RESEARCH REVIEW JOURNALS
ICCMCT-2018
SEP- 2018
Special Issue

ISSN: 2455-3085 (Online)
RESEARCH REVIEW International Journal of Multidisciplinary
www.rrjournals.com [UGC Listed Journal]

Pricing and Performance of IPOs in India- A Critical Review

*Viswan M G

Assistant Professor, SSV College, Valaayanchirangara, Kerala (India)

ARTICLE DETAILS

Article History
Published Online: 29 Sep 2018

Keywords
IPOs, Winners curse, under pricing, signaling theory

***Corresponding Author**
Email: viswanmg[at]ssvcollege.ac.in

ABSTRACT

Initial public Offers (IPOs) become the most popular way of raising finance in India. A Lot of studies has been conducted on various aspects of IPOs, i.e., Valuation and pricing of securities and performance of these securities after listing. Literatures are also available regarding the factors affecting the pricing and performance of securities. Various theories/hypothesis explains the reasons of under pricing of IPOs such as Winners curse hypothesis, Signaling theory, Information gathering theory etc. In this paper an attempt is made to critically review the studies done on the subject of IPOs in India as well as abroad.

1. Introduction

Public issue can be classified into Initial Public Offer (IPO) and Further Public Offer (FPO). An Initial Public Offering (IPO) is a company's first offering of equity to the public in its life. Any further issue of securities is called Follow on Public offer or further public offer .Initial public offers are considered as the good source of finance by the enterprises. But from the investors point of view, they need to get adequate return for their investment.

The valuation, pricing and performance of shares of companies making initial public offer are of interesting topics among academicians and research scholars. The whole theories regarding IPOs can be classified in to three broad heads, namely:

1. IPO Valuation
2. IPO pricing
3. Performance of these securities in share market.

A lot of literatures, both empirical and conceptual, are available in each area of Initial Public Offers in different parts of the world. In this paper I am trying to analyse the empirical studies related with basic propositions and theories of capital market, specifically IPOs around the world. The literature available for IPO pricing and performance are abundant in number.

1.1 Objectives

The main objective of this paper is to study the literatures available in the area of Initial Public Offers in India and abroad.

1.2 Methodology

Various literatures on IPOs were collected from Journals and from the websites of publishers. A descriptive analysis is used for the presentation of the studies.

1.3 Limitations

Literatures on IPOs are abundant in number. But in this paper only ten studies are incorporated. So various phenomenon are left unaddressed.

2. Review of Literature

Numerous studies have been done in the world on the subject of Initial Public offers in various aspects such as Valuation, pricing, performance etc. The present study focused on reviews pointing on the performance of Initial Public offers.

Rock's model (Rock, 1986) presented the cause of under pricing of IPOs, the phenomenon popularly known as Winner's Curse. This hypothesis also known as asymmetric information theory. His argument depends on the existence of two groups of investors, one who have the knowledge about the true value of the firm and the other who are completely unaware about the true value of the firm. The informed investors are cognizant about the future prospect of the firm and will ready to buy only when the issue is underpriced. Whereas the uninformed investors don't have any knowledge about the under pricing and overpricing of issues and therefore they cannot differentiate the issues. If the new shares are priced at the expectations of informed investors, they will buy in IPOs, otherwise they restraint from the market. The uninformed investors, due to lack of knowledge will subscribe to issues and get negative initial returns. So the offering firm must under price the shares in order to guarantee that the uninformed investors buy the issue.

For the explanation of the model, he had made the following assumptions:

1. The informed investors have perfect information about the future value of the new issue and they cannot borrow securities or short sell. (Because they cannot sell their private information.
2. Informed demand, I is no greater than the mean value of the shares offered ,v/Z
3. Uninformed investors have homogenous expectations about the distribution of v/
4. All investors have the same wealth.

Rock's model was for firm's commitment offerings, but can be generalized for other types of offerings also. This model provides a basic explanation for the question why new issues are underpriced?

- **Information Gathering theory- (Benveniste & Spindt, 1989)** It stated that underpricing is a way to convince informed investors to disclose private information about the demand for shares in the pre-selling phase.In the IPO market, lead Managers consult clients before setting offer price in the prospectus. Lead managers may intentionally underprice IPOs, to attract more and more clients.The demand information is gathered during the pre-selling phase , which form the basis of pricing the issue.So the merchant bank play game with many of their large clients.

