VIABILITY OF THE AUCTION METHOD OF FRENCH PUBLIC OFFERINGS IN INDIA – AN ANALYSIS

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The initial months of 2010 witnessed a new method, called the French Auction, being used for the pricing of subsequent share issues of several public sector undertakings. This was admittedly brought about with a view to maximizing the divestment proceeds of the undertakings. The method was used in place of the book building method, where the issuer would specify a price band and allocate shares at a specific price within that band, depending on the demand. While competitive bidding in the absence of a price band under the French Auction system is expected to result in a more accurate valuation of the IPO and greater capitalization for the issuer, we point out its shortcomings, which make it unfit for implementation in the Indian markets, as the IPO price is prone to manipulation and argue that it may not result in more accurate pricing than the book building method.

I. INTRODUCTION

The most important reason for any company to go public is that it needs to generate capital to fund the future growth of its business activities. Newly raised capital can also be utilized to fund extensive advertising and marketing efforts in order to increase public awareness about the company and its product.[1] The cash infusion also makes it easier for the company to raise capital in the future because the cash infusion may strengthen the company's balance sheet, making it more attractive to lenders. A sale of shares in a registered public offering for the first time is known as an Initial Public Offer (IPO) while any such subsequent sale is referred to as a follow on public offering (FPO).

The primary and most preferred public offering method in India is book building method. It is essentially a process used by companies raising capital through public offerings to aid price and demand discovery. It is a mechanism where, during the period for which the book for the offer is open, the bids are collected from investors at various prices, which are within the price band specified by the issuer. The process is directed towards both the institutional as well as the retail investors. In this kind of auction, the highest price at which

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[1] *See* Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795, 1796 (2002).

the issuer gets bids for all the shares on offer is the cut-off price.[2] It is thus believed that the book building process allows for efficient price and demand discovery. Its popularity rests on the fact that the costs of the public can be kept at minimum, and the time taken for completing the process is relatively short. However when companies fix a price band for public offers, the maximum difference permitted between the floor and ceiling prices in the band is 20 per cent.[3] Also the investors are free to revise their bids and even withdraw in case the book is not built as per their expectations. Also there is a strong view that the book building system did not result in any real price discovery since a price band is already specified by the issuer.

In light of the shortcomings of the book building system, the 'Auction System' has been gaining prominence the world over in recent times. It was made famous by Google which used the system to raise over $1.67 billion in the year 2003 becoming the second largest Internet company IPO of all times.[4]

In India the SEBI (Issue of Capital and Disclosure) Regulations, 2009 were recently amended to provide for "French" auction as one of the methods of price discovery in follow-on public offerings. This was supposedly brought about with a view to encourage the use of such auction mechanism in Government disinvestments and maximizing the divestment proceeds raised by the government. The French Auction method was used for the first time in the institutional portion of the FPO of National Thermal Power Corporation (NTPC) in the month of February through which the government divested 5 per cent of its equity in the PSU.[5]

The Government thought that the extant book-building process which follows the Dutch auction system[6] denies the issuer the advantage he could gain by following the French model. The experts are however divided in their opinion regarding response to the NTPC offer.[7] While many term the response as disappointing, some blame it on a nervous market environment; others said that the process used was flawed. Despite the lukewarm response the government went ahead with the implementation of the French system in the subsequent offering of the shares of state owned Rural Electrification Corporation (REC) as well which was eventually a moderate success after the government persuaded some public sector banks and the insurance major, LIC to participate in the issue. In this paper, the authors intend to comprehensively describe and discuss the

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2 About bookbuilding, Bombay Stock Exchange, http://www.bseindia.com/bookbuilding/about.asp (Last visited on March 10, 2010).

3 Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009, § 30(4).

4 *See* Choo Eugene, *Going Dutch: The Google IPO*, 20 BERKELEY TECH. L.J. 405 (2005)

5 P.Vinod Kumar, *French model fails to set Indian market on fire*, available at http://in.biz.yahoo.com/100222/50/bav4a7.html (Last visited on March 20, 2010).

