IPO PROCEDURE: AN ANALYSIS ON THE BOOK BUILDING METHOD IN BANGLADESH

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Abstract
The purpose of the present study was to highlight the Bangladesh Capital Market status with having Book Building method and identify the problems regarding this method that impedes the development of capital market in Bangladesh. In the beginning of the study I have given a general idea of Initial public offering (IPO) and mentioned the listing procedure. I have also explained the methodology regarding this report. Both primary and secondary data have been used in preparing this report. I have tried to focus on Book Building method in the security market of Bangladesh and discussed about its problems created by manipulators. Like all study, this report has also certain limitations, which were in some cases unavoidable. In the end I have concluded with the overall analysis of my project and recommend some solutions, which is on, “IPO Procedure: An Analysis on The Book Building Method In Bangladesh”. The present study is a tentative one and will be revised and corrected in the light of further study. I hope and firmly believe that this research will help us to understand the contribution of Book Building method in the capital market development and that will improve economy in poor performing countries.

Keywords: IPO, Book Building Method, DSE, CSE, Securities

1.0 INTRODUCTION

Initial public offering (IPO), also referred to simply as a "public offering" or "flotation," is when a company issues common stock or shares to the public for the first time. They are often issued by smaller, younger companies seeking capital to expand, but can also be done by large privately owned companies looking to become publicly traded. IPOs generally involve one or more investment banks known as "underwriters". The company offering its shares, called the "issuer", enters a contract with a lead underwriter to sell its shares to the public. The
underwriter then approaches investors with offers to sell these shares. Initial Public Offering can be made through the Fixed Price Method, Book Building method or a Direct Listing Method. For minimize the risk and attract more investor to the market The IPO has three part as mention in the following diagram. 10% Shares are restricted for mutual fund; another 10% shares are restricted for Non Residence Bangladeshi (NRB); and rest of the 80% shares are allocated for the general public.

Figure 1: IPO allocation percentage

2.0 OBJECTIVES OF THE STUDY

The main objective of the study is to analyze the Book Building method in the capital market of Bangladesh. To accomplish this principal objective, following specific objectives have been covered:

- To highlight the Bangladesh Capital Market status with having Book Building method
- To identify the problems regarding this methods that impedes the development of capital market in Bangladesh
- To suggest some important policy measures regarding IPO procedure for the development of Capital Market

3.0 METHODOLOGY OF THE STUDY

The nature of the study will allow us to explore the utilization and usefulness of stock exchange to satisfy our research interest. The study is mainly based on secondary data which will be collected from different published research articles, World Bank reports, Annual reports of Bangladesh Bank, portfolio, published journals, textbooks, websites, and various published and unpublished materials. I also conduct in depth interview, face to face conversation with the Stockholders and Brokers to collect primary data.

4.0 BOOK BUILDING METHOD IN SECURITY MARKET OF BANGLADESH

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. The stock market regulatory body of Bangladesh introduced book-building method on 5th March 2009 to ensure fair price in the initial public offerings (IPOs) for the entrepreneurs whose companies will go public.

5.0 PREREQUISITES OF AN ISSUER FOR BECOMING ELIGIBLE FOR BOOK-BUILDING METHOD

An issuer may determine issue price of its security being offered following book-building method (i.e., price discovery process) subject to compliance with the following:

a. The issuer
b. Must have at least Tk. 30 crore net-worth;
c. Shall offer at least 10% shares of paid up capital (including intended offer) or Tk. 30 crore at face value, whichever is higher;

d. Shall be in commercial operation for at least immediate last three years;

e. Shall have profit in two years out of the immediate last three completed financial year;

f. Shall have no accumulated loss at the time of application;

g. Shall be regular in holding annual general meeting;

h. Shall audit at least its latest financial statements by a firm of chartered accountants from the panel of auditors of the Commission;

i. Shall appoint separate person as issue manager and registrar to the issue for managing the offer;

j. Shall comply with all requirements of these Rules in preparing prospectus.

k. The Commission, if it deems appropriate for the interest of investor or development of capital market, may exempt or relax any of the above prerequisites.

