CHAPTER VI

PROBLEMS FACED BY MERCHANT BANKERS

INTRODUCTION

The Indian merchant banking fraternity numbering over 374 in category I as on October, 1995, managed 1343 public issues in 1994-95 with 188 merchant bankers. This means 50 percent of them did not get any issue at all. The standard deviation is high enough to indicate the high business risk in this industry which is currently exposed to a host of threats, primarily let down by the investors in primary markets.

With the slump in the primary markets and development of issues becoming the order of the day, the merchant bankers can no longer hope to see issues sailing through on their own.

Today, every issue needs rigorous marketing efforts to push it through the market successfully.

PERSONNEL

The merchant bankers in the country have organised themselves, with high overheads, to retain their personnel. The personnel turnover in this sector
is very high as quoted by an official in the Catholic Syrian Bank, "Last week he was representing capital markets Ltd., now he is with finance Ltd., I have four visiting cards of his under the banners of his past and current employers, I expect him to float his own outfit shortly! "In bad times as these, this turnover increases the pressure on performance."

The executives of most merchant banking outfits are under pressure of performance. Some are quick to shift from a fixed compensation package to a package with more weight of performance bonus, thus converting some of their fixed cost drivers to variable costs, and thereby reducing the operating risk by strategic cost management.

BIAS IN FAVOUR OF THE ISSUING COMPANY

A merchant banker is supposed to be an intermediary answerable to the investor for proper appraisal of the project. But things are not going by the book. Merchant bankers have shown a definite bias towards the issuer company.

According to Ramachandran, Vice President of Reliance capital Ltd., "it is very normal for the merchant banker to show a bias in its activities as it is the issuer company which "rewards" the merchant banker and not the investor. Interestingly, one merchant banker who refused to be quoted said that the high

---

number of merchant bankers. India is to some extent responsible for the bias they have in favour of the issuer company. At present, India has perhaps the highest number of category I merchant bankers in the world with increased competition. Merchant bankers are ready to promise the moon in broad daylight to the issuer company totally ignoring the viability of the project."

The consequence has been issues with fancy projects vying with each other for attracting public money. Aggressive pricing has been the problem with good issues. Issues which had some substance were overpriced by the lead managers at the instance of the issuer company. As a natural corollary listing prices were well below the issue price.

Pricing of the issue has been a problem plaguing the Indian primary markets. An excellent project can be made risky by aggressive pricing and a bad project can be made attractive by a low issue price strategy. The merchant banker cannot survive, if he prices aggressively, thus helping promoters, as the investor will experience higher risk, and shy away from him. Once this happens, he is in a vicious circle, and he becomes irrelevant to the promoter or issuer company.

JUSTIFICATION OF PREMIUM

Now the responsibility shifts to the lead manager for the justification of the price which means that the pricing is done up front and it is forced on to the

1 Ibid, p.54
investor. Pricing is also done based on projections which are not necessarily true as cost and time overruns are the order of the day in Indian markets. In such a scenario it becomes highly deceptive to have a price, based on the projections.

DISCLOSURE NORMS

A general feeling among the investing fraternity is that the disclosure norms in India needs a total revamping. More importantly there should be strict enforcement of the laws Prospectus in India get cleared ever though 50 percent of the project costs are applied towards intangibles like pre-operation expenses, miscellaneous expenses, preliminary expenses, and contingencies, such a thing can never happen abroad.

INFORMATION ACCESSIBILITY

Another important problem is the information accessibility in the Indian system. In the US company reports, total information on the company are available at the press of the button from the company itself or the consultant or even from a broker. Ram K. Reddy, chief executive officer, Global Industry Analysis Inc. observes "The American market is purely driven by the fundamentals and not on sentiments as in the Indian markets because an average US investor is more informed and educated due to the sheer availability of the information."3

PROJECT APPRAISAL

Next important rung of the issue ladder is the project appraisal by the lead managers. Based on the viability and feasibility of the project, the lead manager goes about his business of pricing and marketing of the issue. G. Ramachandran, merchant banker pointed out the "The depth of appraisal being done is very shallow and people are not adequately equipped for the required levels of analysis." US prospectuses do not carry projections because of the simple reason that the future is too uncertain to be predicted." In the US, appraisal of the project is the foremost concern of the company and they have the skills developed for doing justice to the project.

This is not the case in the Indian markets where projections are insisted upon and carried in the prospectus. Another interesting thing about the projected profits is that they always have linear progression with no sign of cyclicality or maturity curve of the industry. Projections always give a rosy picture of the company's future and at time may mislead the investor.

