International Journal of Advanced Research in Commerce, Management & Social Science (IJARCMSS)
ISSN : 2581-7930, Impact Factor : 5.880 , Volume 05, No. 01(I), January - March, 2022, pp 29-33

UNDERPRICING OF INITIAL PUBLIC OFFERING: A REVIEW OF LITERATURE

Kamal Kumar*
Dr. Ravindra Kumar Katewa**

ABSTRACT

Indian primary markets are emerging because the fast-growing markets and have a possible of acting as an investment avenue. If investors sell the share on the very first day of listing, they will reinvest the identical money in another IPO and repeat the identical process throughout the year. The wait from the offer date to the listing date in India is around 12 working days. Hence, investors have the chance of earning huge returns in barely 12 days lag and thereafter reinvest the same money in another IPO. But doing so needs an efficient evaluation of the IPOs and forecasting the returns. Such evaluation depends upon the technical and fundamental information available to the investors in the type of detailed prospectus and other reliable information sources. But do the investors take the advantage of all the data available to them? During this research work, a trial has been made to review and find the relevant information for an IPO evaluation in the stock market. Also, an endeavor has been made to eliminate the data asymmetry for the retail investors by educating them of the factors for IPO evaluation and making the correct judgment for investing in an IPO. An investor needs more protection in the primary market because the risk is incredibly high because the primary time valuation of the corporate may get it wrong, there's no prior stock history available and therefore the fundamentals of the corporate might not be known to the investors. For this purpose, two forms of studies have to be undertaken. One to check the determinants that cause the primary day underpricing and second to check the investors' attitude about the IPO underpricing in Indian market.

Keywords: *Underpricing, Investor, Prospectus, Evaluation, Information, Derivative, Capital Market.*

Introduction

Through an intensive literature review, the researcher has categorized the various IPO characteristics studied up to now and a few more that were enumerated during the study into firm related, issue related and market related variables. These IPO characteristics were then detailed to review their impact on IPO underpricing. There are two styles of investors: uninformed investors who were assumed to neither hold any private information nor any analysis and forecasting powers and informed investors who could draw matured decisions supported secret (private) information available and their predictions of the long run market conditions. in the current study, different models were studied to seek out out the prediction powers of every of the excellent IPO characteristics on the choices of informed investors and also the impact of the publicly available information before subscription close date on the choices of uninformed investors. Supported detailed study on the past trends on initial underpricing, the researcher has tried to suggest some investment strategies to the investors. The general results of the study would be of interest for investor community, equity issuers, and academicians. The findings of the study would throw an insight to the organizations coming with IPO about their user's perspective who are the informed and uninformed investors. Getting their insight would help them time their new equity issue as per the present market conditions, value it appropriately, and would help them to form further necessary disclosures in the IPO advertisement or publicize about the relevant technical and fundamental information.

---

* Ph.D. Research Scholar, Department of E.A.F.M, University of Rajasthan, Jaipur, Rajasthan, India.
** Head, Department of E.A.F.M., R.N.R. Government P.G. College, Ramgarh, Shekhawati, Sikar, Rajasthan, India.

Indian Capital Market and Initial Public Offer (IPO's)

The stock markets have grown much beyond acceptance of deposits by banks and lending to borrowers by them. The stock markets will be divided into different subtypes like debt & equities market, money markets, derivatives, Foreign Exchange markets, commodity markets etc depending upon the sort of securities traded. The capital markets can even be classified as primary and secondary markets with both performing important functions. The fresh issue of securities takes place in the primary market and subsequent trading of those securities among investors takes place in the secondary market. Capital market plays a vital role to access future debt and equity funds to lift cash for projects that the businesses cannot finance internally. The sort of the funds raised through capital markets includes debt funds and company equity. The foremost common type of the debt is bank loans and bonds. Debt holder receives continual interest payment, and that they have a hard and fast claim on the firm's assets if bankruptcy occurs. Share is the most recognizable type of equity. Shareholders' have the secondary claim on the cash flows and are paid in spite of everything the debt liability is met. Equity repayment doesn't have any date. Out of the 2, equity capital is the owners' fund and they are the owners of the corporate. Capital market transactions occur in the organizations called organized stock exchanges or over the counter markets. Organized stock exchanges trade listed securities in auction market. These exchanges have trading floors where the securities are bought and sold. Over the counter markets don't have any physical locations. Trading occurs through dealers connected with computers. The role of the stock exchanges is incredibly crucial as they change capital. The businesses must fulfill minimum requirements to be listed on these stock exchanges like minimum paid up share capital, number of shares, income level of the corporate, etc. Also, this stock market regulates the businesses to keep up the transparency of transactions, thereby ensuring the security of public money with these companies. The Capital market is further categorized in two parts: equity market and debt market. The equity market is split in two parts - the first market and therefore the secondary market. The Initial Public Offerings (IPOs) form part of primary markets.

