Initial Public Offerings (IPO) Underpricing: A Case Study on the Capital Market of India

Dr.Savitha.P, Muktha Gangothri,

Assistant Professor, Dept of Management,

Karnataka State Open University, Mysuru – 06.

Abstract-The study has concentrated on the stocks of Indian equity market in order to view the underpricing phenomenon in the context of India between the duration 2006 to 2011, in which the companies undertaken includes the companies that are listed in both BSE as well as NSE. As per the examination conducted in the study on the Indian context of the issue of an IPO, we can find the presence of underpricing phenomenon for over a period of six years. And we can also observe from the various extant literatures that the underpricing exists not only in the Indian context but also it can be seen that it prevails worldwide, which is also supported by various other researchers such as Saurabh Ghosh (2005). From the analysis the value of skewness obtained from the study is 1.48, which is highly positive representing the presence of higher positive skewness and shows the presence of underpricing which is prevailing in the Indian context also.

Keywords: Underpricing, Skewness, BSE, NSE, Stock Market, Investment Banks.

I. INTRODUCTION

1.1 How an IPO Is Valued

Initial public offering is a process in which a company becomes publicly traded on a stock exchange from a private company. So the company is owned by the shareholders who purchase the company's stock when it is put on the stock market, once a company is public or a publically traded company.

The only real exposure for many investors which they have for the IPO process occurs a few weeks which is prior to the IPO, when the sources of media inform the public. Except to the investment bankers involved and those serious investors who are willing to pour over registration documents for a glimpse at the company's financials, How a company gets valued at a particular share price is relatively unknown by the investors.

1.2 Facts and Risks of IPOs

The initial goal of an IPO is at the possible best price to sell the number of shares which is pre-determined that is being issued to the general public. This means that when the appetite for stocks is low a very few IPOs come to market - that is, when stocks are cheap. The likelihood of an Offering getting priced at the high end of the range is very slim when the equities are undervalued. So, it should be understood that before investing in any IPO, the investment bankers promote IPO’s at times when the demand for the stocks is quite favorable. There will be a greater risk of IPOs hype which is outstripping of its fundamentals, when the prices are high and demand is quite strong. This is, not so good for the investors who are buying shares but is great for the company which is raising the required capital. IPOs encompass many unique risks which make them different from the average stock.

During the 2009-2010 recessions the market of IPO basically died because as the valuations of stock were low across the market. Hence most chose not to test the market as because, IPO stocks couldn't justify a high offering valuation when existing stocks were trading in value territory.

II. REVIEW OF LITERATURE

Anlin Chen and Lanfeng Kao (2006) investigate to mitigate the winner’s curse; a simple way in the process IPO is to lessen the number of investors who are informed in IPO markets. As the study signify that the institutional investors in Taiwan are not permitted to subscribe to IPO’s of fixed price. So excluding the institutional investors it raises the uninformed investor’s allocation rates. The winner’s curse is still present in the Taiwan’s fixed price IPO markets as the results which are obtained from the study, even without the institutional investor participation. Underpricing of IPO is reduced by at least 4 percent because of alleviating the winner’s curse, as institutional investors are excluded from the fixed price offerings as shown by the study.

David R. Williams, W. Jack Duncan and Peter M. Ginter (2010) have analyzed the relationship among secondary-market, Pre-market, and the primary-market characteristics. Signalling theories and the agency theories have been utilized in the study. Study examines the high-technology firms which are seeking for an IPO for the agency and market signals which is related to a sample chosen for the study. For the purpose of examining for IPO offer process in high-technology firms a model have been tested. The results of the study indicates the secondary market factors have not affected the offer price of the IPO but the offer price is affected by certain primary market and Pre-market factors which is received by the entrepreneurs and the investors.