6 *See* discussion *infra* Part II.

7 *Supra* note 5.

two types of the Auction Method i.e., the Dutch and French Auction Mehod, their advantages and disadvantages so as to facilitate a better understanding of the method. Subsequently they intend to analyze the peculiar dynamics of the Indian capital markets and make a case for the non implementation of the auction system and the continuance of the book building system in India.

II. THE AUCTION METHODS DEFINED

A. THE DUTCH AUCTION METHOD[8]

The Dutch auction is an open bidding process in which the issuer announces its intention to offer a fixed quantity of shares and solicits bids from investors who are interested in participating. Each potential investor submits a bid specifying how many shares he/she is willing to buy and at what price, and these bids become irrevocable and binding at the close of the bidding period. At that time, the issuer will have received a range of bids, some offering to buy large quantities of shares at very low prices, and others offering high prices for just a few shares.[9] Next, the issuer will arrange the bids in descending order of price and will accept the highest bid first, then the next highest bid, and so forth. Eventually, the issuer will arrive at the bid that depletes the shares in the offering. This bid determines the "clearing price,"[10] or cut off price which is the price that the accepted bidders will pay for their shares. The issuer rejects all bids below the clearing price and accepts all higher bids at the clearing price.[11] The Dutch IPO thus represents an alternate mechanism by which pricing and allocation are removed from the realm of issuer and underwriter discretion.[12]

The idea of using a Dutch auction for public offerings of corporate securities is a relatively recent idea. A subsidiary of Exxon first drew attention to the method in 1977 when it issued debt securities (bonds) using a Dutch auction worth $135 million. Similar auctioning methods have enjoyed broader use in Great Britain in the form of "offers for sale by tender," as well as in France.[13]

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8 Lucas C. Townsend, *Can Wall Street's "Global Resolution" Prevent Spinning? A Critical Evaluation Of Current Alternatives*, 34 SHLR 1121.

9 Although most authorities on the subject do not expressly address such situations, it is theoretically possible that a bidder may bid a low price for a small number of shares, or a high price for a large number of shares. In the former instance, the bid will likely have no effect on the auction, as it will fall below the clearing price. Conversely, the bidder in the latter situation can expect that its bid will be successful, as its bid likely will fall above the clearing price.

10 "Clearing price" is the highest price at which all of the shares in the offering may be sold.

11 "The lowest price accepted by the issuer through this process is the price paid by all the bidders whose bids were accepted through the process."

12 Peter B. Oh, "*The Dutch Auction Myth*", 42 Wake Forest L. Rev. 853.

13 Townsend, s*upra* note 8, 1164.

The name and concept of Dutch auctions derived from tulip bulb auctions in Holland, where sellers wanted to find the highest price at which an entire tulip lot would sell.[14] Some suggest that there is a traditional Dutch auction, in which the tulips would be sold to the single highest bidder for the entire lot, and a modified Dutch auction, in which the tulips are sold to multiple bidders at the highest price that will result in the sale of the entire lot.[15] The Google IPO and others that have adopted the Dutch auction model, of course, follow the modified approach.[16] The Dutch auction approach to initial public offerings has received much attention recently as a possible challenger to the long-utilized method of book building.[17]

B. THE FRENCH AUCTION METHOD

Under the French Auction method the bidders who have bid at higher or equal to the cut-off price get allotments at their bids while the bids at cut-off get pro-rata allotment. Unlike this, in a Dutch auction, all the bidders who have bid at more than or equal to the cut-off price get pro-rata allotment at the cut-off price. Thus the French model allows the issuer to gain an advantage which is denied to him under the Dutch system. The issuer is able to garner additional resources by issuing shares to successful bidders at prices higher than the cut off. In India the government has adopted a variation of the French Auction method wherein a floor price is specified by the government. While all bids made by the institutional investors must be made at a price higher than or equal to the cut off price, retail and non institutional investors are to be issued shares at the cut off price.[18]

