

# Introduction to underwriting



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## **INTRODUCTION TO UNDERWRITING**

Underwriting is an agreement, entered into by a company with a financial agency, in order to ensure that the public will subscribe for the entire issue of shares or debentures made by the company. The financial agency is known as the underwriter and it agrees to buy that part of the company issues which are not subscribed to by the public in consideration of a specified underwriting commission. The underwriting agreement, among others, must provide for the period during which the agreement is in force, the amount of underwriting obligations, the period within which the underwriter has to subscribe to the issue after being intimated by the issuer, the amount of commission and details of arrangements, if any, made by the underwriter for fulfilling the underwriting obligations. The underwriting commission may not exceed 5 percent on shares and 2.5 percent in case of debentures.

Underwriting has become very important in recent years with the growth of the corporate sector. It provides several BENEFITS to a company:-

- It relieves the company of the risk and uncertainty of marketing the securities.
- Underwriters have an intimate and specialized knowledge of the capital market. They offer valuable advice to the issuing company in the preparation of the prospectus, time of floatation and the price of securities, etc. They also provide publicity service to the companies which have entered into underwriting agreements with them.
- It helps in financing of new enterprises and in the expansion of the existing projects.

- It builds up investors' confidence in the issue of securities.
- The issuing company is assured of the availability of funds. Important projects are not delayed for want of funds.
- It facilitates the geographical dispersal of securities because generally, the underwriters maintain contacts with investors throughout the country.

### **TYPES OF UNDERWRITING**

- **Syndicate Underwriting:** – is one in which, two or more agencies or underwriters jointly underwrite an issue of securities. Such an arrangement is entered into when the total issue is beyond the resources of one underwriter or when he does not want to block up large amount of funds in one issue.
- **Sub-Underwriting:-** is one in which an underwriter gets a part of the issue further underwritten by another agency. This is done to diffuse the risk involved in underwriting.
- **Firm Underwriting:** – is one in which the underwriters apply for a block of securities. Under it, the underwriters agree to take up and pay for this block of securities as ordinary subscribers in addition to their commitment as underwriters.

### **UNDERWRITERS**

To act as an underwriter, a certificate of registration must be obtained from Securities and Exchange Board of India (SEBI). The certificate is granted by SEBI under the Securities and Exchanges Board of India (Underwriters) Regulations, 1993. These regulations deal primarily with issues such as registration, capital adequacy, obligation and responsibilities of the underwriters. Under it, an underwriter is required to enter into a valid <https://assignbuster.com/introduction-to-underwriting/>

agreement with the issuer entity and the said agreement among other things should define the allocation of duties and responsibilities between him and the issuer entity. These regulations have been further amended by the Securities and Exchange Board of India (Underwriters) (Amendment) Regulations, 2006.

## **ROLE OF UNDERWRITERS**

- The primary role of the underwriter is to purchase securities from the issuer and resell them to investors.
- Underwriters act as intermediaries between issuers and investors, providing for an efficient of capital.
- The underwriters take the risk that it will be able to resell the securities at a profit.
- Perhaps the most visible and familiar element of the initial public offering process is the underwriter. The underwriter is the organization that is actually responsible for pricing, selling, and organizing the issue, and it may or may not provide additional services. With direct public offerings, there is no need for an underwriter.

Selection of a good underwriter is of the utmost importance, but it's important to understand that many underwriters are equally selective of their clients. Because an underwriter's reputation depends on successful issues, few firms will be willing to stake their reputation on questionable companies.

- When selecting an underwriter, it's important to seek out an established company with a good reputation and quality research coverage in your field. The decision may also depend on the kind of

agreement the underwriter is willing to make regarding the sale of shares. For profitable and established private companies, it shouldn't be difficult to locate an underwriter willing to make a firm commitment arrangement. Under such an agreement, the underwriter agrees to buy all issues shares, regardless of ability to sell them at a particular price.

- For riskier or less established companies, an underwriter may offer best efforts arrangement for the initial public offering. A best efforts contract requires the underwriter to buy only enough shares to fill investor demand. Under this arrangement, the underwriter accepts no responsibility for unsold shares.
- Aside from fees and sales arrangements, most underwriters are fairly similar in their roles. An underwriter will assist in the preparation and submission of all appropriate SEC filings, helping potential investors make informed decisions about your offering. All underwriters are required to exercise due diligence in verifying the information they submit, so a certain amount of investigation should be expected from any responsible underwriter.

