INTERNATIONAL JOURNAL OF SCIENTIFIC PROGRESS AND RESEARCH (IJSPR) ISSN: 2349-4689
Issue 133, Volume 46, Number 01, April 2018

Underpricing of Initial Public Offering: a Study of Indian Equity Stocks listed in BSE and NSE

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Abstract-The study has concentrated on Indian equity stocks in order to observe the phenomenon of underpricing in the Indian context between the duration 2006 to 2011, of which it includes companies listed in NSE as well as BSE. An observation made in the study is that the phenomenon of underpricing has been existed in these years which are considered for the study of IPO's in the Indian context. As Ritter have also suggested about the risk which is undertaken by the uninformed investors for making a venture in the IPO. Over 144 companies was taken into consideration for the study of which during the years between 2006 to 2010, the observation which has been made is that only for these two periods overpricing exists from the result obtained. And for the remaining years we can observe the presence of underpricing phenomenon. So finally it can be said that underpricing exists even in the Indian equity market.

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I. INTRODUCTION:

Pricing the initial public offering (IPO) below its market value is known as underpricing. The stock is considered to be underpriced, when the offer price is lower than the price of the first trade. As the laws of supply and demand which will eventually drives the value of the stock towards its intrinsic value, the stock is usually underpriced temporarily. And An IPO is a newly traded stock on the market and as such it may be newly introduced to investors. The proceeds of its sale are used by the company as capital for funding and future growth. The process for arriving at the offering price includes many factors. Quantitative factors are first considered; however, they are not the only factors that lead to the IPO price.

An indirect cost of going public is borne by the issuing firm in the process of underpricing of IPOs. But the magnitude of underpricing varies across IPOs with different allocation mechanisms, issue characteristics, general financial market conditions, and underwriter reputations. So the commonly used methods of share allocations in IPOs are the auction method, book-building, and the fixed price. Where book-building is the most popular method among all, which allows the smaller, as well as the companies which are known lesser to go for public.

In order to signal the issue quality, reward investors for truthfully revealing information, mitigate adverse selection problems, lessen underwriters' potential legal liabilities, and allow underwriters to curry favor with their clients, attract media attention/publicity, and promote ownership dispersion for liquidity and control, hence the IPOs are underpriced. By engaging reputable underwriters and auditors, having frequent disclosures, waiting until they possess desirable characteristics, and/or if they are of high quality using the auction method, Issuing firms can make an attempt to reduce the extent of underpricing.

II. THE PRICE OF IPO

Additionally, an IPO may be priced based on marketability factors for its specific industry and the market as a whole. If bankers expect a high demand for the product, that will be factored into the price. Also, if there is a high demand for the IPO market in general at the time of the offering that will also help the price. Once an IPO price is arrived at by the investment bankers or IPO deal leaders, it is marketed prior to its first day of trading at its IPO price. Because of the concerns relating to the liquidity and also the uncertainty about the level at which the stock will trade, it is generally believed that IPOs are often underpriced.

To investors, an IPO may also be perceived as risky because it does not have historical trading data. The less liquid and less predictable the shares are, the more underpriced they will have to be in order to compensate investors for the risk they are taking. A company must under-price its stock to encourage investors to participate in the IPO, because an IPO issuer tends to know more about the value of the shares than that of the investors. The stock officially becomes publicly traded and also owned by the shareholder who purchases the stock. The shareholders then have control over the stock's pricing in the open market, and the stock's price will fluctuate greatly from its initial offering price.

III. MAKING IT HAPPEN

Although underpricing may be inevitable due to certain risk and liquidity constraints, there are ways in which issuing firms can reduce it if they want to.

- Some suggestions are given below:

- Engage reputable auditors and underwriters:

Reputation capital is used by prestigious underwriters in order to certify the firm's value and decrease uncertainty of investor about the value of the issue, and that as a result lowers the level of IPO underpricing. To certify the accuracy of the financials and reduce uncertainty as well, the reputable auditors are quite competent. The prestigious underwriters are expected to have more future deals to compensate investors, from the perspectives of partial adjustment. So for each issue they do not have to pre-commit a large underpricing and thus are predicted to under price less.

- Frequent disclosure of Information:

By voluntary and frequent disclosing of information about the issuing company in the press, Issuing firms can also reduce underpricing provided that the rule of quiet period is not violated. Asymmetric information is reduced by frequent disclosures, which lowers the costs of information production which is incurred by the investors.