An Initial Public Offering (IPO) is offering equity stock to the general public in an open marketplace for the first time. Initial Public Offering (IPO) marks the transformation from the private company to the public company. The ownership of the firm is then liquidated and therefore the subscribers of the equity issue become the owners of the corporate. Going public yields two obvious benefits to the businesses, one is congregation of giant equity capital and second is escalating wealth for company's insiders. But to make sure this, an IPO must achieve success. The IPO process involves huge costs. Sometimes, the businesses roll back their IPOs due to the dearth of clarity of the IPO process, their valuation and also the way it'd be perceived after listing. To mitigate such instances, the managers must have an entire insight of an IPO process and also the factors that ought to be considered while assigning a worth to the new issue so forecast how the retail investors will perceive the new issue on the first day of listing.

Regulatory Framework of Initial Public Offerings (IPOs) in India

Initial Public Offerings is the process of transferring ownership from private hands to public. The method of going public varies across different countries in terms of the regulatory procedures, stock exchanges, expectation of investors and therefore the secondary markets. This section, therefore, will highlight the Indian primary markets and therefore the issue procedures. The investors would favor to take a position in primary markets as long as they expect to induce higher returns because the primary markets are entailed as high risk market due to the shortage of previous documentation about the businesses. The detailed explanation would help reduce any ambiguity into the IPO process. The businesses going public for the primary time are required to abide by the regulation of Securities and Exchange Board of India (SEBI) (Disclosure and Investor Protection) Guidelines, 2000. The issuers desiring to go public for the primary time or issue a right issue exceeding Rs.50 lakhs must appoint a Merchant Banker and file a draft prospectus with SEBI a minimum of 30 days before filing a prospectus (in case of fixed issue) or a red herring prospectus (in case of book built issue) with Registrar of Companies (RoC). Before issuing shares, an application for listing of securities has to be submitted with the designated stock exchange(s). Also, the issuing firms have to holdup with the depository to carry and issue the shares in dematerialized form.

IPO Underpricing-Indian Experience

The existence of underpricing in India capital market has already been supported by many researchers which they described the existence of underpricing of IPOs in Stock 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 vulnerable 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 company which ends into overpricing. The structures of IPOs in India is tiny different during which the management expects an oversized listing returns from such IPOs and it affects the pricing of such IPOs in the hands of the company which ends into overpricing.

Objectives of Study

- To determine the issue related determinants of IPO underpricing.
- To determine the market related determinants of IPO underpricing.
- To determine the IPO underpricing predicting powers of uninformed investors.
- To evaluate the cause and effect relationship between firm-related variables and underpricing.
- To evaluate the impact of recent regulatory changes in Indian primary market.
- To suggest IPO investment strategies to retail investors.

Review of Litreature

The IPO underpricing is the peculiar feature of the markets internationally and lots of empirical researchers have tried to clarify the explanations for IPO underpricing. Most of the studies proved that the knowledge asymmetry has been the first reason of underpricing and researchers have used different proxies to elucidate the effect of data uncertainty on the degree of underpricing.

Alford (1992) studied the IPO valuation of 256 Malaysian firms during the amount 1999-2004 and suggested that the difference between the offer price and the list price of equity should be zero; else the valuation supported any of the above methods isn't accurate. The author called this phenomenon as Absolute Prediction Error. Alford concluded that markets are efficient because the difference between the list price and also the offer price fades out by the tip of the day. The author also founded that the P/E valuation method are most favoured method of IPO valuation followed by NAV method which has been specifically prevalent in the young firms catering mainly to technology sector. The explanation appended is that such sectors are volatile and also the historic accounting information isn't available. Thus, such young firms use NAV method.

Beaver and Morse (1978) deduced that the P/E and also the DY methods of valuation suffer from the conceptual flaw. The researchers argued that the 2 methods consider only forecasted profits or forecasted dividends to value the new equity. However, the investors are benefitted from the capital appreciation which has not been considered (Barker, 2001). Other researchers argued that the forecasted P/E multiples might not be comparable across industries and across sectors. The explanation appended has been the difference in the accounting policies for example; the depreciation and inventory valuation methods differ across firms and across industries. Hence, valuing stock supported P/E need adjustment of accounting policies additionally.