III. ADVANTAGES OF THE AUCTION METHOD

The auction method's popularity rests on the fact that it represents an alternate mechanism by which pricing and allocation are removed from the realm of issuer and underwriter discretion.[19] The pricing is thus said to be more accurate and transparent.[20]

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[14] Alan J. Berkeley, *Some Background and Simple FAQs about Dutch Auctions and the Google IPO*, ALI-ABA Continuing Legal Education Post Graduate Course in Federal Securities Law: Current Developments, 349 (2004); *See also*, Brianne M. Hess, *Google, Inc.: The Dutch Auction Approach As An Alternative To Firm Commitment Underwriting*, 7 DUQUESNE BUS. L.J. 89, 98.

[15] Brianne, *Id*.

[16] *Id*.

[17] *Id*.

[18] Peter B. Oh, *The Dutch Auction Myth*, 42 WAKE FOREST L. REV. 853; *See also*, John G. McDonald and Bertrand C. Jacquillat, *Pricing of Initial Equity Issues: The French Sealed-Bid Auction*, THE JOURNAL OF BUSINESS, VOL. 47, NO. 1 (1974), 37-47; François Derrien and Kent L. Womack, *Auctions vs. Bookbuilding and the Control of Underpricing in Hot IPO Markets*, THE REVIEW OF FINANCIAL STUDIES, VOL. 16, NO. 1 (2003), 31-61.

[19] *Id*.

[20] Ann E. Sherman, *Global Trends in IPO Methods: Book Building vs. Auctions*, available at http://ssrn.com/abstract=276124 (Last visited at September 13).

In the book building method the underwriter has an incentive to price the offering below market demand so that complete sale is assured and the offering is oversubscribed. In the auction method, these practices are eliminated because competitive bidding determines the offering price, not the underwriter. The result is a more accurate valuation of the IPO and greater capitalization for the issuer.

Moreover, the auction method promotes accurate valuation in another way. Ordinarily, bidders who are influenced by a desire to pay as little as possible may understate their demand by submitting low bids. But because the issuer in an auction IPO sets and accepts all bids at or above the cutoff price, the price that bidders pay does not necessarily correspond to the price they bid. Thus, bidders have an incentive to bid what the IPO shares are actually worth to them, since understating demand lessens the likelihood that the issuer will accept their bid. The investors benefit from the fact that investor's choose their preferred price based on their assessment of the stock's worth. Further efficiencies arise from the fact that auction IPOs generally involve more bidders than traditional IPOs.[21]

The auction method also eliminates one of the underwriter's most difficult and time-consuming tasks, valuation of the shares. During the traditional IPO process, investment bankers incorporate dynamic business and stock market conditions into their valuation analysis, but investor demand ultimately drives valuation. The auction achieves the same result but in a more efficient manner by having investors indicate their demand by submitting bids.[22]

IV. DISADVANTAGES OF AUCTION METHODS

While the method has met with lukewarm successes in the recent follow on public offerings of National Thermal Power Corporation (NTPC) and Rural Electrification Corporation (REC) there are certain issues that need to be considered before deciding on the long term viability of the Auction methods in the Indian markets.

The key feature or advantage of auction methods is that it is considered to have an effective price mechanism. The proponents of the auction IPO method support it mainly because of the popular belief that an auction will eliminate the under-pricing of the IPO shares.[23] The perception is that investors choose their preferred price based on their assessment of the stock's worth. But in fact it is the issuer who sets the floor price or the price below which no bids shall be acceptable to the issuer and sells the number of shares it wishes to sell at prices that it receives in excess of the floor price. If demand for the shares is low, the allocation

[21] Lucas C. Townsend, *Can Wall Street's Global Resolution Prevent Spinning? A Critical Evaluation Of Current Alternatives*, 34 Seton Hall L. Rev. 1121.