- Issuer characteristics:

With certain characteristics of the issuing firm, the IPO underpricing is quite lower. If issuing firms can wait until they are larger in size, have a longer operating history, and possess a record of positive earnings before going public, they are likely to reduce the level of underpricing. If there are insiders who more experienced and sitting on the board of the issuing firm, even in such case the underpricing is reduced

- If feasible the use of auction method:

From the framework of book-building process many explanations of underpricing were derived. Issuers in IPO markets in which the auction mechanism is available might want to go public that way, in order to reduce underpricing. Only if the issuing firm is a superior quality firm that has high investor awareness, however the auction method works. And also if the firm issuing is concerned more about factors other than underpricing for example such as, post-IPO analyst coverage provided by investment banks, price stabilization—in such case book-building may be a better choice.

IV. REVIEW OF LITERATURE:

Garima Baluja and Balwinder Singh (2014) Performance of IPO's have been examined by many researchers for both the short term duration and as well as for the long term duration. But in India especially, the empirical evidence on the survivability of public issues is quite limited. So a need is required in order to explore the survivability of public issues in the aftermarket in the light of vast instability in the IPO market of Indian and also a rate of failure of IPO's is quite high. Hence an attempt has been made in the study to examine the Indian IPO's survival profile for duration from 1991 to 2011 for a quite long period. So a logistic regression model is estimated in order to examine the influence on non-survivors and the survivors on the post-issue transition of IPOs of variables such as issue, market and company-specific. Further in order to investigate the effect of observable factors on the survival time of the issue, the survival analysis methodology is employed. So results obtained reveals that the issues which survive for the longer duration are the firms with backed by reputed lead managers, more demand, large size and of older firms. And those firms who survive for smaller duration in the aftermarket with high risk, more list delay, Underpricing and during the period of IPO activity as well as high market level. So the IPO's which belongs to construction, accommodation, communication, retail trade and wholesale and insurance sectors and finance, the duration of IPO and the survival probability is affected positively. But affected negatively if belongs to sector such as administration and the agriculture.

Arno Forst, Myung Seok Park, Benson Wier (2014): Study examines how the CEOs compensation contracts of the post-public offering influence the insider entrenching governance choices of companies, conducting their public offering. Study finds that entrenching governance decisions have a significant effect on CEO compensation of post- public offering by using ten legal provisions which affects the entrenchment of the insider. So in particular a association of positivity is achieved between the total compensation, levels of post-IPO salary and entrenchment and the sensitivity of pay-for-performance. And negativity is achieved between the proportion of CEOs' salary to total compensation and entrenchment. Rather than voting rights limitation choices, the observed relationships are principally driven by takeover readiness provision choices. So in order to control for effects of potential confounding, results obtained are quite robust.

Seshadev Sahoo(2014) The impact of corporate board structure on the performance of IPO's by considering a data set of 176 public offerings between the duration 2007 to 2011 is been examined by the study. From the viewpoint of leadership, reputation, diversity, maturity and board size, board structure of IPO firms is being evaluated. And by measuring underpricing, subscription rate, and aftermarket volatility, the performance of public offerings is being estimated.

Rohit Bansal; Dr. Ashu Khanna (2012) in the shareholding pattern of IPO's, the Ownership structure plays a dominant role as the ownership structure has significant effects on IPO. So study investigates the relationship between the level of underpricing and the ownership structure of that of Indian stock market. So for the study companies listed in BSE with a sample size of 319 firms is being considered between the duration 2000 to 2011. It has been argued that the participation of investors is being induced by higher underpricing. The pattern of share holding is been divided into four categories such as foreign promoters, Indian promoters, non institutional non promoters, institutional non promoters. So the level of underpricing is affected significantly by only non-institutional non- promoters and Indian promoter's. And a positive relationship exists between level of underpricing and non institutional non-promoters. Further results represent an important relationship that exists between institutional non promoters holding and foreign promoter and the level of underpricing.