Keasey and Short (1992) studied the reliability of the Winner's curse model and conclude that the winner's curse model holds true in presence of number of conflicting assumptions and produces propositions that would not be tested. They claimed that the uninformed investor cannot expect all the IPOs to be underpriced so as to avoid their Winner's curse and therefore the individual issuers therein case can easily cheat the investors by overpricing the difficulty and uninformed investors subscribing to the problem in honesty. They further explained the issuer's perspective that every individual issuer might not have an interest to unravel the Winner's curse and intentionally underprice the issue.

Loughran and Ritter (2004) examined the explanation behind variation of underpricing over time. The authors attributed atiny low a part of the rise in underpricing from the1980s to changes in the risk composition of the businesses going public. An extension of idea from Ritter (1984) where Ritter tested riskier IPOs is underpriced quite less risky IPOs. The upper the chance of an IPO, the upper underpricing investors expect for taking the danger. However, they conclude that these changes in the characteristics of firms going public are too minor to clarify much of the variation in underpricing over time if there's a stationary risk-return relationship. The most reason for the bubble period underpricing has been the change of objective function from maximizing proceeds to obtaining analyst coverage.

Michaely and Shaw (1994) examined the sample of IPO Master Limited Partnership (MLP) and also the regular IPOs issued during 1984-1988. The institutions avoid the MLPs because the income received from such IPOs is taken into account as unrelated business income and taxable also. The informed investors tend to avoid MLP IPOs. The results from the study conclude non MLP IPOs are much better underpriced as MLP IPOs. The institutional investors aren't really interested to buy MLP IPOs. The authors, thus, hold institutional investors as a proxy for informed investors.

Hypothesis for Study

$H_0$1: The Firm related and Issue Related variables do not have any impact on underpricing.

$H_0$2: The Market related and Issue Related variables do not have any impact on underpricing.

Research Methodology

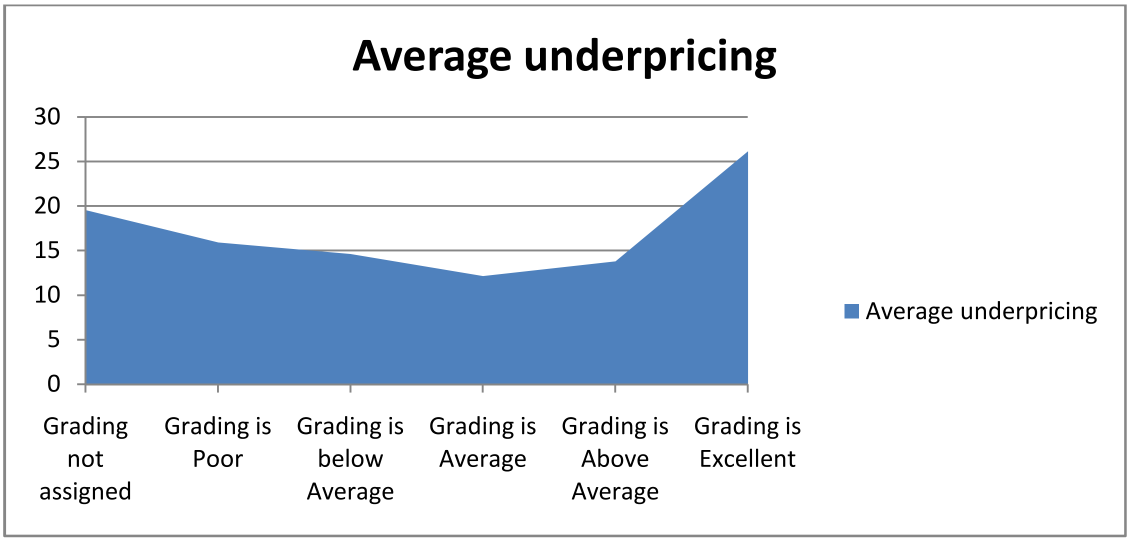
Deemed primary data or secondary data are collected for the aim of measuring and for the aim of finding the determinants of the IPO underpricing. Deemed primary data are collected from the multiple authentic databases. As an example, the statistical information and also the literature review have been based on online databases like Capita line Plus and Prowess and online Journals like Emerald, Ebsco host and Proquest.

