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GREEN SHOE OPTIONS: AN INDIAN PERSPECTIVE

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ABSTRACT

For the economic development of a country, the primary market for securities plays an important role. The Green Shoe Option (GSO) provides the option of allotting equity shares in excess of the equity shares offered in the public issue as a post-listing price stabilising mechanism. The objective of this mechanism is to reassure investors that they would have an exit route during the first 30 days after the listing of shares at a price close to the issue price. In India, the Green Shoe Options (GSOs) were introduced by the Securities and Exchange Board of India in 2003. It was ventured to bring the Indian Primary Markets at par with global markets and to boost investor's confidence and thus result in short term volatility in post listing price. The objective of this paper is to examine the GSO mechanism and its impact on the Indian Primary Markets. The paper concluded with the remark that in India, the GSO mechanism is still in infantry stage. Very few companies have gone for GSO and reaped the benefit of price stabilization. It requires proper awareness programme to understand the mechanism.

KEYWORDS: - Primary Market, Merchant Bank, Market Volatility, GSO Window Period.

1. INTRODUCTION:-

A Green Shoe (sometimes "greenshoe"), legally called an "over-allotment option" (the only way it can be referred to in a prospectus), is an option of allotting equity shares in excess of the equity shares offered in the public issue as a post listing price stabilizing mechanism. It gives underwriters the right to sell additional shares in a registered securities offering at the offering price, if demand for the securities exceeds the original amount offered. The greenshoe can vary in size up to 15% of the original number of shares offered. The greenshoe option is popular because it is one of a few SEC-permitted means for an underwriter to stabilize the price of a new issue post-pricing, and it presents no risk to the underwriter. Issuers will sometimes not permit a greenshoe on a transaction when they have a specific objective for the offering and do not want the possibility of raising more money than planned. The term "greenshoe" came from the Green Shoe Manufacturing Company (now called

Stride Rite Corporation), founded in 1919. It was the first company to implement the greenshoe clause into their underwriting agreement.

Public Offerings may supply a large number of securities into a market, as a result of which, there is a risk that the price of the securities will be highly volatile immediately after the commencement of the offering. Price volatility is likely to be even greater in the case of an Initial Public Offering (IPO) because there is no established Secondary Market for the securities. The purpose of an issuer and/or a selling security holder in providing an underwriter with an over-allotment is to allow the underwriter to stabilize the after-market for the issuer's securities in the period immediately after the public offering begins. By allowing an underwriter to obtain additional securities covering an over-allotment and to sell these securities to the public, an underwriter can maintain a balance between the demand for an issuer's securities and the supply of securities available to satisfy market demand.

The Securities and Exchange Commission (SEC) introduced this option in order to enhance the efficiency and competitiveness of the fund raising process for IPOs. SEBI introduced this option with a view to boost investor’s confidence by arresting the speculative force, which works immediately after listing and thus result in short term volatility in post listing price. It ensures price stability. One of the benefits of using the greenshoe is its ability to reduce risk for the company issuing the shares. It allows the underwriter to have buying power in order to cover their short position when a stock price falls, without the risk of having to buy stock if the price rises. In return, this helps keep the share price stable, which positively affects both the issuers and investors. It is an Investor Protection measure especially for the small investors during post-listing period

2. OBJECTIVES:-

The objectives of this study are:-

1. To highlight the GSO mechanism.
2. To analyse the purpose for opting for GSO.
3. To review the impact of GSO in the Indian Primary Markets since inception.

3. RESEARCH METHODOLOGY:-

The study is purely based on secondary data. The mythology adopted involves review of literature in the theoretical, practical, legislative and other aspects. The sources of data include SEBI Annual Reports, and mainly websites. To analyse the data percentages are used.

4. LITERATURE REVIEW:-

There has been a lot of research on IPO pricing; however, very little research has focused on the inclusion of GSOs in IPO programmes. The under pricing of IPOs seems to have received reater attention than the phenomenon of overpricing. Aggarwal et al. (2002) Su and Fleisher (1997), and Hunger (2003) found that under pricing was rampant in the US during 1981–2000, reaching its peak during the dot-com bubble. Chowdhry and Nanda (1996) provided a justification for the aftermarket stabilisation of IPOs by underwriting syndicates, and showed that stabilization dominates under pricing as a means of compensating uniformed investors of the adverse selection that they face. Lewellen (2003) studied the price effects and cross sectional determinants of price support, and found price stabilisation to be extensive in the US, inducing significant price rigidity at and below the offer price. Ana Gonzalez Ribeiro (2009) emphasised that the companies those want to venture out and start selling their shares to the public have ways to stabilize their initial share prices. One of these ways is through a legal mechanism called greenshoe option. The pricing mechanism and the phenomenon of under pricing in Indian IPOs were analysed by Madhusoodanan and Thiripalraju (1997) and Jegadeesh et al. (1993). Financial Analysts Journal © 1992 CFA Institute: GSO protects underwriters from potential losses resulting from overselling the IPO. The actual exercise patterns of these options in samples of closed-end-fund IPOs and industrial IPOs shows that underwriters rationally exercise the options when they are "in-the-money." Prashanta Athma, J. Anitha Rani (2012) the Securities and Exchange Board of India (SEBI) has introduced Green Shoe Option (GSO) on 12 Aug 2003, in order to bring the Indian Primary Markets on par with global markets such as US, Canada and others where over 90 percent of the primary issues is through the Book-Building route having the GSO.