A. K. Mishra (2010) by using a set of 235 IPOs which is listed newly between the duration 1997 to 2008 on the stock exchanges of India, an attempt is made by the study in order to provide evidence on the first-day IPO market performance. Study examines how the level of underpricing is affected by the institutional arrangement changes which govern the IPOs price, from that of the fixed price traditional approach to that of a book building approach. By making a comparison of the underpricing under the two pricing methods, studies have extended the literature on underpricing of IPO and have added new evidence to the existing literature. It highlights that on the main board of the Indian Exchange; in 2007 the IPO underpricing increased and is inconsistent with the 'hot issue markets' theory (Ibbotson and Jaffe, 1975; Ritter, 1984). a significant mean positive underpricing (14.45 %); nonetheless, 60% of IPOs in the sample are initially overpriced is found out by the empirical findings. Secondly the study finds no evidence that there is difference in underpricing between fixed price and book built offers, in contrast to the Giudici and Paleari (1999).

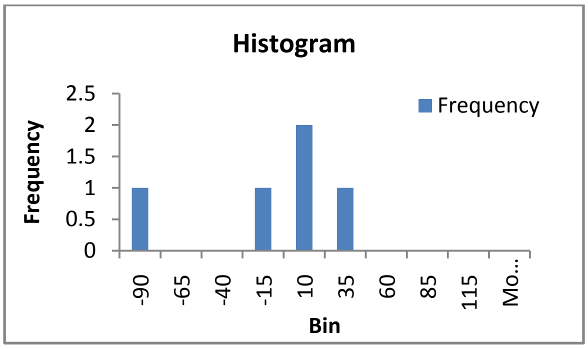
V. ANALYSIS AND INTERPRETATION:

Table: 1.1 the below table represents value of skewness and mode for different years of IPO issue:

IPO Issue Year	No of Companies	Skewness value	Underpricing/ Overpricing
2006	5	**-1.5706**	Overpricing
2007	24	2.2325	Underpricing
2008	17	1.2850	Underpricing
2009	12	1.8350	Underpricing
2010	54	**-0.3391**	Overpricing
2011	32	1.1773	Underpricing
Total	**144**		

Source: Data obtained from capital line data base from the year 2006 to 2011

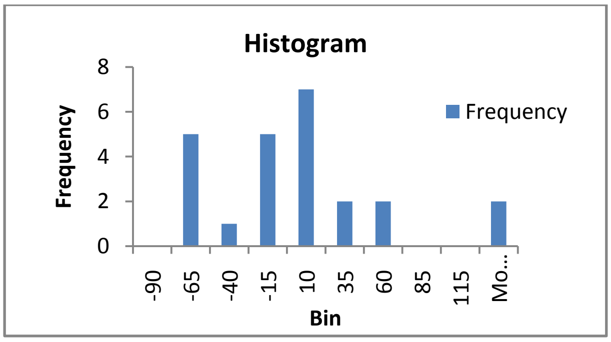
Table: 1.2 shows histogram for the IPO issue of 2006



Interpretation:

- The value of skewness obtained for the data for the year 2006 histogram is -1.5706.
- The value obtained is highly negative which represents the presence of a low degree of negative skewness.
- And also represents that there is an overpricing as the returns obtained for the investors is negative.

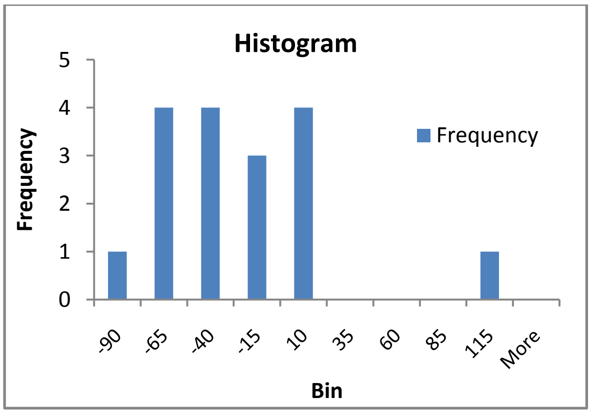
Table: 1.3 shows histogram for the IPO issue of 2007



Interpretation:

- The value of skewness obtained for the data of the year 2007 histogram is 2.2325.
- This is highly positive which represents a very high degree of positive skewness.
- And shows that there is an underpricing of the IPO issue as the skewness value obtained is positive.
- Because of which investors obtain the positive returns.