5.1 Price Discovery For Determining Indicative Price

The price discovery process for determining indicative price of security will involve the following institutional investors registered with or approved by the Commission in this regard:

a. Merchant bankers excepting the issue manager concerned to the proposed issue;

b. Foreign institutional investors registered with or approved by the Commission;

c. Recognized pension funds and provident funds;

d. Bank and non-bank financial institutions under regulatory control of Bangladesh Bank;

e. Insurance companies regulated under Insurance Act, 1938 (Act No. IV of 1938);

f. Institutional venture capital and institutional investors registered with or approved by the Commission;

g. Stock Dealer registered with the Commission; and

h. Any other artificial juridical person permitted by the Commission for this purpose.

5.2 Procedures To Be Followed For Determining Price Under Book-Building Method

a. Issuer shall invite for indicative price offer from the eligible institutional investors through proper disclosure, presentation, document, seminar, road show, etc;

b. Issuer in association with issue manager and eligible institutional investors shall quote an indicative price in the prospectus and submit the same to the Commission with copy to the stock exchanges;

c. Such indicative price range shall be determined as per price indications obtained from at least five eligible institutional investors covering at least three different categories of such investors;

d. Rationale for the indicative price must be included in the prospectus i.e. the issuer is required to disclose in detail about the qualitative and quantitative factors justifying the indicative price;

e. The indicative price shall be the basis for formal price building with an upward and downward band of 20% of indicative price within which eligible institutional investors shall bid for the allocated amount of security;

f. Eligible institutional investors bidding shall commence after getting consent from the Commission for this purpose;

g. If institutional quota is not cleared at 20% below indicative price, the issue will be considered cancelled unless the floor price is further lowered within the face value of security;

h. Provided that, the issuer’s chance to lower the price shall not be more than once;

i. Prospectus will have to be posted on the Websites of the Commission, stock exchanges, issue manager and issuer at least two weeks prior to the start of the bidding to facilitate investors to know about the company and all aspect of offering;

j. No institutional investor shall be allowed to quote for more than 10% of the total security offered for sale, subject to maximum of 5 bids;

k. Institutional bidding period will be 3 to 5 working days which may be changed with the approval of the Commission;

l. The bidding will be handled through a uniform and integrated automated system of the stock exchanges, or any other organization as decided by the Commission, especially developed for book building method;
m. The volume and value of bid at different prices will be displayed on the monitor of the said system without identifying the bidder;

n. The institutional bidders will be allotted security on pro-rata basis at the weighted average price of the bids that would clear the total number of securities being issued to them;

o. Institutional bidders shall deposit their bid with 20% of the amount of bid in advance to the designated bank account and the rest amount to settle the dues against security to be issued to them shall be deposited within 5 working days prior to the date of opening subscription for general investors;

p. In case of failure to deposit remaining amount that is required to be paid by institutional bidders for full settlement of the security to be issued in their favor, the Commission shall forfeit 50% of bid money deposited by them. The securities earmarked for the bidder who defaulted in making payment shall be added to the general investor quota.

q. General investors, which include mutual funds and NRBs, shall buy at the cut-off price;

r. There shall be a time gap of 25 working days or as may be determined by the Commission between closure of bidding by eligible institutional investors and subscription opening for general investors;

s. Subscription for general investors shall remain open for the period as specified by the Commission;

t. General investors shall place their application through banker to the issue; and

u. All application money shall be kept in a separate escrow account opened with a designated bank with prior intimation to the Commission. Issuer will not be allowed to utilize such money until all the process of issue is completed and Commission’s consent to this effect is obtained.

5.3 Distribution Mechanism For Issuance Of Security

The distribution of security to be issued under book-building method will be made in accordance with the following ratio:

Figure 2: Distribution mechanism for issuance of security under book building method (General Investors’ Quota)
Figure 3: Distribution mechanism for issuance of security under book building method (Eligible Institutional Investors’ Quota)

| First Company Under Book-Building Method |
| IPO Summary of RAK Ceramics               |
| Eligible Institutional Investor (EII’s)   | 20% of shares offered i.e. 6.9m equity shares |
| Eligible Institutional Investor           | 15 trading days                                      |
| Face Value                                | Tk 10/- each share                                   |
| Indicative Price                          | Tk 40/- shares, including a premium of Tk 30/share   |
| Issue Manager(s)                          | IDLC Finance Ltd & BRAC EPL Investments Ltd          |
| Lead Banker to the issue                  | Citibank N.A.                                       |
| Mutual Funds                              | 10% of shares offered i.e. 3.45m equity shares       |
| Non Resident Bangladeshi                  | 10% of shares offered i.e. 3.45m equity shares       |
| Price Bond for Bid                        | Upward & downward band of 20%(Tk 32 to 48 share)    |
| Public Offering in Bangladesh             | 60% of shares offered i.e. 20.7m equity shares       |
| Register to the issue                     | Prime Finance & Investment Ltd                       |
| Shares Allotted in last 1 year            | 1 year                                               |
Table 1: IPO Summary of RAK Ceramics

