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## Here is how you can decide if an IPO is worth investing

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Analyzing an IPO is difficult since by definition it is an "initial" public offer and hence there is less information available about the company's operating history. However, since the regulators are also worried about this a lot of information is made mandatory as far as the draft red herring prospectus (DRHP) is concerned. This gives one a good start at attempting to analyse it.

Let us begin with what not to do with an IPO. Definitely, in the beginning do not pay too much attention and weight to the media reports on how great and visionary the management is and how great are the prospects for the industry and the company in future.

There is a section of the DRHP which states the "**Objects of the offer**". One should familiarize oneself as to the intended object for which an IPO is being conducted. Typically, some of it is for a partial exit of the existing promoters and the strategic investors, such as private equity owners, might want a full exit. This portion of the money realized from the IPO doesn't get into the company's books and hence is not going to be useful for growth. If this portion is very large then it should be viewed with scepticism.

Then comes the **balance sheet** in the financial information section of the DRHP. One needs to determine the extent of debt in the company. What is the debt-to-equity ratio? Is debt less than 30% or at most 50% of equity or total shareholder funds including reserves? What is the interest coverage? Is the earnings before interest and taxes at least 4 times or more than the interest costs?

If the **debt** is higher than one should see if one of the objects of the fund-raising is to reduce the debt significantly. One will have to then restate the financial statements assuming that the debt is reduced to the extent mentioned and then see if the balance sheet looks robust post the debt reduction.

Next comes the **revenues and operating profits**. Are revenues substantial? Any company with revenues less than Rs. 250 crores is probably too small for most retail investors to consider further. Are the profits substantial? Are the operating margins in the range of 15% or higher? Companies with operating profits in the range of Rs. 50 crores or more can be considered for retail investors. Are the company's revenues stable or growing over the last few years? Are the operating profits stable? Was the debt portion stable or being lowered or was it increasing? A significant increase in debt over last few years is something that should be seen as a warning signal. If the growth required a corresponding increase in debt then one needs to dig deeper to understand why it was required and can the company grow without taking on too much debt in the future. Is the company generating sufficient cash flow from operations to maintain its growth rate? How efficiently is the company using its assets? Is the company at least recovering the cost of capital? A return on assets of 15% or more should be fine.

Given all this what percentage of the company will be listed for public trading or as non-promoter holdings? **Promoters should have at least 25% shareholding left post the listing**. This will ensure that there is continued interest in the performance of the company.

Now comes the most important part. At what price the shares are being offered? **One can look at the ratio of share price to earnings-per-share,** i.e. PE ratio. One should also look at the PB ratio. Ideally, the company should be offered at a PE ratio and PB ratio which are at a discount to the similar larger companies which are already listed. In general, a PE ratio > 25 is a sign that one should probably not participate.

Keep in mind that one can always buy the shares once they are listed and start trading freely. Typically, once the initial euphoria which is artificially created at the time of IPO is over, one can buy the same shares in large quantities and cheaper prices.

In general, it can be inferred that post-IPO most company's share prices drop significantly below their offer prices. Hence, the general advice is to keep away from IPOs. **Some exceptions when one should seriously investigate an IPO for investments are when they are from public sector enterprises or when they are being offered during bear markets.** Some of these IPOs could be offered significantly below their intrinsic values. Otherwise there is no reason to participate in them.