INTRODUCTION

An initial public offering is the sale of a company’s stock to the public for the first time. The primary impetus for an IPO is generally either to raise capital or to offer an exit strategy to some of the firm’s existing owners, but a number of other motivations and considerations also influence a firm’s decision to go public. This decision process illuminates a firm’s goals in issuing an IPO. Start-up companies rarely have the resources, history, or credibility to conduct an IPO. In fact, firms in the most incipient stage of development generally rely entirely on personal loans, savings, family, and friends for their initial financing. Even as a company begins to develop and show some signs of promise, it will rarely attempt a public offering; instead, it will look to angel investors or venture capital. Angel investors are wealthy individuals, often prior entrepreneurs, who will provide financing in exchange for equity in the company. Venture capital comes from firms rather than individuals, but the principle is the same: investors offer financing in return for a stake in the company. Both angel investors and venture capital firms frequently take an active role in the company, advising management on the most of issues it faces.

The initial investors are naturally hesitant to provide all the funding upfront, and different private equity investors target companies at different stages of growth. Thus, successful companies will typically undergo multiple rounds of financing and will develop a base of investors that intend to eventually liquidate their stakes. When investors decide it is time to cash in on their investment, they have three choices: sell their equity to a larger or later-stage investment firm, sell the company to a larger company looking to make an acquisition, or sell their equity in an initial public offering of the company. Similarly, when an “IPO-ready” company requires additional financing, it has multiple options: pursue further equity financing from the private market, issue debt, or conduct an IPO. So what prompts investors and the company to go with the IPO option? In addition to provide an immediate capital influx and mechanism through which existing owners can cash in on their investment, there are other advantages of going public. Since the expectation is that a liquid aftermarket will develop following the offering, firms conducting an IPO can expect to be in a position to raise additional capital relatively easily and on favourable terms.
following the initial offering. The increased liquidity also makes it possible for public companies to offer stock-based incentives and compensation, which can help them attract and retain top employees and improve employee productivity.

Trading on an exchange also makes mergers and acquisitions easier since stock can be issued as part of the deal. Due to increased visibility, companies going public may also experience an increase in prestige, which can improve their credibility with suppliers and customers, resulting in better credit terms and more pricing leverage. Even the increased scrutiny of public companies is not all bad since it usually allows the company to issue debt at lower rates. The history of IPO mechanism can be traced back to period of CCI regime i.e. Controller of Capital Issues. Prior to nineties all the public issues have to take the permission of C.C.I. The latter determines all other aspects of the issue. The office of C.C.I. was abolished. In 1993 after the formation of SEBI during 1992. SEBI was honoured to regulate all aspects of Capital market, including primary market and IPO’s. IPO market has undergone a change with an introduction of fixed price regime and has further advanced with implementation of Book Building process as a result of Malegam Committee which was set up in 1995.

**IPO Process:** First the firm has to select an underwriter for selling its securities in primary market. The company usually consults with an investment banker to determine how best to structure the offering and how it should be distributed. Since most of the new issues are too large for one underwriter to effectively manage, the investment banker, also known as the underwriting manager, invites other investment bankers to participate in a joint distribution of the offering. The group of investment bankers is known as the syndicate. Members of the syndicate usually make a firm commitment to distribute a certain percentage of the entire offering and are held financially responsible for any unsold portions. The underwriter syndicate can choose either best effort method or firm commitment method for selling of the securities. There exist two main mechanisms in India for the sale of public issues.

1. Fixed Price Method.
2. Book Building Method.
1. **Fixed Price Method**

In a fixed priced offer, an issuer company is allowed to freely price the issue. The basis of issue Price is disclosed in the offer document where the issuer is closes in detail about the qualitative and quantitative factors justifying the issue price. The issuing firm (with the help of the underwriter) decides upon a selling price and offers a set number of shares at that price. The underwriter does not build a book of potential orders; instead, the price is based upon the underwriter’s judgment of the market conditions and the intrinsic value of the company. The Issuer company can mention a price band of 20% (cap in price band should not be more than 20% of the floor price) in the Draft offer documents filed with SEBI and actual price can be determined at a later date before filing of the final offer document with SEBI / ROCs. In its offering materials, the issuer will give both a qualitative and quantitative justification for the chosen price. If the offering is oversubscribed, the shares are allocated on a pro rata basis. This type of offering is commonly used in Singapore, Finland, India and the U.K.

2. **Book Building Process**

In the traditional IPO process, an investment bank is always hired to “underwrite” an IPO. The issuing firm will choose a “lead underwriter” (book runner) or “co managers” risk, the investment banks themselves almost always form a syndicate, and each member of which will sell part of the issue. Deals can be structured in a variety of ways. One major consideration is whether it is a "firm commitment" or “best efforts” agreement. In a firm commitment, the underwriter buys the entire offer and resells it to the public, thus guaranteeing the amount of money that will be raised; under a best efforts agreement the underwriter sells as much of the security to the public as it can sell at the offering price, but it does not guarantee the quantity. Underwriting contracts will also specify the underwriter fee (typically 5%) and the “green shoe” option (allows the underwriter to increase the number of shares offered, typically by 15%). After the details of the deal have been worked out, the underwriter files a registration statement with the SEBI. This document provides details on the offering, as well as company information, such as financial statements, management
backgrounds, legal proceedings, and insider holdings. Next, the underwriter puts together a “red herring” (a preliminary prospectus that contains information on the company and offering), and goes on a “road show” in which they present 5 to potential investors and gauge demand. Most of these potential investors are institutional investors, such as mutual funds, pension funds, and hedge funds, and they give the underwriter feedback as to how much stock they intend to buy and at what price. This is called the “book building process” since the underwriter builds a book of potential orders. After the SEBI approves the registration and the road show is complete, the underwriter and issuing firm decide on an offering price range, which will depend upon the success of the road show, the current market conditions, and the company’s goals. After the offering range is decided upon, the underwriter will accept bids from interested investors. If the orders exceed the value of the issuance, the IPO is “oversubscribed.” When this is the case, the offering will price at the high end of (or even a little above) the offering range, the underwriter will have partial discretion over how to allocate the limited shares among the bidding institutional investors, and the underwriter will exercise its green shoe option. When an offering is undersubscribed, it will price at the low end of the range; or, if the offering is extremely undersubscribed, the issuer may decide to postpone the deal. Since institutional investors are their best clients, investment banks heavily favour them over retail (individual) investors. Thus, there is a degree to which retail investors are “excluded” from IPO’s. This is compounded by the fact that in many IPO’s, only those individual investors who have a brokerage account with one of the underwriters are even eligible to participate in the offering. The defining features of the book building mechanism are: a price that is elastic to demand but ultimately set by the underwriter, and a discretionary share allocation mechanism that has historically led to the exclusion of most retail investors. This method is used in almost all domestic IPO’s.