In addition to SEC registration filings, the underwriter will create a preliminary prospectus that will become a major part of the issue's marketing campaign. This document is also referred to as the red herring, after a small red passage in the document that states that the company is not attempting to sell shares prior to SEC approval.

Once SEC approval is obtained, the underwriter and the corporation will embark on a road show to gauge and attract interest from investors. While the road show does not involve getting binding commitments from investors,

it helps the underwriter determine the best strategies for pricing and issuance.

After the initial public offering, the underwriter continues to provide services for the newly public corporation. For months or even years after the offering, the underwriter may continue to make a market for the stock, ensuring liquidity for investors and making the shares more desirable. Twenty-five days after the issue, the underwriter is also permitted to make statements or projections regarding the company and its prospects.

## **ANALYSIS OF RESEARCH ARTICLES**

### **ARTICLE 1**

#### **ROLE OF UNDERWRITER IN INITIAL PUBLIC OFFERING (IPO)**

When a company wants to raise funds through initial public offering (IPO) it appoints an investment bank for underwriting the issue. An investment bank is also called a merchant bank. There is no regulatory restriction to use the services of a merchant bank for IPO. Since in an IPO a company participates for the first time, it doesn't have complete understanding of the rules and documentation, required to be submitted, to get a clearance from the regulator.

Famous merchant bankers world over are Goldman Sachs, Credit Suisse and Morgan Stanley. Banks like Deutsche, Citi, UBS etc have investment banking wings. Underwriters assess and analyze firm's current performance, firm's future earnings potential, industry scenario, competition in the same sector, current local and global market situations etc. to decide the issue price/price band. They also work on the activities like completion of the mandatory

documentation as required by the regulatory body. Underwriters charge a fee for this activity, which is generally a percentage of the issue size.

If the issue size is very large a syndicate of merchant banks takes up the task of underwriting the issue. However one merchant bank leads the other.

### **MERCHANT BANKERS**

- The merchant bankers are those financial intermediaries involved with the activity of transferring capital funds to those borrowers who interested in borrowing.
- They guarantee the success of issues by underwriting them.
- Merchant banks are popularly known as “ issuing and accepting houses”.
- Unlike in the past, their activities are now primarily non-fund based (fee based).

They offer a package of financial services. The basic function of merchant banks is marketing corporate and other services that are guaranteeing sales and distribution of securities and also other activities such as management of customer services, portfolio management of customer services, portfolio management, credit syndication, acceptance credit, counseling, insurance, etc.

As per SEBI (Merchant bankers) Rules, 1992:

“ Merchant bankers means any person who is engaged in the business of issue management either by making arrangements regarding selling, buying or subscribing to securities or acting as manager, consultant, advise or rendering corporate advisory service in relation to such issue management.”

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## **MERCHANT BANKING**

Merchant banking activity was formally initiated into the Indian capital markets when Grindlays Bank received the license from Reserve Bank in 1967. Grindlays started with management of capital issues, recognized the needs of emerging class of entrepreneurs for diverse financial services ranging from production planning and system design to market research. Even it provides management consulting services to meet the requirements of small and medium sector rather than large sector. Citibank setup its merchant banking division in 1970. The various tasks performed by this division namely assisting new entrepreneur, evaluating new projects, raising funds through borrowing and issuing equity. Indian banks started banking services as a part multiple services they offer to their clients from 1972. State Bank of India started the merchant banking division in 1972. In the initial years the SBI's objective was to render corporate advice and assistance to small and medium entrepreneurs.

## **REGISTRATION OF MERCHANT BANKERS WITH SEBI**

- It is mandatory for a merchant banker to register with the SEBI. Without holding a certificate of registration granted by the Securities and Exchange Board of India, no person can act as a merchant banker in India.
- Only a body corporate other than a non-banking financial company shall be eligible to get registration as merchant banker.
- The applicant should not carry on any business other than those connected with the securities market.
- All applicants for merchant bankers should have qualifications in finance, law or business management.



- The applicant should have infrastructure like office space, equipment, manpower etc.
- The applicant must have at least two employees with prior experience in merchant banking.

## **MERCHANT BANKERS IN INDIA**

There are 135 merchant bankers who are registered with sebi now in India.