Results and Analysis

Table 1: Experts Opinion Regarding Impact of Covid 19 on Environment

IPO Grading	Average underpricing
Grading not assigned	19.53%
Grading is Poor	15.92%
Grading is below Average	14.63%
Grading is Average	12.15%
Grading is Above Average	13.81%
Grading is Excellent	23.96%

As we can see in Table 1 that, Around23.96% companies are there who is enjoying excellent grading having highest percentage of underpricing, as they are not able to issue their shares at the current market value. On the contrary the companies to whom no grading is assigned are having around 19.53% underpricing in their IPO. The companies having average grading is having lowest underpricing in their shares which is 12.15%.



Conclusion

The current research has elaborated the literature on underpricing scenario across the globe and therefore the varied theories supplemented in the literature as a evidence for underpricing across the Determinants of Underpricing of Indian Initial Public Offerings and Attitude of Investor Community world. However, the results for determinants of underpricing haven't been in consensus across different markets and therefore the time periods. Thus, supported backdrop of existing literature on IPO underpricing and its reasons, the present study derived two schools of thoughts that are founded to be providing contradictory opinion. The findings from this study have dissonance with the sooner studies in terms of the degree of underpricing. The degree of underpricing has been decreasing over years which act as a decent indicator for the issuers as underpricing is an indirect cost to issuers. Though the degree of underpricing has been decreasing over years, on the other hand the investors aren't at economic loss by investing in primary market in India. Several recent amendments by Securities and Exchange Board of India (SEBI) are studied for its impact on IPO underpricing. However in financial studies, there couldn't be one fit model and human factor plays an equally important role together with the financial variable to work out IPO underpricing. That's why, financial decisions are considered as more of an art than the science. Also, several IPO characteristics act differently in keeping with market conditions. Thus, it's difficult to predict which factor is crucial in prevailing state of environment. The findings from the present study including the acceptable experience and therefore the analysis of obtainable information would help in predicting the trend of underpricing.

References

1. Alford A (1992), "The Effect of the Set of Comparable Firms on the Accuracy of the Price Earnings Valuation Method", Journal of Accounting Research, Vol. 30, No. 1, pp. 94-108.
2. Barua, S. K., Varma, J. R., & Raghunathan, V. (1996), 'Portfolio Management', 1st revised ed., Tata McGraw Hill Publishing Company Limited, New Delhi, pp 27.
3. Beaver W. and Morse D. (1978), 'What Determines Price-Earnings Ratios?', Financial Analysts Journal, Vol. 34, No. 4, pp. 65-76.
4. Chaturvedi, A., Pandey, A & Vishwakarma, Y., (2005), 'Under Pricing of IPO's Under Book Building Route in India: An Analysis of Non Fundamental Factors and Signaling Effects' Paper presented at 6th International Conference on Operations and Quantitative Management (ICOQM) at IIM-Indore, Aug 9-11, 2005.
5. Gupta, L.C. (1976), 'Readings in Industrial Finance,' 1st ed., The Macmillan Company of India Ltd., New Delhi.
6. Keasey, K. and Short, H. (1992) 'The Winner's Curse Model of underpricing: A Critical assessment' Accounting and Business research, Vol. 23, No. 89, pp 74-78.
7. Kothari, C. R. (2008) 'Research Methodology: Methods and Techniques', 2nd ed., New Age International Pvt. Ltd Publishers.
8. Loughran, T, & Ritter, J.R. (2004), 'Why has IPO underpricing changed over time?', Financial Management, pp. 5-37.
9. Michaely, R. and Shaw, W.H. (1994) 'The Pricing of Initial Public Offerings: Test of Adverse Selection and Signalling Theories', The Review of Financial Studies, Vol.7, No.2, pp279-319.
10. Neelamegam R. & Srinivasan R. (1996), 'Investors' Protection: A Study on Legal Aspects", 1st ed., Raj Publications, Delhi.
11. Pathak, B.V. (2008), 'The Indian Financial System', Doring Kindersley (India) Pvt. Ltd.
12. Shanmugham, R. (2000), 'Factors Influencing Investment Decisions', Indian Capital Markets – Trends and Dimensions (ed.), Tata McGraw-Hill Publishing Company Limited, New Delhi.
13. Vinayakam, N. (1994), A Profile of Indian Capital Market, 1st ed., Kanishka Publishers, New Delhi, pp. 61-62.