Somnath Das, Re-Jin Guo and Huai Zhang (2006) the authors have examined the analyst's ability in order to forecast the performance of future firms which is based on the selective coverage of firms newly listed. As hypothesized by the study that the decision to provide the coverage contains information about underlying expectation of a firm's future prospects and an analyst. So the IPO's with high residual coverage have significantly operating performance and better returns compared with the low residual coverage in the subsequent three years as documented by the study. So the evidence obtained from the study indicates that superior predictive abilities are possessed by the analysts and the coverage is provided selectively for the companies for which their true expectations are favourable.

Mingsheng Li and Linda Yu, Kee H. Chung (2005) have analyzed by considering a simple model in the study which positions that the price of IPO is equivalent to the entity's present value of the assets in place and even the growth opportunities of a firm. Model used in the study predicts that after listing the firm the initial return which is obtained is positively related to both risk of growth opportunities and the size. Hence study consistent with this prediction, study finds that initial return to be positively related to both the different proxies of the issue uncertainty and the fraction of the offer price which is accounted for by the present value of growth opportunities. Finally study has also shown that the investors IPO equate one approximately three quarters of tangible assets to one dollar of the growth opportunities.

Ravinder Kumar Arora, Sanjay Dhamija (2014) examined the issue of IPO's which are graded in the Indian capital market for a period of 2007–2010, and have observed that over the long run it has underperformed the benchmark. A considerable variation in performance of IPO's across grades has been found. IPO's which have graded comparatively higher have not shown the better performance than those firms whose grades are lower quite relatively.

Brett D. Cotton (2008) the long-run underperformance of IPO firms was first observed by Ritter (1991) first. This underperformance of IPO is termed as new issues puzzle. One possible explanation which can be given to puzzle of new issue is that prior to IPO's the managers concerned may manipulate earnings upwards, by inducing the mispricing and during the years following the IPO issue it is reversed (Teoh, Welch, and Wong, 1998). Study has made a comparison between the discretionary accruals of performance matched and the abnormal stock performance of the firms which is issuing only the primary shares with those companies issuing only the secondary shares or it can be a combination of both primary shares and secondary shares in order to examine the above explanation. So finally the evidence supporting the hypothesis, which is the earnings management, contributes to the long-run under performance of IPO's as indicated in the study.

Alon Brav (2000) The long horizon event studies is hampered by the fact that the abnormal returns are neither independent nor normally distributed as an observation which is made by the statistical inference. A New approach to the inference which overcomes these difficulties and also dominates the other popular testing methods is presented by the study. By examining the long horizon returns of IPO study illustrates the use of methodology. So the three factor model of Fama and French (1993) is inconsistent with the observed long-horizon price performance of these IPO's as the study gives the result, where the model of characteristic based also cannot be rejected.

Igor Filatotchev, Mike Wright equity and Mufit Arberk (2006) have examined the firms which have the venture capital (VC) backed IPO's, the development of effective boards. from So from the two sets of agency costs which are related to principal-principal and principal-Agent relationships between the founders and members of the VC syndicate is experienced by e backed IPO's as argued by the study. By considering a unique sample set which is of around the 293 entrepreneurial IPO's in the UK, the VC syndicate which usually invests comparatively in the more risky firms is as shown by the study. Study finds that compared to the IPO's with no VC involvement, the VC backed IPO's have more independent boards, and the board independence is quite higher for the syndicated VC baked firms. So these are the governance factors which are used to mitigate the agency costs that are associated with the VC involvement in IPO firms, as the result obtained is consistent with this assumption in the study. Finally it could be said that there is a presence of higher equity of passive private equity firms which is investing in a alongside VC firms as it is been quite observed that in the syndicated IPO's.

III. OBJECTIVES OF THE STUDY

• To understand the phenomenon of Underpricing prevailing in Indian Equity Market.

