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Initial Public Offerings Underpricing: An empirical study

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Abstract:

As one of the most crucial business processes, IPOs have spurred a plethora of studies.This study provides a review of the commonly accepted theories for the underpricing of initial public offerings (IPOs), with the goal of identifying the most plausible explanation from the available research and also classifies the most recent literature into two categories: informative and uninformative.

Keywords: Initial Public Offering, Asymmetry, Underpricing.

Introduction:

One of the most popular ways that cash-strapped businesses are raising money is through an initial public offering (IPO). The main stock market has seen a wave of initial public offerings (IPOs), making it difficult for companies to determine what a fair IPO pricing should be. All data that is publicly available to investors is a major factor in whether or not an initial public offering is underpriced or overpriced. (1) These days, investors use a variety of data sources to craft long-term strategies for their portfolios. Since issuing businesses are obligated by law to adhere to the facts and numbers confessed in the IPO prospectus, investors are now required to read it thoroughly.

The IPO documentation is a legally binding document for the firm, investors, and underwriters, guaranteeing that all required and accurate information is included in accordance with the standards set forth by capital market regulatory organizations delivered to the prospective investors. The first time that a company's stock is offered to the general public is called an initial public offering (IPO). By going public, a corporation can gain access to the equity capital of the investing public.

Financial turmoil in 2008 caused a record low for initial public offerings. IPOs came to a standstill after the economic downturn that followed the 2008 financial crisis, and fresh listings were scarce for a while afterwards. Unicorns, or startups with private valuations of above $1 billion, have become the focus of much of the IPO chatter as of late. The choice of whether or not a company will hold an initial public offering (IPO) is the subject of much speculation from both investors and the media.

Asymmetry Of Information:

In an initial public offering, the company issuing the securities and investors each have access to a large but very diverse pool of information. This discrepancy in knowledge is referred to as "information asymmetry." All three parties involved—the issuer, the underwriter, and the IPO investors—are affected by this lack of transparency.

It is dependent on the issuer's difficulties in measuring the degree of underpricing that happened owing to information asymmetry. The extent to which there is a discrepancy in the amount of information Investors can be divided into two groups: the knowledgeable and the misinformed. So, to rule out any possibility of an unsuccessful issue, the extent to which an issuer/underwriter deliberately undervaluing an offering to attract investors.

Objectives:

The main objective of this study is to evaluate existing underpricing hypotheses and to weigh their merits and shortcomings.

IPO Underpricing:

Underpricing in an initial public offering (IPO) occurs when the issuer and the investors have different ideas about how much the company's equity is worth. This is something that can be influenced by a variety of endogenous and exogenous circumstances, and those elements can either help to mitigate the discrepancy in perception or accentuate it. In this work, we attempt to expound on a number of different characteristics by collecting data on them from previous research and organizing it into categories.

Earlier The study "Investor Experience with New Stock Issues" by Reilly and Hatfield is often cited as the first piece of evidence for IPO underpricing in the existing literature. This paper looked at 53 fresh equity offerings between December 1963 and August 1964, and January 1965 and June 1965, using a small dataset. (2) By comparing the IPO's offer price to its closing price on the first Friday after listing, they were able to assess its initial performance. The data showed that more than half of the problems (31 stocks) generated a higher short-term return than the market, by an average of 18.3%. By comparing the returns on the first Friday, the fourth Friday, and after one year following issuance, the study found that fresh issues do exceptionally well. However, there were two problems with the study.

One, the authors admit that the market was hot during the time of study, which means that demand for new issues was sky high, and two, the authors compared the study's excess return to that of the price-weighted Dow Jones Index. In addition, they noted that the observed excess returns are far lower than the Over-the-Counter Industrial average.Reilly and Hatfield came to the conclusion that the most recent equities offerings are underpriced and gave numerous tautological explanations for why this would be the case. Their initial justifications Centre on the standard practise where the issuer and underwriter work together to set a price. They argue that

1) underwriters are unable to gauge investors' judgement of fresh equity issues because of the issue's unseasoned nature; and as a result, the observed underpricing can occur.

2) The issue will be successful because the underwriters have priced it too low, resulting in greater first-day returns.

3) Underwriters prefer a fast sale to reduce their risk, as their capital bases are proportionally reduced to the amount of underwriting, they do.

4) Since underwriters are allowed to take stabilizing action in case of higher volatility under Securities and Exchange Commission (SEC) oversight, which ties up their cash and resources, they would underprice since successful offerings do not require their involvement and would result in a higher price for investors.

5) Brokers benefits directly from a successful issue since a portion of their fees are paid in the form of stock or they have an option to purchase a substantial block of stock at a price close or below the issue price.

The issuer, on the flip side, is willing to take less money in order to keep the investors happy and ensure the success of any future issuance.

Since a company's financial needs are rarely met by a single share issue, this is crucial information for the company to have. The company that issuing the securities would prefer to accept smaller proceeds in the hope that the new shareholders will contribute to any additional capital needs.ss

Theories of Underpricing:

1. **Noninformational Theories of Underpricing:**

   Due to the immutability of prices, the non-informational theories of underpricing run the risk of being counterproductive. The market price of a company's stock is probably too low because the price established is never completely accurate. From the perspective of Legal Expenses, as Ibbotson tried to explain in 1975, going public entails making a lot of 'self-revelatory' declarations. People place a much higher value on not losing out than on gaining something, as predicted by prospect theory. As a result, dissatisfaction arises whenever the price drops. If shareholders are content, the company may have to spend less on legal fees.

   In 1996, Booth and Chua established the alternative non-informational theory. They reasoned that the low offering price was the present management's approach of fighting off a hostile takeover by a group of shareholders eager to exert power over the company by amassing a large number of shares. As a result of underpricing, managers may be able to divide up the possession. Therefore, their findings imply that underpricing is associated with their ownership heterogeneity as a function of data cost. Similarly, there is scant support for this viewpoint.

2. **Informational Theories of Underpricing**:

There are three distinct schools of thought about the role that asymmetric information plays in underpricing. Investors and issuers make up the first set of parties involved. Investors and underwriters are involved in the second. Finally, the third is between savvy trader's ignorant financiers.

Ibbotson argues that when there is a discrepancy in the amount of information available to each party, high-value firms will accept lower IPO pricing to "leave a good taste in investors' mouths" about future offerings. As a result, the exact same issuer can underwrite more desirable prices in subsequent underwritings. Only high-quality companies, having proven their worth through subsequent, higher-priced IPOs, can afford the signaling expenses. The concept thus offers rationale for underpricing as a means for a good company to set itself apart from a bad one. In addition, companies often go public in the hopes of attracting more attention, and underpricing might facilitate this. Reducing information asymmetry can be expensive, so a cheaper IPO share price is the only way to get more interested parties to contribute to the effort.

Conclusion: The issue of knowledge asymmetry among investors has been extensively researched. The knowledge of some investors exceeds that of others. Hence there is a need for the study of IPOs underpricing and its various theories are focused in this paper. Which corporations are underpriced and which are overvalued is something they know a lot more about. The Winners Curse Model was created by Rock's writings in 1986, as well as those of Beatty and Ritter. In future the researcher can study affect of IPOs underpricing on various sectors.

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