[22] Anita I. Anand, *Regulating Issuer Bids: The Case of the Dutch Auction,* 45 McGill L. J. 133 (2000).

[23] Mira Ganor, *Manipulative Behavior In Auction IPOs*, 6 DePaul Bus & Com. L.J., 1.

will be made at prices close to the floor price and vice versa if demand is high. Thus, it is submitted that the conclusion that the price is a direct result of competitive bidding and gives a more accurate indication of demand than the book building method and leads to an accurate price discovery might not be true as the allocation is made to different bidders at different prices. Allocation of shares at different prices to different bidders makes it extremely difficult to pin point at a single price which could be described as the fair price for the securities or the price at which the demand for the securities is maximum. The post issue listing price of the securities in such cases might not reflect any link with the overall demand for the securities.

Moreover, people who have successfully bid for the company's stock value it at least as high as the issue price. However people who do not own the stock, the potential buyers of the stock whose bids were not successful, value the stock at a price lower than the IPO price. As a result shares will not trade hands immediately following the IPO. The IPO price will remain the stock price in the market. Also since the successful bidders are allocated the entire bid quantity at their preferred price very few bidders might emerge successful from the offering. Unlike the book building method , the auction method does not provide for pro-rata allotment. The auction methods thus does not ensure widespread shareholding and might result in illiquidity with the few successful long term investors who have managed to obtain allotment wanting to hold on to their shares and not willing to trade shares immediately following the offering.[24] In order to ensure complete satisfaction of shares such might deliberately bid for the shares at a price higher than their own valuation of the same. This is because unlike the book building method where pro allotment is ensured if a bid is placed at the top end of the price band, under the auction method there is a possibility that the bidder might end up with nothing if there are a sufficient number of bidders with higher bids. Such long term investors are more likely to hold on to their shares for longer durations rather than sell their shares at a loss even though they might have overpaid for their shares. Any downward pressure on the price of the securities is highly unlikely as the bulk of the shares have been cornered by a few long term investors. Accordingly, it is submitted that the auction IPO is not necessarily more efficient in terms of price discovery. Furthermore, it is submitted that the underpricing still appears to occur when these mechanism is used under the following heads.[25]

A. THE UNDERBIDDING STRATEGY

It has been noted in mature markets such as the United States that rational bidders who wish to maximize the value of their investments can manipulate the IPO price and ensure that it does not exceed the floor price he can increase the

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[24] Laura S. Unger, *Raising Capital on the Internet*, 69 U. Cin. L. Rev. 1205, 1207 (2001).

[25] Anita I. Anand, *Is the Dutch Auction IPO a Good Idea?* (Center for Law, Economics and Public Policy Research Paper No. 320, Yale Law School, available at http://ssrn.com/abstract=794464, last visited on March 20, 2010).

value of his assets.[26] The auction method is of recent origin in India and though it is difficult to establish the practice of such manipulative strategies in the couple odd offerings that have taken place, the possibility of such strategies being implemented in the future cannot be out rightly rejected.

If such a strategy is implemented even bidders who have arrived at a fair valuation of the shares based on their own research and evaluation will be deemed to have overpaid for their shares.

The bidder does not have to bid for as many shares as he can afford at the price that he values the shares. Instead, the bidder can bid for a different number of shares or at a different price, or both. Changing the price for which the bidder offers to buy the shares, either lowering or raising it, not only increases the bidder's risk, but also likely decreases the bidder's profits.[27] If the bidder raises the price of his offer, he exposes himself to the risk that he might have to pay more for the shares than the price at which he values them. He might want to do so to ensure that he gets to lay his hands on some shares in a scenario where the demand for the shares is extremely strong and he feels that the other bidders are most likely to bid at a price higher than the price he values the shares. In addition, if the clearing price is set below the price the bidder believes the true value of the shares to be he might end up paying more than the other bidders. This is because, in a non discriminatory French auction, shares are allotted to successful bidders at the price at which they have bid.[28]

If the bidder, on the other hand, lowers the price he offers for the shares, he exposes himself to the risk that his bid might be too low. Although the floor price may be below his true value of the shares, he might not succeed in participating in the bid because his bid will be below the clearing price.