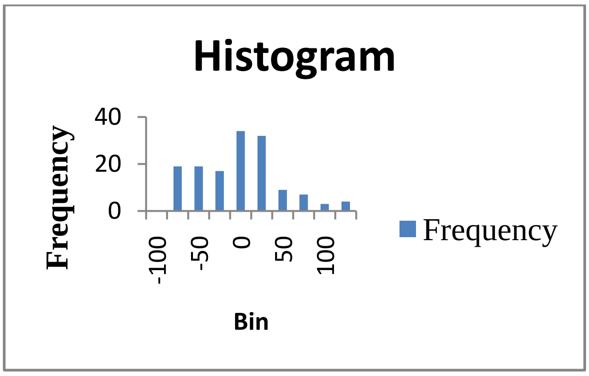
• To analyze the extent of underpricing prevailing in Indian Equity Market.

• To observe whether the underpricing phenomenon exists or not.

• To justify the presence of underpricing with the other researchers.

IV. ANALYSIS AND INTERPRETATION

Graph: 1.1



Source: Data obtained from capital line data base from the year 2006 to 2011 for around 144 companies which are been chosen between the duration from 2006 to 2011.

Interpretation: (need to rewrite)

• The value of skewness obtained from the data for the year 2007 histogram is 1.48.

• 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: 1.1

Statistical Data	
Mean	-13.133
Standard Error	4.59547
Median	-11.343
Mode	#N/A
Standard Deviation	55.1457
Sample Variance	3041.05
Kurtosis	5.70488
Skewness	1.48638
Range	383.419
Minimum	-97.169
Maximum	286.25
Sum	-1891.2
Count	144

Table: 1.2

Bin	Frequency
-100	0
-75	19
-50	19
-25	17
0	34
25	32
50	9
75	7
100	3
More	4

Table: 1.1: Represents the value obtained from the skewness for a period of six years from the year 2006 to 2011 and represents the higher positive value with 1.48 in numerical value, showing the presence of higher underpricing in the Indian equity market.

Table: 1.2: Represents the bin along with the frequency which shows the number of companies comes within a particular bin.

V. CONCLUSION

So finally from the observation of data for the various years of IPO in Indian context of the study, it reveals that in the Indian equity market the underpricing of IPO's is quite high between the duration 2006 to 2011 as the observation is been made, by considering a data set of 144 IPO's between the periods 2006 to 2011 which is listed in BSE as well as NSE. And it has been observed from the extant literatures that, underpricing is present worldwide and from the study it is not an exception even in the case of Indian scenario also for which the data is considered. 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 also have been observed from the study that the company who issue less number of primary shares go for underpricing as they can compensate the cost of underpricing in the further public offerings of the company.

REFERENCES

[1] Anlin Chen and Lanfeng Kao, 2006. "The Benefit of Excluding Institutional Investors from Fixed-Price IPOs: Evidence from Taiwan." Emerging Markets Finance & Trade, Vol. 42, No. 6 (Nov. - Dec., 2006), pp. 5-24.

[2] David R. Williams, W. Jack Duncan and Peter M. Ginter, 2010. "Testing a model of signals in the IPO offer process." Small Business Economics, Vol. 34, No. 4 (May 2010), pp. 445-463.

[3] Somnath Das, Re-Jin Guo and Huai Zhang, 2006. "Analysts' Selective Coverage and Subsequent Performance of Newly Public Firms." The Journal of Finance, Vol. 61, No. 3 (Jun., 2006), pp. 1159-1185.

[4] Kee H. Chung, Mingsheng Li and Linda Yu, 2005. "Assets in Place, Growth Opportunities, and IPO Returns." Financial Management, Vol. 34, No. 3 (autumn, 2005), pp. 65-88.

[5] Alon Brav, 2000. "Inference in Long-Horizon Event Studies: A Bayesian Approach with Application to InitialPublic OfferingsAuthor." The Journal of Finance, Vol. 55, No. 5 (Oct., 2000), pp. 1979-2016.

[6] Igor Filatotchev, Mike Wright and Mufit Arberk, 2006. "Venture Capitalists, Syndication and Governance in Initial Public Offerings." Small Business Economics, Vol. 26, No. 4 (May, 2006), pp. 337-350.