Inspira-Journal of Commerce, Economics & Computer Science (JCECS)
ISSN : 2395-7069, Impact Factor: 5.660, Volume 07, No. 03, July-Sept., 2021, pp. 87-91

# A STUDY OF UNDERPRICING OF INITIAL PUBLIC OFFERINGS (IPO'S)

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## ABSTRACT

*The phenomenon of underpricing of initial public offerings has become ubiquitous feature of markets, the globe over, despite the differences in regulatory environment, the state of economy, issuing mechanisms and therefore the sort of investors involved. Numerous studies have documented the presence of initial abnormal returns or underpricing of initial public offerings and its possible determinants, yet the search continues to be on, what determines underpricing? It therefore becomes desirable to understand on why most of empirical investigation seems insufficient to demystify this anomaly. It's the peculiarities of Indian IPO market, which give strong justification for present endeavour. One, the various pricing regimes that Indian IPO market has undergone, vouch for studying the pricing performance of recent issues. Two, the presence of scores of retail individual investors on the Indian IPO market scene not to mention less developed infrastructure provide strong breeding ground for informational issues and therefore the resultant underpricing. 'Asymmetric information is the core problem underlying IPO underpricing. India's IPO market is exclusive by world standards for the institutions and human capital which enable the marketing of IPOs to a lot of lay investors everywhere the country. From the point of view of IPO underpricing, however, such an IPO market may be a very poor one, because it emphasizes reaching bent on uninformed investors in up to now as these uninformed investors cannot discriminate between "good" and "bad" IPOs, the "good" IPOs must strongly underprice themselves so as to remain attractive'. No doubt, the pioneering process of IPO grading has been recently put in situation for helping the reason for retail individual investors but the concept is new and it offers no comments on pricing issues. It doesn't offer any investment recommendation though it's hoped to be evolved into valuation exercise, over time. Nevertheless, it'd be desirable to research the impact of IPO grading on pricing performance of recent issues and it's also rendered desirable to research underpricing of IPOs.*

***KEYWORDS**: Initial Public Offer, Market Phenomena, Statutory Requirements, Underpricing, Valuation.*

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## Introduction

The underpricing in IPO is one in all the foremost widely studied pragmatic areas within the finance. It's calculated because the proportionate change in the offer price and also the price at which the shares are subsequently listed in the secondary market. Many factors are taken into consideration while pricing an IPO. The most focus is on arriving at a price which is well acceptable to the market and at the identical time also fulfils the needs of the corporate. The procedure of finalizing an issue price also comprises of some commitments from leading institutional investors. Underpricing of IPOs is present in the system since the start of raising capital through issue of shares. The most reason that the share becomes under priced is the anxiety on a part of the corporate to play safe to date as subscription is worried and also stimulate interest in the market. Majority of the investors are able to purchase the shares in sight of getting instant returns through high issue price when the shares become publically traded in the stock exchange, but for the corporate underpricing of IPOs end in the "lost capital". However, from the above discussion it can't be concluded that IPO should be overpriced.

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The overpricing of IPO is equally unfavourable for the investors and therefore the issuing firm. The overpricing of IPOs will end in availability of more funds with the corporate and also involves certain inherent risks. The overpricing may lead to less subscription of shares and ultimately the underwriters will buy those shares. The firm may find it difficult to nominate suitable number of underwriters for the problem. The investors will lose their money because the list price will be less than offer price. This may ultimately end in loss of credibility of the corporate moreover because the underwriter. The most objective of each issuing firm should be to price the IPO fairly so on give genuine returns to the shareholders.

**IPO Underpricing-Indian Experience**

The existence of underpricing in Indian capital market has already been supported by many researchers and that they described the existence of underpricing of IPOs in Indian capital Market by taking a sample of around 2000 firms that were listed on the Bombay stock Exchange (BSE). Predicting the movement of share on the initial days of trading is problematic as there's often little chronological data for analysis. Also, most IPOs were of firms undergoing a changing growth period and were also liable to additional insecurity regarding their future. The evaluation on the premise of its listing and its future period returns, describes the customary valuation of such IPO. The study also distinguishes the structures of IPOs in India in which the management expects large listing returns from such IPOs and it affects the pricing of such IPOs in the hands of the corporate which ends into overpricing. There's always an impression of the edifice of the management on the pricing of IPOs, the status of directors also affects its pricing structure. The structures of IPOs in India is small different during which the management expects a large listing returns from such IPOs and it affects the pricing of such IPOs within the hands of the corporate which ends into overpricing. There's always an impression of the edifice of the management on the pricing of IPOs, the status of directors also affects its pricing structure.

