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Marketing strategy and its influence on listing Price with reference to Indian IPO capital market

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Abstract: ***This study attempts to provide new evidence on the first-day IPO market performance using a set of 235 IPOs newly listed between 1 April 1997 and 31 March 2008 on Indian stock exchanges. The study examines how a change in the institutional arrangements that govern the pricing of IPOs, from the traditional fixed price approach to the building of a book, affects the level of under pricing. It also extends the literature on under pricing by comparing under pricing under the two pricing methods.***

The study adds new evidence to the existing literature on IPOs in a significant manner. Firstly, in consistence with the 'hot issue markets' theory (Ibbotson and Jaffe, 1975; Ritter, 1984), it highlights that on the main board of the Indian Exchange, IPO under pricing increased in 2007. The empirical findings indicate a significant mean positive under pricing (14.45 %); nonetheless, 60% of IPOs in the sample are initially overpriced. Secondly, in contrast with Giudici and Paleari (1999), the study finds no evidence that there is difference in under pricing between fixed price and book built offers. Keywords: India, Under pricing, Price Support, Initial Public Offering, Indian Stock Exchange, Book Building, Fixed Price Offering.

Key Words: IPO, Marketing strategy, Primary Market, Listing

I. INTRODUCTION

The performance of book building vis-a-vis fixed-price Initial Public Offerings (IPOs) is a wellresearched area. Both offering methods lead to underpricing. Underpricing of IPOs, as referred to in the literature, is one of the anomalies observed in the primary markets all over the world.1 The term refers to the positive initial returns over the offer to listing dates of the new issues. Although the evidence on IPOs' long-run underperformance is mixed, the most striking and widely diffused empirical regularity is the initial underpricing, i.e. the positive first-day returns. It appears that the prime factor causing IPO underpricing is asymmetric information (Rock, 1986; Ritter and Welch, 2002). There are other explanations such as conflict of interest and agency problems (Ljungqvist and Wilhelm, 2003; Loughran and Ritter, 2003) and the signalling role (Allen and Faulhaber, 1989). Many of these explanations are likely to be true for emerging economies as well, routed as they are in theory; there could be institutional features that might impinge on both the causes and the extent of underpricing in these countries. Hence, it would be interesting to study an emerging economy like India where a large number of companies went public to finance their expansion in the presence of perverse underpricing

Moreover, international evidence suggests that book-building issues expect to have lower underpricing than fixed-price issues. In Indian IPO markets, book-building mechanism since 1999 has gained popularity particularly for relatively larger IPOs. Traditionally, Indian IPOs used to be fixed-price offerings, wherein prices of the stocks on offer were determined prior to seeking investors' bids.

Second, the study of Indian IPOs should be of interest to the global financial community, as over the time period India has become a favorite destination for FIIs. Finally, the Indian primary markets have witnessed a boom during the last few years. Both the number of new issues coming to the market and the total amount raised have increased in leaps and bounds. Empirical findings indicate that book building has rapidly gained favour as the issue mechanism in India since its inception in 1999. For instance, over 72% of the IPOs brought to the market in 2005 were book built. This trend continued in the later part of the years as well. This study attempts to provide new evidence on the first-day IPO market performance using a set of 235 IPOs newly listed between 1 April 1997 and 31 March 2008 on the Indian exchange. It also extends the literature on underpricing by comparing underpricing under the two pricing methods. Specifically, the study investigates how a change in the method by which price is determined affects the level of underpricing

Empirical findings indicate that the initial underpricing is significantly positive, and substantial money is 'left on the table' by issuers. A strong reduction in the mean underpricing practices, especially in 2008, is documented. This contrasts with the findings by Loughran and Ritter (2003) and Ljungqvist and Wilhelm (2003), documenting a rising severity of IPO underpricing in the US stock market. Separate analysis of IPOs with book building (which are less underpriced than fixed-price IPOs) is provided. In

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contrast with Giudici and Paleari (1999), the study finds no difference in underpricing between fixed-price and book-building offers.