Thus, if the bidder is unable to predict the clearing price precisely other bidders may take her place in the offer and leave her in the losing group of bidders. Reducing the bidding price is a very risky strategy and is likely to be unprofitable.

Similarly, bidding for a large number of shares in the IPO is unlikely to have favorable results; it is likely to decrease the bidder's profits from the bidding. A bidder who offers to buy more shares might be forced to buy the excess shares.[29]

However, a rational bidder will profit from lowering the number of shares he offers to buy in the IPO without increasing the price. By lowering that

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[26] This is because the bidder's assets will now include stocks that are worth more than the lower IPO price which the bidder paid for them; GANOR *Supra* note 23.

[27] Katina J. Dorton, *Auctioning New Issues of Corporate Securities*, 71 VA. L. REV. 1381, 1384-88 (1985) 1391.

[28] Unger, *supra* note 24.

[29] *Id.*

number, without the auction price will be driven downward. A lower IPO price directly increases the the surplus or gain bidder expects to realize immediately on listing of the securities. . At the same time, a decrease in the number of shares bought at the IPO decreases the value for the bidder. The lower price and the decrease of the purchase number are opposing forces. Under certain circumstances, this strategy of lowering the number of shares a bidder offers is a preferred strategy that increases the aggregate value of the bidder's assets.

As a result of bidders lowering the number they offer to purchase in the auction IPO, the company will not see the real demand curve for its shares. Following the IPO, bidders who value the stock for more than the IPO price but did not purchase the optimal number of shares they wished to own because they used the manipulative underbidding strategy will buy shares in the aftermarket. This trading in the stock market will cause the share price to rise.

Hence, the underpricing, or the sale of shares by the company for less than their true value in the market, might openly manifest itself in the trading immediately following the IPO. In the book-building method, although the cut off price is not known to the issuer he has a fair idea about the issue proceeds he is likely to receive as the price band has been fixed by him in consultation with the merchant bankers.

B. OTHER PRACTICAL DISADVANTAGES OR IMPEDIMENTS IN AUCTION METHODS

1. Search Costs

Economists use the term search costs[30] to describe a purchaser's expense of surveying different sellers in a market to discover what price they are asking. In an auction, prospective buyers would bear similar costs in investigating the market value of the securities and determining the price that they are willing to bid.[31] If these costs are substantial, purchasers may find the auction mechanism unattractive for two reasons, The first is a free-rider problem; a prospective purchaser may forgo search and instead bid by mimicking bidders who have investigated the securities' value. The diversion of the economic gains of a bidder's research to free riders will deprive the bidder of the incentive to engage in the amount of search necessary to price the securities accurately. To this my answer would be since in the book building method its the merchant bankers who conduct road shows and research to determine the value of the company and stock, it is not necessary for the investors to carry on their own research. But in auction methods they do so and thus it will deprive the bidder of the incentive to engage in the amount of search necessary to price the securities accurately.

[30] Stigler, *The Economics of Information*, 69 J. Pol. Econ. 213, 224 (1961).

[31] Auctions, Bidding, And Contracting: Uses And Theory 14-15 (R. Engelbrecht-Wiggans, M. Shubik & R. Stark ed., 1983).