<table>
<thead>
<tr>
<th>Shares Offered</th>
<th>34.51 million equity shares</th>
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<tr>
<td>Sponsor Shareholder/ Director</td>
<td>3 years</td>
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### 6.0 Improper Use of Book Building Method

Book building method, it was anticipated at the time of its operationalization will ensure fair pricing of a stock to woo prospective large local and foreign profitable firms enlisting in the stock exchanges, enhance the depth of our local market, and strengthen the corporate governance. Furthermore, it was expected that the method would make, disclosure and reporting to public more transparent and credible and, more importantly, help accelerate the pace of industrialization. Paradoxically, the method has been found to be used as a mechanism to raise money from capital market by inflating the stock price even before being traded started on the same in the stock exchanges.

In the context of Bangladesh’s experiences that, a large difference is observed. Questions now arise as to whether the book building method is itself faulty or getting misused. If it is really faulty, then why it has been used successfully in both developed and developing countries, even in our neighboring country like India. To put it in the right perspective, capital market must be allowed to operate on its mechanism where like any other market; the price of a particular security should be determined matching the demand for, and supply of, the same.

For the time being, if it is assumed that book-building method is OK, then problem lies with how it is being misused. Before digging dip into the determination of price under the book building method, it should be recalled as to what the fair price of a security is. The fair value of a stock is the present value of future cash flows to be generated in the foreseeable period considering a risk adjusted discount rate (which includes risk premium, commonly derived from CAPM). However, such a practice of determining the price is not highly noticeable in our country. Most of the methods used in determining the price are P/Es of market, or respective industry or similar stocks. As our market itself was overheated during period under consideration having a market P/E over 25 times, how can this be used to generate fair price? Moreover, when issuer company arranges road show with this inflated price to invite offer for indicative price from the institutional investors, it has been observed that institutional investors usually agree to give very high price - or even higher one then proposed by the company. Strong allegations are there that there is a prior understanding among the issuer company and the institutional investors participating in the road shows. The situation is further worsened when formal bidding is arranged with such inflated indicative price where it is observed that all the bidders offer at upper band (+20% of indicative price) although lower band (-20% of indicative price) is allowed. Perhaps only 15 days lock-in period provides incentives to bid for such higher prices. In the meantime, book-building method has been postponed and that is being demanded for cancellation, in the face of strong criticism though a good numbers of large and profitable companies are in pipeline to go public under this method. Now, it is a situation about the book-building method that can be likened to that of whether the head should be chopped off not in case of a serious headache.

### 6.1 Manipulators Benefiting from Book Building Method

The introduction of book building system has turned out to be a tool for manipulating market prices, the Centre for Policy Dialogue has observed. Instead of ensuring competition among big investors at the ‘price
discovery’ stage, the market syndicates are abusing it for placement shares at an artificially high price. The artificial price is being maintained for sometime (particularly till the lifting of the lock-in period (15 days) and after that investors are found to offload their shares at higher prices, said the think-tank. Book building is a new system in Bangladesh and only three instances of such practice are there. The CPD analysis found those who hold the private placements took out a substantial amount of money by selling shares at high prices during the first one month. As a result, share prices of a particular company fell by 33 percent within one month and 50 percent in the next two months and did not rise thereafter.

7.0 STAKEHOLDERS DEMAND FURTHER CHANGE TO BOOK BUILDING RULES

Market stakeholders have urged the Securities and Exchange Commission to erase a proposed cause on valuation from the draft on an amended book building method. The clause is related to determining the indicative price of shares of a company, which will use the book building system for an initial public offer (IPO), based on the firm's earnings per share (EPS) and net asset value (NAV). They have argued that if the clause is included in book building rules, an amendment to other sections or inclusion of new clauses will be meaningless. The SEC discussed the book building system with Dhaka and Chittagong stock exchanges, Bangladesh Merchant Bankers Association, Bangladesh Association of Listed Companies and the Investment Corporation of Bangladesh. The proposed clause reads: indicative price will be such that it does not exceed the following yardstick: 15 times of weighted average EPS of the preceding three years or three times of net asset value, whichever is lower but no less than NAV a share.