DUE DILIGENCE

In routine businesses the only policy for survival is - "the client is always right". Give what the client asks for and carry on with the business else lose the client to your competitor. Keen competition for getting merchant

Ibid, p.25
banking mandates has resulted in most merchant bankers extending this theory to the merchant banking business as well.

In fact, with the increase in number, the quality has deteriorated. The result is that merchant bankers are virtually churning out prospectuses like a sausage machine and the SEBI is vetting these like a teacher correcting answer books. This seems a very dangerous situation, as the merchant banks are supposed to be marketing the good issues to the investors putting this responsibility as merchant bankers, SEBI proposed the idea of a due-diligence certificate, to be submitted by the lead manager.

As per the due diligence certificate, the lead managers of any issue have to give an undertaking that they have examined various documents including those relating to litigation and other information in connection with filing of the draft prospectus.

Today, though every merchant bank does submit a due diligence certificate for each issue handled, it is more of a routine job. Many a time the merchant bankers are a party to such non-disclosures. Often the merchant banker is less aware of the track record of the promoter than his competitors or his foes who will leave no stone unturned to make the public issue fair.

There are a number of smaller cases when issues have been withdrawn at the last minute mainly because the merchant banker pulled out on the eve of the issue. Ind bank and SBI caps have done it. They have to develop their skill to judge the risk attached to their promoters and issues abinitio to survive in these markets. Ultimately, the ability to market will determine the survival of merchant bankers.

**LACK OF STAFF**

As far as SEBI is concerned, while vetting the offer document, it relies heavily on the certification made by the lead manager. SEBI does not have professionally qualified, competent and experienced manpower to assess and verify the correctness, fairness and adequacy of disclosures in the offer document. It can only ensure that the various disclosure requirements are met. Nothing more nothing less.

**FREE PRICING**

Under the erstwhile controller of capital issues regime, an issuer would not have been permitted to charge a price of more than 6-7 times of its last three years' average earnings [EPS]. But, after the advent of free-pricing, companies are charging premium invariably on future earnings, which, sometimes discount the earnings more than even 20 times.  

---

6 Kensource Information Services Pvt. Ltd., "Last minute issue withdrawals, Many a slip between the cup and the lip", The Merchant Banker Update, Bombay, Nov. 1995, p.27.

Until recently, Merchant bankers were inclined to suggest high premium as they thought that it was the only way to be in the good books of the issuers and grab business. Issuers were happy because, they got a much bigger amount from the public than they could ever dream of.

During the boom time everything seemed to be all right. But during the bad times financial year 1994-95, 414 companies made initial public offerings (IPOs) at a premium ranging from Rs.2 to Rs.390 per share. Of these, 397 companies have been listed on the stock exchanges until June 8, 1995. Of these premium issues, 51 percent (203 issues) are currently quoting at a discount, inflicting a loss of 1 to 64 percent on the issue prices 174 issues (44 percent of the total) have fetched capital appreciation ranging from 580 percent to 1 percent. 20 issues are quoted without any gain or loss during June, 1995.

UNDERWRITING

Earlier, underwriting only amounted to putting the signature on the prospectus and collecting the commission. Devolvements and under-subscription of issues were unheard of and underwriter's liability was on paper only.

But now with devolvements becoming more of a rule than exception and major brokers withdraw their underwriting commitments in many of the issues. Underwriters have resolved not to work for fees below 2.5 percent of the size
of the issue. This works out to as much as Rs.25 crore or more for an issue of Rs.1000 crore making underwriting one of the most high premia insurance activity in the country. The tough stance taken by SEBI as well as the threat of huge losses due to development of issues has brought about tightening of rules. Strict norms now include physical appraisal of infrastructure, plant and inventories, besides the usual checks adopted for issue appraisals.

While the underwriting community is wary of taking on new assignments in a hurry, the ones who are already committed are looking at some desperate measures to make it difficult for promoters to force devolvements on them. For instance, many are seeking shelter behind technical points which were hitherto glossed over or ignored.

WORK CULTURE OF MERCHANT BANKERS

Another level of inefficiency among the work culture of merchant bankers, is the in-fightings across there own branches and head office. A promoter who decided to sign the mandate with the Bombay head office of the merchant banker, even though the pre-Mou discussions were initiated by the Madras branch. Vice-president, says, "I find Madras always consulting and checking out with Bombay, then why not give the mandate to Bombay and use Madras for liaisoning work". The profit centre concepts in a very competitive situation, without the foundation of a strong team building practice can lead to

---

severe, self defeating, pursuits by the operation branch heads. One's gain is loss to the other, so the later does not encourage the former to gain more.

SUMMARY

If the problems are not checked to-day and the controls are exercised later when problems have mounted out of proportion, we may land up in a situation where no controls could be possible with fly-by-night operators being visible in many areas.