- **Jay R Ritter (Ritter, 1991)** documents the performance of IPOs in the short run and long run with specific hypothesis. Earlier, many studies have documented two anomalies in respect of IPO pricing and performance. (1) The short run under pricing phenomenon, and (2) The hot issue market. He added a third phenomenon in his study which states in the long run, these IPOs are overpriced or underperform in relation to the bench mark returns. Studying the sample of 1526 IPOs went public in the US during 1975-84, he found that major IPOs are underperformed compared to benchmark. His study reveals that the Initial Under pricing and the long run underperformance are negatively correlated.

- **R Michaely and Shaw (Michaely & Wayne, 1994)** studied the empirical implications of several models of IPO under pricing. Their study was consistent with Rock's winner's Curse hypothesis. Their results show that the IPOs underwritten by reputable investment banks experience significantly less under pricing and perform better in the long run. Again their result does not support the signaling theories explaining the reason of IPO under pricing.

- **Shah (Shah, 1995) s**tudied 2056 IPOs during the period from January 1991 to May 1995 and stated 105.6% excess return above the Offer price. Moreover he also reported that the IPO stocks outperform the market in first 200 days and then the shares underperform in 400 days.

- **Purnanandam & Swaminathan (Purnanandam & Swaminathan, 2002)** studied the valuation of IPOs and in their paper explained which is not consistent with the asymmetric information model. The study reveals that the median IPO is overvalued at the offer price over the long run. Taking a sample of more than 2000 IPOs during 1980-1997, they concluded that IPOs are overvalued and earn return more than that of undervalued IPOs on the first day of listing ,but the long run return will be much less than the underpriced IPOs. This overvaluation is common among different types of industries. Here to determine whether an IPO is overvalued or undervalued, they have used the 'fair value' concept which is related with the firm's fundamentals. For the study, they had used the industry peer comparison /Industry peer multiples for the valuation. To choose industry peers, they consider sales, EBITDA, and profit margin of industry peers. Their results are not consistent with the Traditional asymmetric theories of Rock (1986) and other advocates, rather they consistent with the behavioral theories of IPOs.

- Regarding Indian IPO performance another study was done by **Krishnamurti (Chandrasekhar & Kumar, 2002)** which describes the institutional arrangements of the public issue process of IPOs in India. Based on the satisfied criteria, they analysed 386 IPOs which opened for subscription between July 1992 and December1994. Their study provides empirical evidence of the widespread under pricing and relates them to potential factors. The major factors are the lack of a formal mechanism for measuring the extent of demand from potential investors, the regulatory restrictions on pricing of new firms without a track record and the actual opening date of the public issue

- Study made by **Loughran and Ritter (Ritter & Loughran, 2004)** confirms the increase in number of under pricing of issues in US. They tried to explain the causes of increased under pricing attributable to different reasons. Changing risk composition, a realignment of incentives, and a changing issuer objective function. Major reason is attributable to previous latent agency problems between underwriters and issuing firms. Another may be the changes in the composition of the companies going public. They confirmed that the increase in valuations over time has caused issuers to be more complacent about leaving money on the table. But it is true that the degree of under pricing changed

- **Francisco Santos (Santos, 2010)** documents the connection of IPO under pricing and long term underperformance of the firm. He explained the long term under performance in two ways, i.e. In the first, the firm which makes IPO during low under pricing period would be less underperformed/no underperformance in the long run and in second way, if the company made its IPO during high under pricing period, the degree of under pricing will be higher. His evidence shows that the investor's sentiments in High under pricing firms will be higher. These results are consistent with a story in which low quality firms, in periods in which the average under pricing in the market is high, try to exploit investor's sentiment by going public during high underpriced periods.

- **Bhatia & Singh (Bhatia & Singh, 2018)** made a study which analysed the long run performance of 438 initial public offerings offered during June 1992 and March 2001.The result shows that firms with least issue size have performed better than firms with greater issue size. The results of the determinants of long run performance of IPO shows that initial return, issue size and market condition have significant and negative effect on the aftermarket returns.

