Common mistakes made when investing in the Primary Market

The Primary Market, also called the New Issue Market, is the market for issuing new securities. The Colombo Stock Market witnessed 18 new share issues last year and four new share issues during the first quarter of 2012. Investors in the Colombo Stock Market continuously make some common mistakes when investing in the Primary Market. This article was compiled by speaking to the experts of the Primary Market.

These are some common mistakes investors make when applying for new share issues.

1. Not going through the 'prospectus' carefully: After getting the company incorporated, promoters will raise finances. The public is invited to purchase shares and debentures of the company through an advertisement. A document containing detailed information about the company and an invitation to the public subscribing to the share capital is issued and this document is called 'prospectus'.

A prospectus is issued free of charge to the public and contains all the important information about the company making the initial public offering (IPO). It is important for an investor to read and understand the terms and information in the prospectus in order to be able to assess for himself the risks or merits in investing in the company.

A prospectus contains the following important information:

- Underwriting/minimum subscription
- Litigation, disputes and contingent liabilities
- Debt
- Details of directors
- Basis of allotment
- The price at which securities are being issued
- Name and address of bankers, auditors (if any) of the company, bankers to the issue, lawyers, registrars, secretaries, auditors, managers to the issue
- Name and registered address of the company
- Date, place and authority of incorporation
- Number of securities which are being issued and the stated capital
- The reason for raising funds through an IPO (objective of the issue)
- A full profile of the company

- Information on the management
- Financial information of the company
- Corporate governance practices
- Declarations

Some investors who apply for shares from IPOs do not read the prospectus which outlines the relevant information about the company making an IPO, but subscribe to shares only by going through the IPO application form.

Some investors during the recent past did not even request for a prospectus but obtained only the share application form. An investor must go through the prospectus carefully and understand what is at stake before making an investment. An uninformed decision can cost the investor dearly.

If an investor is unable to read and understand the contents of the prospectus on his own, he should seek the assistance of his stockbroker. Furthermore, most stock broking companies have research departments which conduct research on IPOs and investors can make use of these research reports when applying for new share issues.

2. The company decides on the price at which the shares are issued in an IPO. The Securities and Exchange Commission of Sri Lanka (SEC) and the Colombo Stock Exchange (CSE) do not play a role in setting the price for an IPO. Some investors have a misconception that these two institutions are responsible for determining the issue price of an IPO.

The determination of initial public offering price depends on several things, such as the net asset value (NAV) of the company, market condition, growth rate of the company, profitability etc. The NAV is clearly stated in the prospectus. If a prospective investor feels that the IPO price is not fair, then he can refrain from applying for shares of that company. The company only extends an invitation or offer to the public to subscribe for shares and the decision to subscribe for shares is entirely a decision that the investor is required to take.

The investor needs to ascertain whether the share is a worthwhile purchase and the issue price is fair. A stockbroker should be able to provide proper guidance to investors on their decision to invest in an IPO. An investor can gain access to research reports compiled by stockbroker firms with recommendations on investing in IPOs. Often research reports published by stock brokering firms will contain insights and recommendations indicating whether buying shares from an IPO is a short-term or long-term investment.

Even though these research reports provide useful insights, the final decision to purchase shares should be made by the investor. The stockbroker is able to explain to the investor the difference between the issue price and actual value of a share, as well as forecast whether a certain share price will rise or not by going through research reports.

Therefore, it is important to obtain proper guidance from a stockbroker prior to investing in an IPO. But it must be borne in mind that the final decision to invest in an IPO must be that of the investor.

The Securities and Exchange Commission of Sri Lanka and the Colombo Stock Exchange are not responsible for providing investment advice or making recommendations about subscribing to IPOs. Prior to investing in the share market, it is important for investors to have a sound knowledge of the role of a stock broking firm, the SEC and the CSE and how the stock market operates.

In the recent past, the number of companies which resorted to IPOs increased significantly. And most of these share subscriptions were heavily oversubscribed. The share price of these companies also saw a significant increase when they started to trade on the CSE. Most investors were under the impression that this was a general trend with all IPOs.

But prices of shares fluctuate and investors should be mindful of this. Investors should purchase shares bearing in mind that share prices can increase and decrease. Therefore, generally it is advisable to not depend on too much of debt to buy shares. Before investing a substantial amount of money into stock market, an individual must be well aware of the risks and benefits involved in this kind of investing.

3. All applicants for IPOs from the year 2011 must open a Central Depository Systems (Pvt) Ltd. (CDS) account and indicate their respective CDS account numbers in the IPO application form. In some instances investors handover the relevant documentation to their stockbroker in order to open a CDS account to trade in shares and without ascertaining whether the account has been opened they subscribe to shares. Since a CDS account is necessary to conduct share transactions through the Colombo Stock Exchange and even to apply for an IPO, it is important to find out whether the account has been opened prior to subscribing to shares.

4. Another mistake that investors make is not completing the application to subscribe for shares correctly. Most often they fail to read the instructions given on the reverse of the application and therefore make mistakes in completing the form. Care must be taken to follow the instructions on the reverse of the application form.

5. Investors also make the mistake of indicating an inaccurate number of shares on the application form. In most IPOs the minimum number of shares that can be applied for is indicated in the prospectus and reverse of the application form. I.e., if the instructions state that an application should be made for a minimum of 1000 shares then the investor cannot apply for 500 shares.

6. Most IPOs indicate that the number of shares applied for should be in multiples of hundred. I.e. they should be in 100,200,300,1000,10000 shares etc. If a share is valued at Rs.15/- some investors mistakenly apply for shares to the value of Rs.10,000 instead of 10,000 shares. In this scenario the number of shares would amount to 666.6 (10,000/15). This would result in the rejection of the application form.

7. Applicants must be above the age of 18 years. Applications made by individuals below the age of 18 years will result in the application being rejected.

8. An applicant can apply under only one application form. If multiple applications are submitted by an applicant, those application forms will get rejected.

9. Investors also fail to accurately indicate the broker code when indicating the CDS number. This too will result in the rejection of an application form.

10. In certain instances, investors make mistakes in writing the cheque. The cheque should be drawn in favour of the name of the IPO and not in the name of the investment bank or the stock broking company. Care must be taken in writing the cheque accurately, singing the cheque and indicating the exact value of the number of shares applied for.

11. The NIC number must be accurately stated on the application form. Since the CDS account number is based on an individual's NIC number, care must be taken to indicate the same number for both.

"When it comes to investing, nothing will pay off more than educating yourself. Do the necessary research, study and analysis before making any investment decisions."
-Benjamin Franklin