5. GSOs IN INDIA:-

The Securities and Exchange Board of India (SEBI) has introduced Green Shoe Option (GSO)on 12 Aug 2003, in order to bring the Indian Primary Markets on par with global markets such as US, Canada and others where over 90 percent of the primary issues is through the Book-Building route having the GSO. This facility was expected to be a major policy initiative to reassure investors, especially the RIIs. Ravi Kapoor, senior vice-president, DSP Merrill Lynch, said, “The amount raised in the form of GSO will be used to stabilise the price of the stock post-listing, raising comfort levels of investors (that price would be stabilised post listing) and encouraging increased participation from investors.”One of the major beneficiaries of the GSO happens to be the investor as this option helps to preserve his capital as buying of excess shares limits panic selling in the market, as and when the stock gets listed on the bourses.

The rationale for the introduction of GSOs in India was stated as follows: Unexpected developments may have an adverse impact on price of newly listed securities. The facility of green shoe option introduced by SEBI facilitates the investment bankers to stabilize the post listing price of the security. This measure is expected to mitigate volatility and enhance investor confidence. The process of GSOs in India is described below.

5.1 GSO Mechanism in India:-

The entire process of a green shoe option (GSO) works on over-allotment of shares. For instance, a company plans to issue 1 lakh shares, but to use the green shoe option; it actually issues 1.15 lakh shares, in which case the over-allotment would be 15,000 shares. The company does not issue any new shares for the over-allotment. The 15,000 shares used for the over-allotment are actually borrowed from the promoters with whom the stabilising agent signs a separate agreement. For the subscribers of a public issue, it makes no difference whether the company is allotting shares out of the freshly issued 1 lakh shares or from the 15,000 shares borrowed from the promoters. Once allotted, a share is just a share for an investor. For the company, however, the situation is totally different. The money received from the over-allotment is required to be kept in a separate bank account.

A company making an initial public offer of equity shares through the book building mechanism can avail the green shoe option (GSO) for establishing the post-listing price of its share. In GSO mechanism, the allocation shares in excess of the shares included in the public issue is made through a stabilizing agent (SA). The concerned issuing company should seek authorization for the possibility of allotment of further issues to the SA at the end of the stabilization period together with the authorization for the public issue in the general meeting of its shareholders. It should appoint one of the lead book runners as SA who would be responsible for the price stabilization process. The SA should enter in to an agreement with the issuer company, prior to the filing of the document with SEBI, clearing stating all the terms and conditions relating to GSO including fees charged/expenses to be incurred by him for the purpose. He should enter into an agreement with the promoter(s) who lend their shares, specifying the maximum number of shares that may be borrowed from the promoters, but in no case exceeding 15 per cent of the total issue size. The details of these two agreements should be disclosed in the draft red herring prospectus, red herring prospectus and final prospectus. They should also include as material documents for public inspection in terms of the disclosures in the contents of the offer documents. The lead book runner, in consultation with the SA, would determine the amount of shares to be over-allotted with the public issue within the ceiling specifies above. The SA should borrow shares from the promoters to the extent of proposed over-allotment. They should be in dematerialized form only and their allocation should be *pro rata* to the applicants.

The stabilization mechanism would be available for the period disclosed by the company in the prospectus up to a maximum of 30 days from the date when the trading permission was granted by the stock exchange(s). The money from the applicants against the over-allotment in the GSO should be kept in a separate GSO Bank Account and to be used for the purpose of buying shares from the market during the stabilization period. These shares should be credited to the GSO Demat Account. They should be returned to the promoters immediately within two working days after the close of the stabilization period.

To stabilizing the post-listing prices of the shares, the SA would determine the timing of buying them, the quantity to be brought, the price at which brought and so on. In case the SA does not buy shares to the extent of their over-allotment from the market, the issuer company should allot shares to the extent of the shortfall from the GSO Demat Account within 5 days of the closure of the stabilization period. These would be returned to the promoters by the SA in lieu of those borrowed them and the GSO Demat Account would be closed. The company would be making a final listing application in respect of such shares to all the concerned stock exchanges where the shares allotted in the public issue are listed. The provisions related to preferential issues would not be applicable to such allotment. The shares returned to the promoters in either case would be subject to the remaining lock-in period.

The SA would remit the issue price to the company from the GSO Bank Account. The remaining balance, net of deduction of expenses by the SA, would be transferred to the Investors Protection Fund of the concerned stock exchange and the BSO Bank Account would be closed.

The SA should submit a daily report to the stock exchange(s) during the stabilization period. He should submit a final report signed by him/company to the SEBI in the specified form together with (i) a depository statement for the GSO Demat Account for the stabilization period indicating the flow of shares into and from the account and (ii) an undertaking by the SA and countersigned by the depository (ies) in respect of confirmation of lock-in shares returned to the promoters in lieu of the shares borrowed from them for stabilization purpose. The SA should maintain for at least 3 years from the date of the stabilizing period a register in respect of each issue with GSO in which he acts as a SA containing the following details: (i) price, date and time of each transactions, (ii) promoters and number of shares borrowed from each and (iii) allotment made.