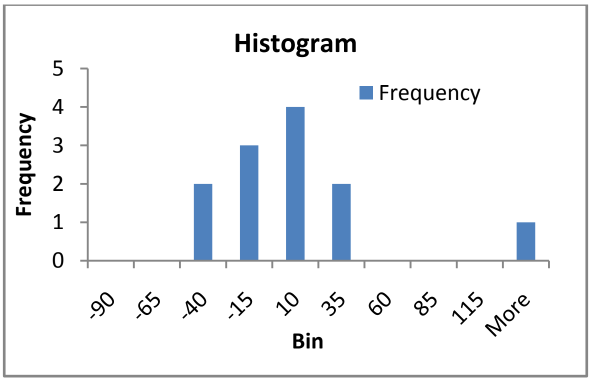
Table: 1.4 shows histogram for the IPO issue of 2008



Interpretation:

- The value of skewness obtained for the data of the year 2008 histogram is 1.2850.
- The value obtained is highly positive and represents a high degree of positive skewness.
- And shows that there is an underpricing of the IPO issue as the skewness value obtained is positive.
- Because of which the investors gain positive returns.

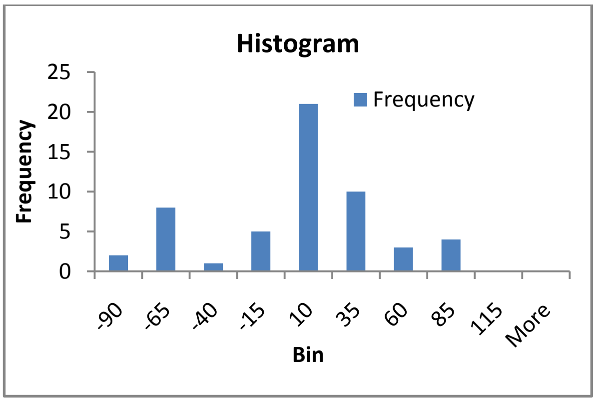
Table: 1.5 shows histogram for the IPO issue of 2009



Interpretation:

- The value of skewness obtained for the data of the year 2009 histogram is 1.8350.
- The value obtained is positive and represents a high degree of positive skewness.
- This also further represents that there is an underpricing of the IPO issue as the skewness value obtained is positive with which the investor obtains positive returns.

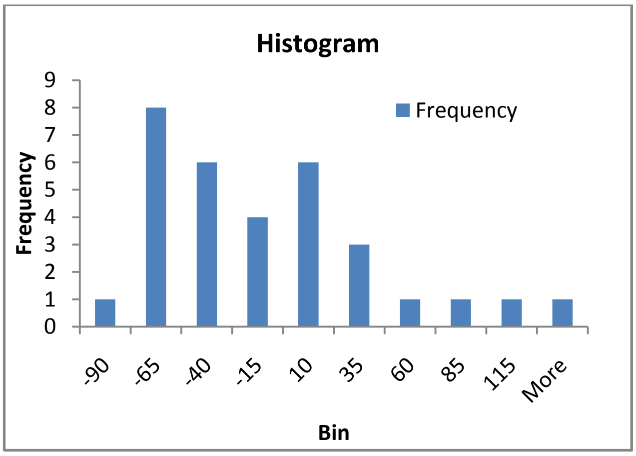
Table: 1.6 shows histogram for the IPO issue of 2010



Interpretation:

- The value of skewness obtained for the data of the year 2010 histogram is -0.3391.
- The value obtained is negative and represents that there is a high negative skewness.
- This shows that there is an overpricing of the IPO issue as the skewness value obtained is negative. Hence with which the investor obtain negative returns.

Table: 1.7 shows histogram for the IPO issue of 2011



Interpretation:

- So finally the value of skewness obtained for the data of the year 2011 histogram is 1.1773.
- The value obtained is positive which represents that there is a positive skewness.
- This shows that there is an underpricing of the IPO issue as the skewness value obtained is positive.
- Finally with which the investors obtain positive returns.

VI. CONCLUSION

So finally from the observation of data for various years of IPO in the study, it reveals that in the Indian equity markets, the underpricing of IPO's is quite high as per the observation made, which has been observed in the study by considering a data set of 144 IPO's between the periods 2006 to 2011. As it has been observed from the extant literatures, underpricing is present worldwide and it is not an exception in case of Indian scenario also. The study strongly agrees the argument of the Ritter who states that underpricing is required in order to compensate the risk taken by the uninformed investors. As they don't posses any information relating to the company issuing the IPO's. It has been also observed from the study that company who issue less number of primary shares go for underpricing as they can compensate the cost of underpricing in the further public offerings also.

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