II. LITERATURE REVIEW

The underpricing of IPOs is a universal phenomenon well documented in the economic literature (Ibbotson, 1975). Underpricing is ubiquitous but the amount of underpricing varies across countries. Loughran, Ritter and Rydqvist (1994) provide data on the initial listing performance of IPOs made in 25 countries. They show that the initial listing return ranges from 4.2% in France to 80.3% in Malaysia. Researchers provided explanations for this widely diffused 'anomaly' of the financial markets. The identified possible reasons developed in the finance literature to explain the underpricing are: information asymmetry among participants, agency problems and institutional setting when the firm goes public. It appears that the prime factor causing IPO underpricing is asymmetric information between the issuer and the investment banker, asymmetric information among investors and asymmetric information between issuer and investment banker. Rock (1986) assumes asymmetric information between investors. He classifies investors into two types: informed and uninformed, based on their knowledge of the future market price of the offered shares. Informed investors are knowledgeable about the future prospects of the shares being sold and will only attempt to buy when the issue is underpriced. Uninformed investors, on the other hand, do not know which issues are underpriced or overpriced, and therefore do not discriminate between issues when they apply for IPOs. Therefore, they face a "winner's curse" due to the adverse selection externalities. Due to this adverse selection problem, the uninformed investors will exit the market unless they find issues of underpriced IPOs are available on average to recompense them for their informational handicap (at least to a risk-free rate). An implication of the winner's curse theory is that riskier issues should be underpriced more in order to make them attractive to a larger group of investors. Beatty and Ritter (1986) extend this and show that the expected underpricing is an increasing function of the uncertainty about the market-clearing price of an IPO. They defined 'ex-ante uncertainty' as a proxy of information asymmetry, which in turn is related to some variables, such as the firm's age, size and assets typology, as well as the file price-range spread. A number of authors have tested this proposition and they are in general agreement with it (see, for example, Cheung and Krinsky, 1994 and Miller and Reilly, 1987). Many researchers are of the view that information asymmetry exists between the offering parties and the investors about the price and the level of the stock demand. Benveniste and Spindt (1989) introduce the "information gathering theory" and state that the underpricing is a means to induce informed investors to reveal private information about the demand for shares in the pre-selling phase, thus allowing better evaluation of offerings by the intermediaries. Chemmanur (1993), Jegadeesh et al. (1993) and Spiess and Pettway (1997) show that the underpricing may also generate useful information for the firm in order to plan future seasoned offerings ("market feedback hypothesis"). Allen and Faulhaber (1989), Grinblatt and Hwang (1989) and Welch (1989) instead identify the firm's managers as the informed party and interpret the underpricing as a "signal" of a firm's superior quality(signalling hypothesis). A key assumption is that high-value firms with favourable prospects tend to underprice more than low-value firms. Baron and Holmstrom (1980) and Baron (1982) postulate information asymmetry between the issuer and the investment banker (principal agent model). They assume that an investment banker is better informed about the capital market than the issuer and is therefore better able to gauge demand for the offer and set the price5 .He is thus encouraged to sell underpriced shares6 . A similar story is modelled by Mandelker and Raviv (1977), stating that the underpricing is related to intermediaries' risk aversion. Tinic (1988), Hughes and Thakor (1992) and Drake and Vetsuypens (1993) hypothesise that risk aversion also derives from the willingness of the intermediary to avoid litigation. Introducing agency and moral hazard consideration, Ibbotson (1975) states the desire to leave a "good taste in investor's mouths" as a potential explanation of underpricing by intermediaries7 . Fulghieri and Spiegel (1991) hypothesise that intermediaries also want to gain the goodwill of strategic clients, assigning them underpriced shares. More easily, Baron and Holmström (1980) highlight that marketing expenses have a decreasing marginal return and it is less costly to convince investors to subscribe underpriced IPOs. Ritter (1984) claims that investors prefer underpricing because they expect that after the IPO the controlling shareholders may extract private benefits from the firm. Su and Fleisher (1999) admit that also bribery and corruption can explain high underpricing in IPOs. Nevertheless, other works relate the underpricing to irrational behaviours due to speculation bubbles and market "fads" (see Aggarwal and Rivoli, 1990), to noisy trading activities (Chen et al., 1999), to naïve investors' over optimism (Rajan and Servaes, 1997; Bossaerts and Hillion, 1999). Mauer and Senbet (1992) propose an explanation based on stock pricing in segmented markets; in particular, they assert that in these markets problems of incomplete access and incomplete spanning do exist, causing a remarkably high risk for investors. Welch (1992), in his model of informational cascades, holds that an issuer underprices the issue in order to persuade the first few potential investors to purchase and spawns a cascade in which other investors follow suit despite their earlier lack of enthusiasm in subscribing to the issue. In the Indian context, Shah (1995) conducted the earliest study on underpricing. Using a large sample of 2056 IPOs for 1991-1995, he showed an average underpricing of 105.6% in India's primary market. Narasimhan and Ramana (1995). after analysing the performance of 103 IPOs, and Baral and Obaidullah (1998) with 433 IPOs analysis conjectured that Indian markets were seeing 'overpricing and artificial support', although they also found initial returns to be higher. All these studies have discussed the short-term performance of Indian IPOs. Madhusoodanan and Thiripalraju (1997), after analysing the long-run performance (up to 3 years) of 1922 IPOs from 1992 to 1995 concluded that Indian IPOs were subject to wide-scale underpricing with investors resorting to manipulations to increase the odds of getting the shares allocated. Table 1 compares the level of underpricing reported by the earlier studies exhibiting that the initial excess return on IPOs in the Indian primary capital market has been very high.

The present study differs with regard to above theories on several dimensions. Firstly, the Indian book-building mechanism requires retail and institutional investors bid on independent pools of shares. Auctions are nonexistent in the Indian market. This leads to an altogether different set of theoretical issues compared to the setting in which all investors bid for the same pool of shares. The present analysis focuses on the effect of introducing book building as a mechanism in the IPO market formerly dominated by fixed-price offerings. Secondly, the focus is on the time period when book building was introduced to the

marketplace in contrast to the markets that Cornelli and Goldreich study, where book building has historically been available. Lastly, the present study is studying a different set of issues. Prior studies of IPO analysed variation within book-built IPOs, which sheds light on micro-level bidding by individual investors. On the other hand, this study examines the differences between mechanisms. The present study will verify if in India book building is useful to reduce underpricing.