5.2 GSO & Debt Issues in India:-

In India, the Securities and Exchange Board of India (SEBI) has tightened norms relating to public issue of debt securities, by limiting funds that an issuer can retain in the event of oversubscription. The market regulator has directed the merchant bankers to maintain parity between the amount a company intends to raise through the basic offering and the green-shoe option. The market regulator has told these bankers that the green-shoe option of a debt issuance should not be more than 100% of the basic offer size. Also, the minimum subscription has to be at least 75% of the basic issue size, failing which the issue needs to be withdrawn, and the application money, received till then, refunded, said a person familiar with the development.

Henceforth, if a company intends to raise Rs 100 crore, the green-shoe option cannot exceed Rs 100 crore, and the minimum subscription has to be at least Rs 75 crore. These restrictions come following the huge success of the recent public issue of non-convertible debentures (NCDs) by Tata Capital. The non-banking financial arm of the Tata Group had raised Rs 500 crore with a green-shoe option of an additional Rs 1,000 crore. The regulations at that time permitted an oversubscription of 200%, and minimum subscription of 40% of the basic issue size for that issue.

But, SEBI is now concerned that companies with lesser financial strength than Tata Capital would look to raise money through this route. The fears are not unfounded, as the issuer, who had made a debt offer with the green-shoe option fully exercised, could come under pressure later, in case, it is unable to cough up enough money at the time of redemption. "With this new directive, a company approaching the public issue of NCD market would have to be a little more careful while finalising its fund-raising plans and objects of the issue".

5.3 Data Analysis:-

Of the 365 companies that made an IPO from August 2003 (when GSOs were introduced in India) to December 31, 2011, only 18 companies availed of the GSO facility in their IPO programmes. A detail scenario of companies opted for GSOs in India is given in Table-1.

Table – 1

Number of Companies that opted for GSO in their IPO in India from the year 2003 to 2011

Year	No. of IPOs	No. of Companies opting for GSOs	% of Companies opting for IPOs
2003	03	00	0.00 %
2004	21	02	9.52 %
2005	43	03	6.98 %
2006	60	06	10.00 %
2007	86	05	5.81 %
2008	30	00	0.00 %
2009	17	01	5.88 %
2010	66	01	1.51 %
2011	39	00	0.00 %
Total	365	18	4.93 %

From August 24, 2003 (the day GSOs were introduced in India) to December 31, 2011, 365companies made IPOs in India. Of these companies, only 18 companies (4.93%) had included GSOs in their IPO programme (see Table 1). If we consider a more recent time period, wesee that only two out of 122 companies (1.64%) included GSOs in their IPO programmes from January 1, 2009 to December 31, 2011.

Based on the analysis of the aftermarket price performance of the companies that availed of the GSO facility in their IPO programmes, it could be concluded that GSOs were not effective in stabilising the prices in the period immediately following the listing date. However, broad generalizations cannot be made due to the small size of the companies, both in absolute terms and as a proportion of the companies making IPOs. Of the companies that did not include the GSO facility in their IPO programmes, a disproportionately large number of companies performed poorly.

5.4 Reasons for indifference towards GSOs

The data reveals that there is a case for issuer companies and merchant banks to avail the facility of GSOs to reassure investors, especially RIIs, and to discourage them from exiting the capital markets. What then is the reason for this indifference to GSOs on the part of issuer companies and merchant banks? The possible reasons are:-

- Uncertainty about impact of GSOs.
- Interference with free play of market forces.
- Unfair advantage for merchant banks.
- Lack of incentives.
- Absence of market discipline.
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6. CONCLUSION:-

The price stabilization proves to be a blessing in disguise for the retail investors in case of violent fluctuations in the share prices. Investors tend to give better pricing of offers with a green shoe option or with price stabilization, as they are sure that in post-listing, the merchant banker will guarantee price stability.

In India, after a decade of its introduction, the GSO mechanism is still in infantry stage. Very few companies have gone for GSO and reaped the benefit of price stabilization. We found that most issuer companies and merchant banks were indifferent to GSOs, and such options were rarely availed. There are various reasons for such indifference emerged, such as the uncertainty about the effects of GSOs, the unwillingness to bear additional responsibility, the lack of incentives, the absence of market discipline, and so on. So, after this review, it could be concluded that in India, GSOs were not effective in stabilising the prices in the period immediately following the listing date.

7. SUGESSIONS:-

In India, we proposed the following suggestions for an effective implementation of GSOs in India.

- Awareness programs should be conducted to educate the Companies, Merchant Bankers and Investors about the GSO and its importance.
- GSO can be made mandatory in case of IPOs.
- Some penalties would need to be imposed on Qualified Institutional Buyers (QIBs) who sell the shares in the immediate aftermarket.
- Merchant bankers would need to disclose their track record.
- The IPO norms would have to be tightened, especially for small issues.

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