of the last 3 years of audit. It is expected that such information could be used to estimate the firm's value on the date of the IPO. The primary goal of the disclosure rules is to reduce the information asymmetry that exists between a company entering the public securities market and potential investors. However, the issuers and sponsors could also exploit the prospectus as a means of signaling important insider information. All the significant factors that make the offering speculative or risky should be discussed. The issuer should set forth each risk factor under a sub caption that adequately describes the risk.

The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 has issued guidelines regarding risk factor disclosure in prospectuses as following:

(A) Risk factors are to be printed in a clearly legible font, preferably of a minimum point size of ten that is readable

(B) Risk factors are to be defined as those that are project-specific and internal to the issuer, as well as those that are external and outside the control of the issuer.

(C) Risk factors is to be identified on the basis of their materiality. While identifying, the following will be taken into account:

1. Certain risks may not be material when considered individually, but they may be material when considered collectively.
2. Certain risks may have a qualitative but not a quantitative impact.
3. At present, certain risks may not be material, but in the future they may have a material impact.

(D) Every risk factor must appear as follows:

1. The issuer's assumption of risk.
2. Proposals for mitigating the risk, if any

(E) Risk factor disclosure shall not include any speculative statement on the favourable outcome of any matter or lawsuit, and shall not be submitted to any court or tribunal on any sub-judgmental matter.

(F) The risk factors should be disclosed according to the descending order of their materiality. Probable or possible consequences, including financial implications, where quantifiable, are disclosed whenever material impact risks are established. If it cannot be quantified, a separate statement must be made as to the fact that the implication cannot be quantified.

(G) Where appropriate, risk factors covering the following subjects must be disclosed:

1. The significant regulatory clearances and approvals that the issuer has yet to obtain;
2. Seasonality of the issuer's business;

3. Any issuance of the stated securities by the issuer at a price lower than the issue price within the last twelve months (other than the issuance of bonus shares);
4. Where the issue's intent is to finance acquisitions and the acquisition targets have not been specified, details of interim use of funds and the likely date of acquisition completion;
5. Risks associated with orders for plants and machinery that have not yet been placed in relation to the issue's already specified object, including the percentage and value terms of the plant and machinery for which orders are to be placed.
6. The issuer's or its promoters' lack of substantial experience in the industry segment for which the issue is raised;
7. Losses incurred by the company in the previous three fiscal years, if any.
8. An issuer's or any of its business divisions' reliance on a single or a few customers; the loss of one or more customers could have a significant negative impact on the issuer.
9. Refusal over the last ten years to list any of the issuer's shares or any of its subsidiaries or group companies on any of the stock exchanges in India or abroad.
10. Failure by the issuer or any of its subsidiaries or group companies to comply with the listing requirements of any stock exchange in India or abroad, and the specifics of the penalty, if any, including suspension of trading imposed by any such stock exchange.
11. Limited or intermittent trading of the issuer's designated securities on stock markets.
12. In the case of outstanding debt instruments, any default in accordance with material covenants, such as the establishment of full protection under the terms of issuance, default in payment of interest, default in redemption, non-creation of debenture redemption reserves, default in payment of penal interest where applicable, non-availability or non-maintenance of asset coverage, interest coverage, debt service coverage, etc., shall be considered a default under this section.
13. Unsecured loans, if any, borrowed by the issuer and its subsidiaries that can be recalled at any time.

14. The issuer's and subsidiaries' failure to repay deposits or pay interest on deposits, as well as the rollover of liability, if any.
15. Potential conflict of interest of the issuer's promoters or directors if they are participating in one or more enterprises in the same field of activity or business as the issuer.
16. Performance shortfalls or delays in relation to the objects stated in any of the listed issuer's or listed subsidiaries' issues issued in the last ten years, as quantified under the heading "Performance vis-à-vis Objects" in the section "Other Regulatory and Statutory Disclosures."
17. Performance shortfalls or delays in relation to the objectives indicated by any of its listed subsidiaries or listed promoters in the preceding five years, as quantified under the heading "Performance vis-à-vis Objects" in the section "Other Regulatory and Statutory Disclosures."
18. Other than recovery of expenditures spent or customary salary or benefits, the interests of the issuer's promoters, directors, or senior management staff.
19. Any part of the issue proceeds that the issuer intends to pay to the issuer's promoters, directors, or key management employees.
20. Relationships between the issuer's promoters or directors and entities from which the issuer has purchased or intends to purchase land in the last five years, including relevant facts.
21. Over-reliance on any key managerial figure for the project under consideration
22. Any significant investment in unsecured debt instruments by the issuer
23. Failure to account for investment value loss.
24. In a tabular style, summarise any pending litigation and other items revealed in the section labelled "Outstanding Litigations and Material Developments," including the amount involved, when measurable. Any criminal, regulatory, or tax concerns that may have a major unfavourable effect on the issuer will be highlighted individually by the issuer.
25. Any delays in the completion of the project for which funds were raised through a public offering.
26. If the issuer is not required to select a monitoring agency under these Regulations, the declaration that the issue continues is solely at the issuer's discretion.

27. Negative cash flow from operational operations in the previous three fiscal years
28. If the land to be purchased with proceeds from the issuance is not registered in the issuer's name.
29. Any restrictive covenants in any shareholders' agreement, promoters' agreement, or other arrangement for short-term (secured and unsecured) and long-term borrowings that affect the interests of equity shareholders.
30. There are several pending investor complaints against the issuer, its listed subsidiaries, and the top five listed group firms by market capitalization.
31. Risks associated with the creation of a second or residual charge or a subordinated obligation on the asset cover in the event of the issuance of secured convertible debt instruments.

When a firm is getting ready to go public, it frequently determines its debut issue price by gauging investor demand through a process known as book building. Though IPO issue prices are set by issuers and underwriters, motivated by market forces yet their value may differ from the issue price because of investors' prediction, regarding IPO price, based on expected profits and risk factors revealed in the prospectus. As a result, this research investigates whether risk factor disclosures have any effect on IPO pricing. The following research issues are empirically researched and analysed in order to reach the objectives of study:

1. Is there enough information in the IPO prospectus on risk factors specific to the business, issue, and market?
2. What risk disclosure pattern do Indian companies follow in their prospectuses?
3. Whether the risk factor data can be standardised by assigning each specific risk factor to mutually exclusive risk factor categories?
4. Whether mutually exclusive risk factor disclosures have significant influence on the performance of an initial public offering (IPO)?
5. Whether various risk categories affect IPO performance in the same way in different sectors?