Table 1
Reviews at a glance

Author(s)	Year	Title description	Features/ Variables	Major findings
Kevin Rock	1986	Why IPOs underpriced	Firm commitment offering-	Under pricing due to information asymmetry.
Benveniste and Spendt	1989	How investment bankers determine the offer price and allocation of new issues	use of indications of interest from client by the investment bankers to price and allocate new issues	lead Managers consult clients before setting offer price in the prospectus.Lead managers may intentionally underprice IPOs,to attract more and more clients
Jay R Ritter	1991	The long run performance of Initial Public offerings	3 anomalies 1.Short run underpricing 2.Hot issue market 3.Long run under performance.	The Initial Under pricing and the long run underperformance are negatively correlate
R Michaely and W.H Shaw	1994	The Pricing of Initial Public Offerings: Tests of Adverse Selection and Signalling theories	Does not support the signaling theories	Consistent with winner's curse hypothesis
Shah A	1995	The Indian IPO market: Empirical Facts	stated 105.6% excess return above the Offer price	Support under pricing in India
Purnanandam & Swaminathan	2002	Are IPOs underpriced?	Return Comparing fair value and market value of shares	IPOs are overpriced with respect to their fair value
Chandrasekhar, Krishnamurti; Kumar, Pradeep	2002	The Initial Listing Performance of Indian IPOs	386 IPOs which opened for subscription between July 1992 and December1994	1)lack of a formal mechanism for measuring the extent of demand from potential investors,2) the regulatory restrictions on pricing of new firms without a track record and 3) the actual opening date of the public issue
Loughran and Ritter	2004	Why has IPO under pricing changed over time?	Reasons for IPO under pricing Patterns of IPOs in the U.S	1) Changing issuer objective function. 2)changes in the composition of the companies going public 3)Incentives.
Francisco Santos	2010	IPO under pricing and Long Term Under performance	Establishes relationship between IPO under pricing and long un underperformance	Investors sentiments and under pricing have positive relationship and firms try to exploit this sentiments.
Shikha & Balwinder	2018	Long Run Performance of Initial Public Offerings in India	long run performance of 438 initial public offerings offered during June 1992 and March 2001.	1) Firms with least issue size have performed better than firms with greater issue size 2) Initial return, issue size and market condition have significant and negative effect on the aftermarket returns.

Source: Compiled from Secondary data

3. Conclusion

Under pricing is a most documented phenomenon in the academic area of Initial Public Offerings. Beyond the explanation of basic hypothesis such as Winners Curse and Information Gathering, well documented studies done by the academicians around the world, particularly in India and the U.S are also incorporated here. From the literatures, it can be concluded that under pricing is a common phenomenon and the reasons are different according to the unique environment of each economy.

References

1. Benveniste, L. M., & Spindt, P. A. (1989). How Investment Bankers Determine the offer price and allocation of New Issues. *Journal of Financial Economics* , 343-361.
2. Bhatia, S., & Singh, B. (2018). Long Run Performance of Initial Public Offerings in India.

3. Chandrasekhar, K., & Kumar, P. (2002). The Initial Listing Performance of Indian IPOs. *Managerial Finance,28,2* , 39-52.
4. Ghosh, S. (2014). Underpricing of Initial Public Offerings:The Indian Experience . *Emerging Markets Finance and Trade,41:6* , 45-57.
5. Michaely, R., & Wayne, S. H. (1994). The Pricing of Initial Public Offerings:Tests of Adverse Selection and Signalling theories. *The Review of Financial Studies-7* , 279-319.
6. Purnanandam, A. K., & Swaminathan, B. (2002). Are IPO's underpriced? *Review of Financial Studies* , 811-848.
7. Ritter, J. R. (1991). The long run performance of Initial Public offerings. *Journal of Finance 46* , 3-28.
8. Ritter, J. R., & Loughran, T. (2004). Why has IPO underpricing changed over time? *Financial Management* , 5-37.
9. Rock, K. (1986). Why new issues are underpriced. *Journal of Financial Economics* , 187-212.
10. Santos, F. (2010). IPO underpricing and Long Term Underperformance. *Stanford GSB.* St anford.
11. Shah, A. (1995). *The Indian IPO market: Empirical Facts.* Mumbai: Technical report, Centre For Monitoring Indian Economy.