**Factors Affecting Underpricing**

A large number of things play a deciding role in generating listing gains to the investors. These include the factors associated with financial characteristics of the firm. Other signalling variables, regulatory framework and various disclosure practices of the businesses and are discussed below:

- **Size of Issue:** Size of issue is a very important factor taken for measuring IPO underpricing. The businesses issuing more shares are bigger in size and can be less risky as compared to smaller sized companies. The scale of issue is probably going to be negatively affecting underpricing. little size issue is going to be mainly brought within the market by relatively small and new firms and most of which can be standalone firms not affiliated to any business group. Small firms will must provide investors with a chance to yield quick returns than the massive firms and that they cannot afford to require risk of issue not being fully subscribed.
- **Firm's age:** The age of the corporate on the date of issue may be a variable that measures the difference between the year of incorporation of the firm and therefore the year of offering the IPO to the general public. The relatively old companies will have an extended history and can be ready to provide more information to the general public. They going to have data available for previous years and can even have the support of assorted financial intermediaries. New firms have a high risk as compared to the older firms and that they have higher uncertainty about firm's value.
- **Delay in listing:** Listing delay refers to the postponement between the issue date and the listing day. The firm sets the issue price at time 0, and also the issue opens at time T. whether or not the firm has a precise idea of the worth beforehand, the firm would tear of visit the longer-term prices since the worth fluctuates on routine. This could make the public issue unattractive and also the confidence of the investors will lose. Firms won't wish to take the chance of failing of IPO. They price the IPO at a relatively cheaper price than what it can actually fetch within the market to hide for the delays which will occur within the listing process.
- **Trading Volume on First Day:** Trading volume on first day of listing also affects the underpricing of IPOs. If the quantity traded is high than there are chances of upper listing returns in such IPOs and vice-versa. High trading volume may be a symbol of more demand of those shares on the primary day and as per the straightforward economic rule more demand of a product will end in increase in prices and this may ultimately lead to more underpricing. IPOs with higher initial return tend to experience the increased levels of trading volumes.

- **Type of Industry:** The kind of industry to which that specific company belong also affects the degree of underpricing of the IPOs. The IPOs of the sectors from which the market has greater expectations tend to be more underpriced as compared to the IPOs of the sectors that the demand is relatively less. The IPOs of technology firms have higher underpricing as compared to the opposite sectors because the risk involved and therefore the future uncertainty is high in technology firms as compared to the non-technology firms.
- **Regulatory Framework:** The regulatory framework that governs the IPOs' issue through fixed pricing mechanism or book building process has also affected the listing gains. it's a general view that with the introduction of book building method of issuing IPOs, underpricing has reduced because it is the economic process or rather investors who decide the ultimate price of the share. Because the firm can have a price band of 20% and also the final price is determined only after the closure of issue, that the sentiments of the investors are generally taken care of at the time of applying for the shares.

**Analysis**

On the idea of above regression of y on x has been applied to check the effect of the chosen independent variables on underpricing by the researcher. So as to grasp the interaction of assorted parameters on underpricing of all industries, it's found that overall model has explained power of 19 per cent with overall significant model as F-value - 105.12 is critical al 5 per cent level of significance.

Table showing

**Regression of Underpricing all Industry**

| Independent Variable | Coefficient | t-value | p-value |
|---|---|---|---|
| Constant | 88.943 | 3.152 | 0.000 |
| PUB | 0.814 | 5.159 | 0.000 |
| Log_SI | 97.556 | 21.23 | 0.000 |
| Log_AGE | -13.201 | -2.231 | 0.020 |
| Log_DLY | -13.522 | -1.654 | 0.000 |
| Log_VOLFD | -33.413 | -7.656 | 0.000 |
| Log_TOI | 6.263 | 1.565 | 0.097 |
| | Adj $R^2$ = 0.18 | f-value – 105.10 (0.0000) | |

Source: Author's calculation * (It 0.05 level of significance)