There are public sector, private sector and foreign players registered with sebi. The below are the examples of few of the merchant bankers in each of the public, private and foreign players.

- PUBLIC SECTOR MERCHANT BANKERS
- SEBI CAPITAL MARKETS LTD.
- PUNJAB NATIONAL BANK.
- IFCI FINANCIAL SERVICES LTD.
- KARUR VYSYA BANK LTD.
- STATE BANK OF BIKANER AND JAIPUR.
- PRIVATE SECTORS MERCHANT BANKERS:
- ICICI SECURITIES LTD.
- AXIS BANK LTD(FORMERLY UTI BANK LTD.)
- BAJAJ CAPITAL MARKETS LTD
- TATA CAPITAL MARKETS LTD.
- ICICI BANK LTD.
- RELIANCE SECURITIES LIMITED.
- KOTA MAHINDRA CAPITAL COMPANY LTD.
- YES BANK LTD.
- FOREIGN PLAYERS IN MERCHANT BANKING.

- GOLDMAN SACHS(INDIA)SECURITIES PVT. LTD.
- BARCLAYS SECURITIES(INDIA)PVT. LTD.
- BANK OF AMERICA. N. A.
- DEUTSCHE BANK.
- DEUTCHE EQUITIES INDIA PRIVATE LIMITED.

## **SERVICES OF MERCHANT BANKS**

### **PROJECT COUNSELLING:**

Project counseling includes preparation of project reports, deciding upon the financing pattern to finance the cost of the project and appraising the project report with the financial institutions or banks. It also includes filling up of application forms with relevant information for obtaining funds from financial institutions and obtaining government approval.

### **MANAGEMENT OF DEBT AND EQUITY OFFERINGS**

This forms the main function of the merchant banker. He assists the companies in raising funds from the market. The main areas of work in this regard include: instrument designing, pricing the issue, registration of the offer document, underwriting support and marketing of the issue, allotment and refund, listing on stock exchanges.

### **ISSUE MANAGEMENT**

Management of issue involves marketing of corporate securities viz. equity shares, preference shares and debentures or bonds by offering them to public. Merchant banks act as per SEBI guidelines, the merchant banker arranges a meeting with company representatives and advertising agents to finalize arrangements relating to date of opening and closing of issue, registration of prospectus, launching publicity campaign and fixing date of

board meeting to approve and sign prospectus and pass the necessary resolutions. Pricing of issues is done by the companies in consultant with the merchant bankers.

### **MANAGERS, CONSULTANTS AND ADVISERS OF THE ISSUE:**

The managers of the issue assist in the drafting of prospectus, application forms and completion of formalities under the companies act, appointment of registrar for dealing with share applications and transfer and listing of shares of the company on the stock exchange. Companies can appoint one or more agencies as managers to the issue.

### **UNDERWRITING OF PUBLIC ISSUE:**

Underwriting is a guarantee given by the underwriter that in the event of under subscription, the amount underwritten would be subscribed by him. Merchant banking subsidiaries cannot underwrite more than 15% of any issue.

### **PORTFOLIO MANAGEMENT:**

Portfolio refers to investment in different kinds of securities such as shares, debentures or bonds issued by different companies and government securities. Portfolio management refers to maintaining proper combinations of securities in a manner that they give maximum return with minimum risk.

### **RESTRUCTURING STRATEGIES:**

AA merger is a combination of two companies into a single company where one survives and other loses its corporate existence. A takeover is the purchase by one company acquiring controlling interest in the share capital of another existing company. Merchant bankers are the middlemen in setting

negotiation between the companies. Merchant bankers assist the management of the client company to successfully restructure various activities, which include mergers and acquisitions, management buyouts, joint ventures among others.

### **OFFSHORE FINANCE:**

The merchant bankers help their clients in the following areas involving foreign currency:

1. Long term foreign currency loans
2. Joint ventures abroad
3. Financing exports and imports
4. Foreign collaboration arrangements

### **ROLE OF MERCHANT BANKER IN A PRIMARY MARKET ISSUE MANAGEMENT:**

Merchant banker is the intermediary appointed by companies in the primary market issue. It has to look at the entire issue management and work as the manager to the public issue.

### **References:**

- <http://lastbull.com/ipo—role-of-underwriter/>