After the stock market debacle, the government in January 2011 directed the SEC to suspend the book building method. Following recommendations by a high-profile probe committee on the share market scam, the government instructed the SEC to alter the book building rules, instead of stopping the system, as it is well practiced in other countries. The stakeholders also recommended increasing the number of category of institutional investors who builds up the indicative price. As per the draft amendment, the indicative prices should be supported by at least 20 EIIs including at least five quotations from each of the following category: merchant banks, commercial banks and asset management companies.

The stakeholders also opposed the proposal of having a committee composed of experts that will scrutinize and verify the audited financial statements submitted in connection with an IPO. They argued that it would increase the complexity in the IPO process. Some of them also recommended reducing the lock-in period for eligible institutional investors from six months to three months, while some others requested to keep the existing lock-in period of 15 days. The market stakeholders gave different opinions and proposals or suggestions on each and every issue of the draft on amendment in the book building method, a meeting source added.

7.1 CSE Recommends Changes To Book Building Method

The Chittagong Stock Exchange has made a series of recommendations about the book building method to make the price discovery system of a company's shares effective. The government suspended the method in January 2011 following criticisms that companies misused the system to list on the capital market.

SEC initiated the move to amend the system after the government-sponsored probe committee on the stock market made recommendations to make a “unique guideline” for all stakeholders.

For determining the indicative price, CSE has urged the SEC to consider 25 percent of net asset value (NAV), 25 percent of past earnings per share (EPS) and 30 percent of future EPS of a company. The price earnings ratio of similar stock should be 10 percent, while the book value of a similar stock should be the same as the PE ratio to discover the indicative price. In case of P/E and price book value of similar stock, the issue manager should use reasonable due diligence. The checklist of due diligence should be provided by the SEC to the issuer manager, the CSE recommended.

CSE recommended that the bid price during the book building process will be more or less 10 percent of the indicative price, while the institutional investors shall
be allowed to quote more than 5 percent of the total security offered for sale. It said a draft copy of the proposal should also be sent to Bangladesh Association of Publicly Listed Companies, apart from five associations. CSE said the role of the two bourses and other associations mentioned in the SEC proposal need to be defined by SEC. The SEC proposal says hardcopy of draft prospectus will be sent to Bangladesh Merchant Bankers Association, Dhaka Stock Exchange, CSE, Bankers Association, Bangladesh Leasing and Finance Companies Association, Insurance Association of Bangladesh. CSE recommended the indicative price discovery form should be submitted online after the road show and within two workdays. The application form should be available online, it said. It said the lock-in period for institutional investors should be 30 days. The CSE also suggested the SEC form a panel of experts and auditors to securitize and verify audited financial statements. The fee of such panel should be determined and paid by the SEC.

Securities and Exchange Commission (SEC) of Bangladesh has initiated to develop Book Building System in collaboration with Dhaka Stock Exchange (DSE), Chittagong Stock Exchange (CSE) and Central Depository of Bangladesh Limited (CDBL) for the efficient, fair and transparent price discovery and allocation of securities using Book Building System at the time of initial public offerings. In this context, SEC has already made required modifications in the rules and regulations and notified the stakeholders through its circular.

8.0 Stock Market Gains On August 2011

Dhaka stocks returned to the black yesterday amid expectations of a turnaround in the market on the middle of August 2011. The benchmark gauge of the Dhaka Stock Exchange, DSE General Index, gained 0.8 percent to 6,212 points. Gainers beat losers 184 to 66, with eight securities remaining unchanged on the premier bourse. Among the major sectors, the telecom sector advanced 0.6 percent, banks 1.05 percent, non-banking financial institutions 1.29 percent and pharmaceuticals 1.11 percent. Total turnover on the prime bourse also increased almost 20 percent to Tk 536 crore on a transaction of 7.5 crore shares and mutual fund units.