Log of variables has been taken for all independent variables aside from public issue as per cent of post issue of capital so as to get rid of the variation in the data. To know the interaction of assorted parameters on underpricing of all industries, it's found that overall model has explained power of 19 per cent with overall significant model as F-value - 105.10 is significant at 5 per cent level of significance (see above table). Regression results elaborate that there's a positive effect of public issue as per cent of post issue capital on underpricing and 1 per cent change in the same will increase underpricing by 0.814 per cent which although isn't much significant. Similarly, underpricing is additionally laid low with size of Issue during a positive and significant way. Larger the issue size, more are the underpricing. 1 per cent increase in issue size will cause 97.566 per cent increase in underpricing. there's no way that the corporate is able to meet the aspirations of all the investors and there'll be many investors who won't be able to get the shares as original allotment from the corporate, the investors who won't be ready to get the shares from the corporate may be able to perish from the stock markets and can even be able to pay the next price for that. This whole cycle will cause increase in demand of the shares on the listing date which can ultimately lead to underpricing as is obvious from the model. Underpricing is negatively tormented by the age of the firm as on date of issue. Older the corporate on the date of issue, more information is going to be available this company which is able to reduce the data asymmetry and can lead to reducing underpricing. The investors are going to be better informed and can even be in an exceedingly better position to require a rational decision about the worth at which he can purchase the shares of that company. The scale of the difficulty also leads to reducing underpricing as a greater number of shares are available for bigger issues which can reduce the gap in the demand and provide of the shares and also the price of the shares is kept in restraint after listing. Above Table concludes that type of Industry in and of itself has no significant impact on underpricing and same is additionally true in context of delay in listing. However, underpricing isn't affected to an oversized extent by the Regulatory framework or disclosure practices in India as compared to other mature primary markets of developed countries. The mandatory disclosure practices are contributing in reducing underpricing in the shares but the contribution of voluntary disclosures has been found to be insignificant. The varied regulatory authorities, mainly SEBI, are bringing necessary modifications in the disclosure requirements so on reduce the effect of data asymmetry and also the interests of the investors are protected.

In case of all industries, age of the firm is additionally significantly reducing underpricing additionally to issue size. Delay on listing is one variable which has been found to be insignificant altogether regression models. The gap between the opening of issue and therefore the listing date isn't affecting the choice of the investor to buy the shares. As per the final notion, delay in listing should affect the underpricing negatively because the investors may lose interest within the shares because of beyond normal listing delay but it seems that it's mainly considered to be a procedural delay and undue to some problem in the issue which is why the investors don't deter from buying the shares.

The general regression model has been found to be significant for all the industries which clearly signify that the chosen independent variables do leads to increase or reduction in underpricing but there are variables aside from those considered in the present study that cause or reduce underpricing in the IPOs. Standalone companies have performed far better as compared to companies affiliated with foreign groups, India business groups or were government companies. The results are in conformity with the sooner studies that the firms related to strong business groups are subject to more underpricing as compared to other firms. The affiliated firms disclose less information in the group can retain effective control over it. This can be the most reason in underpricing of those IPOs. The knowledge shared by the affiliated firms is relatively less and not complete. The knowledge asymmetry problems are more in -case on affiliated firms and aren't keen on disclosing full information causing more underpricing within the shares.

## Conclusion

IPOs are the foremost preferred source of raising funds by companies. The businesses always attempt to fix a good price for the shares but generally find pricing IPO at a lower price so as to draw in investors. The shares are literally listed at the higher price than the actual price and this safe play or rather conservative approach adopted by the businesses lead to underpricing of IPOs. Underpricing in IPOs could be a universal phenomenon that's present altogether the countries. The explanations that cause underpricing in IPOs may vary from one country to a different. Past studies have supported this view that the majority of the problems in every country are under-priced to an outsized extent. Underpricing is additionally thought to be indirect cost of issuing IPO. The most reason behind this belief is that the quantity with which the shares are underpriced is really the loss to the corporate because it is the amount that the firm has not been able to convert into inflow because of issuing of shares at an occasional price as compared to the market expectation or the fair price.

There are many factors that affect the underpricing in IPOs. The regulatory framework plays a pivotal role in determining initial returns to the investors. Various measures are taken by regulatory authorities to get confidence in the market and protect the interest of the investors. The introduction of book building system of issuing shares was one such measure. The presence of knowledge asymmetry in the market is one amongst the foremost reasons that leads to underpricing. The above discussion also brings into focus the opposite factors which cause underpricing. Size of issue, delay in listing, number of underwriters, issue size, affiliation to a selected group and disclosure practices adopted by the firms are the opposite factors that affects underpricing.

The limitations of study like large sample period, considering only IPOs for study, methods of measurement of returns and forecasting etc. logically necessitate the further research of the study. The study, although complete all told respects, can still be carried on to a next level with more in-depth analysis of all factors causing underpricing in IPOs. Further research will be made to explore the effect of enormous number of small policy changes which collectively can affect the underpricing. Event study also can be conducted so as to seek out out the effect of some particular regulatory changes on underpricing or performance of the shares. The research can even be expanded to incorporate other sort of securities like FPOs, shares issued through private placement etc.

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