III. PUBLIC ISSUE PROCESS IN INDIA & MARKETING STRATEGY

This section briefly outlines the current regulations and procedures involved in the new issue process in India. Prior to May 1992, the government of India controlled the pricing of equity issues. A government-appointed official, the Controller of Capital Issues (CCI), priced the issue of equity capital using a pre-determined formula. Since then the government has abolished price controls. After May 1992, companies are free to price the equity issues. Currently, the Securities Exchange Board of India (SEBI) regulates the new issue process9 . All companies planning to make equity offerings to the public submit an offer document for approval by SEBI. Companies are also required to state the price at which the public offering is to be made. The offer document should provide an adequate justification of the offer price.

An investment banker, who is the lead manager, manages such public issues10. He can enlist the support of other investment bankers. He is responsible for all the key decisions and the administration of the issue process and is required to adhere to the disclosure norms prescribed by SEBI. Since 1995, SEBI has allowed companies/lead managers to indicate a price band within which the final offer price must lie. The maximum price should not be more than 120% of the minimum price. SEBI is also concerned with adequate information disclosure to potential investors and ensuring that companies and their merchant bankers do not follow discriminatory policies that harm the interests of investors. Investment bankers cannot discriminate between the different investors while allocating shares in the public issue process. In the case of oversubscription, the allotment is finalised in consultation with the stock exchange and a SEBI-nominated public representative. However, companies can retain a certain amount out of the public issue for a particular class of investors. The usual classes of investors include the resident Indian public, non-resident Indians (NRI), foreign institutional investors (FII), mutual funds, and employees of the company

With the introduction of the book-building process and the scrapping of the concept of par value for shares, the pricing process has become more open12. It is now possible to follow the fixedprice route or the book-building route for an issue. In case of the book-building process, the price is not fixed, but a price band is suggested. The investors can bid for any price between the cap and the floor and the quantum of subscription. One of the lead managers will work as the book runner. The final issue price is determined as the cut-off at which the issue is fully subscribed. The book building could be used for 75% of the issue, which could be subscribed by institutions and high net worth individuals, and the balance 25% could be issued to individual investors as a fixedprice issue, the price being the cut-off determined via book building. It is also possible to have 100% book-built issues where the individual investors also take part in the book-building process. The book-building process is completely automated (on-line) using the systems of the stock exchanges, and this process is known as e-IPO. This has been made possible by the compulsory dematerialisation of stocks in case of secondary market transactions.

IV. EMPIRICAL ANALYSIS

Sample An initial sample of IPOs on the Bombay Stock Exchange (BSE) during the period 1 April 1997 to 31 March 2008 is identified from the Prowess database, provided by the Centre for Monitoring the Indian Economy (CMIE). To ensure valid estimates of the measures, an IPO is included only when it meets the following additional criteria: (a) The IPO shares are ordinary common shares. (b) The IPO firms must have relevant financial information and daily adjusted closing stock price data on listing day available from the Prowess database or BSE web site.

V. DESCRIPTIVE STATISTICS

In order to test the correlation between the underpricing and some explicative variables pointed out by the literature, Table presents descriptive statistics of the sample. Financial companies figure separately from others as they have different accounting standards. Table also reports about the offering, the market momentum prior to the IPO and the aftermarket price volatility

VI. CONCLUSION

The present study analyses a comprehensive and unique data set about IPOs' short-run market performance in India. It computed the first-day return of 235 IPOs from 1998 to 2008 obtaining a mean (adjusted) underpricing equal to 14.45% (13.04%). The amount of ‘money left on the table‘ by issuers, when they sell underpriced shares, was also computed. Empirical findings indicate that Indian market was experiencing underpricing in 2003, which increased over time and was particularly high during 'hot issue' market of 2007. However, it has decreased in the first part of 2008 (in 2008 it is on an average negative). The present study found no evidence that underpricing in IPOs that use a book-building method are different from underpricing in IPOs that use a fixed-price method. This result is in contrast to the evidence in the study by Giudici and Paleari (1999). It may, however, still be consistent with the premise that the book-building method reduces information asymmetry between investment banker, issuer and investors, but as the results of this study show, this does not necessarily result in a lower level of underpricing. The

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above empirical findings provide original contributions to existing literature, which are important from the point of view of Indian IPO market. The number of firms going public in India has recently increased, but we are much far from the standard of other developed markets; therefore, often IPOs are considered as a speculative opportunity more than an occasion to diversify portfolios. Moreover, the evolution of the placing procedure, from fixed-price offerings to book building, has not improved the efficiency of Indian IPOs market. It is a pity that in India no transparency characterises intermediaries' activism after the listing. SEBI should arrange as soon as possible a list of detailed information to be filed and published by the intermediaries when trading shares after the listing.

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