Chittagong stocks also gained on 11th August 2011, with the Selective Categories Index increasing 0.47 percent to 11,377 points. Advancers beat losers 132 to 39, with 11 securities remaining unchanged on the Chittagong Stock Exchange that traded over 87 lakh shares and mutual fund units worth Tk 60.15 crore changing hands on the trading floor.

8.1 Stock Market Gains On 29th December 2011

Country’s stock market marked a nominal gain in terms of indices and turnover on Thursday 29th December 2011. The Dhaka Stock Exchange (DSE) general index rose over 36 points minus to stand at 5,257 at the close on the last trading day of the week. The volume of transactions, however, rose to Tk 559 crore from Wednesday’s Tk 526 crore. Trade deals stood at 147,184 against the previous day’s 134548. Of the issues traded, 197 advanced, 52 declined and 19 remained unchanged. MICEMENT topped the turnover list with shares worth Tk 135 million having changed hands. The other turnover leaders were BDTHAI, BSRMSTEEL, GP, KEYACOSMET, MERCANBANK, UNITEDAIR, BEXIMCO, RNSPIN and SALAMCRST.

Chittagong stocks also followed suit, with the CSE Selective Categories Index climbing up to 9,572 by gaining over 80 points. Out of the issues traded, 127 gained, 41 declined while 25 remained unchanged. In a latest bid to stabilize the stock market, the Securities and Exchange Commission (SEC) on December 7 eased the rule for sponsor-directors of listed companies to hold 30 percent shares of their respective companies within six months.

Besides, the government on November 23 had formed a committee under a special scheme of incentives to hand out compensation to small investors after assessing within two months the losses they suffered for scam and recurrent market crash.

8.2 Stock Market Gains and losses in 2012

The general index had a bumpy ride with a generally declining trend through 2011, with a recovery apparent since February 2012. The most recent period of decline was in mid-January 2012 in anticipation of further tightening by the central bank. The market reached its
lowest level on February 6, 2012 when the benchmark index closed at 3,616, representing a 60 percent decline from the December 2010 peak of 8,919. Since then the market has been on a generally upward trend, crossing the 5,000 mark in the last week of March (Figure 5). Trade volumes have also picked up. The uptrend can be attributed to (i) market entry by some overseas private equity funds, as the fund managers consider good stocks to have reached their bottomed out, (ii) re-entry by some of the local institutional buyers, as they find the stocks’ current price attractive for long-term holding, and (iii) reaffirmation of a stable outlook for Bangladesh by Moody’s and S&P in January and February 2012.

9.0 Recommendations
1. Bengali version of NRB Application form will be helpful for those who don’t know English
2. Online facilities arrangement: launching online submission of the application form would be really helpful for the non-resident Bangladeshi (NRB) people.
3. Bringing change in IPO procedure by reducing the time of proceeding IPO and simplify the consent and listing Procedure.
4. Demutualization: It is the process by which a customer-owned mutual organization (mutual) or co-operative changes legal form to a joint stock company.
5. The banking sector’s involvement in stocks will have to be reduced slowly so that banks can finance more on expansion of trade and commerce.
6. Need enforceable and more effective laws and rules to attract foreign Institutional Investors.
7. Incentive for private sector entrepreneurs to access the capital market should be more noticeable. Tax gap between listed and non-listed companies should increase.

10.0 Conclusion
It is a common knowledge that both quantitative and qualitative fundamentals are considered for buying shares in the stock market. Future potentials are of course very important for valuing business and shares but this should not be the major criterion in valuing shares on IPO ignoring other fundamentals. Besides, in an uncertain market scenario like ours, this kind of approach should not be considered as major criteria. Further, in our country, it is unfortunate that many of the sponsors of listed companies could not discharge their obligations properly towards small investors and in few cases, investors have been cheated and SEC’s actions were not enough to change this culture to a remarkable level. In such a situation, pricing of IPO obviously deserve special attention of the SEC for a stable, growth oriented and healthy capital market. It has been noticed that before going for IPO, the auditors are changed. Change of auditors is not unusual and not always bad. The intention behind the change is important. If the change is aimed at ensuring quality, it is fine. Otherwise, the reason for change of auditors should strictly be reviewed including pre-change period financial performance of the company and qualifications (observations) made by previous auditors. Book building method is apparently a sophisticated and widely used concept but unfortunately, this method is being misused with some motive. It needs adequate efforts by regulatory agencies to customize it for implementation in Bangladesh context.

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