

INITIAL PUBLIC OFFER (IPO) GRADING

Background

ICRA Nepal's Grading of Initial Public Offerings (IPOs) is a service aimed at facilitating the assessment of equity issues offered to the public. The Grade assigned to any individual IPO is a symbolic representation of ICRA Nepal's assessment of the "fundamentals" of the issuer concerned on a relative Grading scale. IPO Grades are assigned on a five-point scale, where IPO Grade 1 indicates the highest Grading and IPO Grade 5 the lowest Grading. An IPO Grade is not an opinion on the price of the issue, pre- or post-listing.

The Grading Process

ICRA Nepal starts the IPO Grading process on receipt of a formal request (mandate) from the issuer company. ICRA Nepal then sends a questionnaire seeking information on the company's existing operations as well as proposed project(s). This is followed by site visits and discussions with the key operating personnel of the company concerned. Apart from officials of the company, ICRA Nepal also meets the issuer company's bankers, auditors, merchant bankers, and appraising authority (if any). If the case so merits, ICRA Nepal also obtains the views of independent expert agencies on critical issues, such as the technology proposed to be used. Once all the required information has been obtained, ICRA Nepal's team of analysts presents a detailed Grading Report to ICRA Nepal's Rating Committee which then assigns the Grade. Usually, the assignment of Grade takes three to four weeks after all the necessary information has been provided to ICRA Nepal. Once the Grade is assigned, the issuer company is required to disclose the same and also publish it in the Prospectus, which is filed with the Securities Board of Nepal (SEBON) and other statutory authorities, as required. ICRA Nepal does not carry out any unsolicited Grading; the process involves the full co-operation of, and interaction with, the issuer company concerned.

IPO Gradings are a one-time exercise, not subject to subsequent surveillance.

Grading Methodology

The emphasis of the IPO Grading exercise is on evaluating the prospects of the industry in which the issuer company operates, the company's competitive strengths that would allow it to address the risks inherent in the business(es) and effectively capitalise on the opportunities available, and the company's financial position. In case the IPO proceeds are planned to be used to set up projects, either greenfield or brownfield, ICRA Nepal evaluates the risks inherent in such projects, the capacity of the company's management to execute the same, and the

likely benefits accruing from the successful completion of the projects in terms of profitability and returns to shareholders. Due weightage is given to the issuer company's management strengths and weaknesses, and to issues, if any, from the corporate governance perspective. Accordingly, ICRA Nepal's IPO Grading methodology examines the following key variables:

- **Business and Competitive Position**

- *Industry prospects:* Typically, the factors assessed here include the growth prospects of the industry, the extent of cyclicity, competitive intensity, vulnerability to technological changes, and regulatory risks inherent in the business.
- *Market position:* A company's market position is indicated by its ability to increase/protect market share, command differential pricing and maintain margins on a par with, or superior to, its peers. The factors evaluated include the sources of competitive advantage, like brand equity, distribution network, proximity to key markets, and technological superiority.
- *Operating efficiency:* The emphasis here is on evaluating the factors that promote operating efficiency, depending on the industry in which the issuer company is operating, and typically include access to raw material sources, superior technology, and favourable cost structure, among others.

- **New Projects—Risks and Prospects**

- The key issues evaluated here are the company's ability to successfully execute the project being undertaken and the potential upside to shareholders on the completion and commissioning of the project. ICRA Nepal carries out a detailed risk assessment of the project with respect to issues like availability of finances, technology tie-ups being in place, ability to execute the project without time or cost overrun, market risks arising from capacity additions, and the mitigants in place to counter those risks.

- **Financial Position and Prospects**

- The ability to generate sustained shareholders' value, as reflected by trends in profitability margins, Earning per Share (EPS) growth, Return on Capital Employed (RoCE) and Return on Net Worth (RoNW), is evaluated by ICRA Nepal. While the absolute levels and the trends are important, ICRA Nepal also makes a peer comparison to assess the issuer company's relative position within the industry concerned. Complementing this is an analysis of the company's ability to generate free cash flows over the long term. The capital structure of the company is evaluated from a

perspective of balance between the cost of capital for shareholders and the financial risks associated with higher leverage.

- **Management Quality**

- The assessment here is designed to evaluate the issuer company's management depth, the profile of its key operating personnel, the adequacy of the organisation structure, and the systems in place, besides the management's stated plans and policies relating to earnings growth and shareholder returns. ICRA Nepal also evaluates the management's approach towards risk and the long-term business plans in place.

- **Corporate Governance Practices**

- While IPO Grading is not intended to be a detailed evaluation of a company's corporate governance practices, broad issues like apparent quality of independent directors, quality of accounting policies and the nature of transactions with subsidiaries, associates and group companies are looked into.

- **Compliance and Litigation History**

The IPO Grade assigned is the outcome of a detailed evaluation of each of the factors listed, and is a comment on the fundamentals of the company concerned and its growth prospects from a long-term perspective. The assessment involves examining both quantitative factors, as reflected in financial numbers, market shares, etc., and qualitative factors like risks associated with new projects, and the management's ability to deliver on the promises made.

An **[ICRANP] IPO Grade** does not comment on the valuation or pricing of the issue that has been graded, nor does it seek to indicate the likely returns to shareholders from subscribing to the IPO.

ICRA Nepal's IPO Grading Scale

ICRA Nepal's five-point IPO Grading scale is as follows:

- [ICRANP] IPO Grade 1** : Strong fundamentals
- [ICRANP] IPO Grade 2** : Above-average fundamentals
- [ICRANP] IPO Grade 3** : Average fundamentals
- [ICRANP] IPO Grade 4** : Below-average fundamentals

[ICRANP] IPO Grade 5 : Poor fundamentals

Note:

For the Grading categories 2, 3 and 4, the sign of + (plus) may be appended to the Grading symbols to indicate their relative better position within the Grading categories concerned.

What an [ICRANP] IPO Grade Is Not:

- It is NOT a recommendation to buy, sell or hold the securities Graded
- It is NOT a comment on the valuation or pricing of the IPO Graded
- It is NOT an indication of the likely listing price of the securities Graded
- It is NOT a certificate of statutory compliance

The Deliverables

For the IPO Grading exercise, the deliverables are the Grade itself and a rationale (which is published) highlighting ICRA Nepal's key observations against each of the parameters listed in the section titled "Grading Methodology".



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