The second problem for auctions when search costs are high steams from the uncertainty faced by a bidder who does not know whether he will win any securities in the auction.[32] Valuing corporate securities requires analysis of expected returns and risks for a particular company. Learning about the company and its industry can be very time-consuming, and even if all of the relevant information is known, pricing certain types of securities can be quite complicated. Underwriters and investors may be unwilling to expend the resources necessary to submit a bid when they have no assurance of being awarded the securities in the auction. In the book building process the investors will have the assurance of pro rata of some securities if their bid is made at their higher end of the price band. Unlike this, under the auction method the investors might have no inkling whatsoever as to the leval at which the cut off price might settle. Hence the assurance of allocation in the book building process is much higher. Risk neutral[33] bidders will not participate in the auction if the cost of obtaining the information to submit the bid is greater than the probability of being awarded the securities times the profit achievable with the securities.[34]

Failing to attract enough bidders in an auction might hurt a company's image in the financial community. Additionally, sparse bidding could unnerve investors who hold the company's other securities and thereby impair the market for those securities. A large, widely followed company, however, would almost certainly attract enough bidders to an auction announced in advance and publicized widely in the investment community. However small, relatively unknown companies might not be able to attract a sufficient number of buyers to their auction. But Book Building allows such companies to underprice their shares so as to attract attention. In an auction method where no price bands are specified and the investors have to carry out their own research to determine the fair price, investors might be less inclined to expend time and effort to do so. they may market it in same way but since the investor has to put a lot more resources than what he would have done for the bigger company may unable it to attract a more number of buyers.

2. Selling Directly to Investors

The publicly held corporations may believe that they need investment bankers to reach large institutional purchasers. Historically, investment bankers have developed close relationships with institutional investors by providing block trading and financial research services.[35] An issuer may be concerned that by distributing securities through an auction, it would jeopardize the tie to the bankers and thus to the institutional investors.

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32 DORTON, *supra* note 27.

33 J. Henderson & R. Quandt, MICROECONOMIC THEORY 56-59 (ed. 1980).

34 In algebraic terms, let C = the cost of obtaining the information to submit a bid, P = the probability of being awarded the securities, and E = the bidder's earnings from obtaining the securities. Risk neutral bidders will not bid if $C > P \times E$.

35 Hayes, *The Transformation of Investment Banking*, HARV. BUS. REV. 153, 1979, 161-163.

The auction method would also limit the scope to sell the shares immediately on listing, and thus make a killing for institutional investors. This would especially be so in the case of companies that have very attractive growth potential, the final determination price of the securities in the auction being closer to the immediate listing market price. That would lower the first day bounce, the rise in share price immediately upon listing. This is because the auction method is likely to see maximum participation from long-term investors.

V. CONCLUSION

The claimed benefits of the auction method are hitherto unproven and even issuers in developed markets such as the United States are afraid to try this experimental method. The auction method has been used in over 20 countries and has been rejected in favour of other methods such as the fixed price method and the book building method to bring equity issues to the market. Also the experiences in these countries have found little support for the popular belief that the auction method leads to accurate pricing. Though different variants of the auction method have been used namely, the French and the Dutch systems, yet the outcomes have been surprisingly consistent in showing that the auction method is not the best method for raising capital for the company.[36]

Also another major concern is that the auction method is clearly more appropriate for a follow on public offer rather than an IPO. The existence of the book building together with the auction method to be used at different stages of fund raising could be confusing as well as unnerving for potential investors.

Thus it is not advisable to try and implement a method in India which is still in an experimental stage the world over. There is need to gain familiarity with the method before encouraging issuer to adopt the method.

With the book building methods the underwriter can act as a gate keeper, coordinating the number and type of entrants, and the underwriter sets the price only after observing all the orders. With an auction, on the other hand, bidders must place their bids before knowing how many others will enter the auction, and those who invest time and money evaluating an offering risk being squeezed out by free riders who have gathered information about the valuation price of the rival bidders, although it was intended to be kept secret. Without some screening method in place and ensuring the participation of sophisticated long term investors, IPO auctions are highly risky for both issuers and investors.

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[36] Jagannathan, Ravi, Jirnyi, Andrei and Sherman & Ann E., *Why Have IPO Auctions Failed the Market Test?,* (January 19, 2009), available at SSRN: http://ssrn.com/abstract=1330691 [last visited on March 20, 2010].