Underpricing of the Public Issue: an Empirical Study of primary Market in Indian Context

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Abstract:

Underpricing is a phenomenon which is present worldwide and here the study has made an attempt to analyze the primary market of India, in order to observe the phenomenon of underpricing. The period considered for the study is from 2012 to 2017, which includes the companies that has gone for the public issue and is also which is been listed in the stock markets such as NSE as well as BSE. An observation which is made by the study is that, underpricing is been existed in these years between the year 2012 to 2017 in the Indian primary market. As Ritter have also suggested about the risk which is undertaken by the uninformed investors for making a venture in the public issue which is unknown. For the purpose of analysis in the study the numbers of companies considered are 2012 to 2017, over 185 companies are chosen. So finally study declares the presence of phenomenon of underpricing in the Indian context as it is a known phenomenon worldwide through the various extant literatures.

Key Words: Initial Public Offering, Securities Exchange Commission (SEC), Stock Exchange, Book Building.

1.1 The Process of Going Public:

The first step in the IPO process is to identify an underwriter who acts as an intermediary between the capital markets and the company, once a small business has decided to go for the public. The owners of small business solicit the proposals from a number of investment banks, and then on the basis of their reputation will evaluate the bidders, experience in the industry, experience with similar offerings, record of post-offering support, distribution network, and the type of underwriting arrangement, as recommended by Joubert .The bidders' valuation of the company and recommended share price, are the other considerations which are included in the process.

The underwriting arrangements are of three basic types, namely: The investment bank does not commit to buying any shares in the best efforts instead agrees to put forth its best effort to sell as many as possible shares as possible; all or none, which is quite similar to that of the best efforts except that the offerings is been cancelled if all the shares are not sold; and the firm commitment, which mean that the investment bank purchases all the shares by itself only. Since the underwriter holds the risk of not selling the shares, the firm commitment arrangement is probably best for the small business. The firm will form a team of other underwriters and brokers to assist it in achieving a broad distribution of the stock, once a lead underwriter has been selected.

Assembling an underwriting team consisting of attorneys, independent accountants, and a financial printer, is the next step in the IPO process. For the underwriter, attorneys draft all the agreements, while the attorneys advise management about meeting all SEC regulations for that particular company going for an IPO. In order to re-assure potential investors, the accountants issue opinions about the company's financial statements. The preparation of the prospectus and other written tools involved in marketing the offering is been handled by the financial printer.

The small business must prepare an initial registration statement according to SEC regulations, after putting together a team in order to handle the IPO. A prospectus containing the detailed information about the company, including its financial statements and a management analysis, is the main body of the registration statement. So in the IPO process the analysis of management is perhaps the time-consuming and most important part. All of the potential risks faced by the business have to convince the investors saying that it is a good investment, and even the small business owners have to disclose simultaneously. In order to ensure compliance with SEC rules about truthful dis-closure, this section is particularly worded very carefully and been reviewed by the company's attorneys. Regarding public stock offerings, the SEC rules are contained in two main acts: The Securities Act of 1933 and the Securities Act of 1934. In order to protect the public against fraud, the former concerns the registration of IPOs with the SEC, while the latter regulates companies after they have gone public, reporting procedures and outlines registration, and further it sets forth trading laws of insider. After the completion of initial registration statement, it is sent for the review SEC. The company's attorneys remain in contact with the SEC in order to learn of any necessary changes, during the review process, which can take up to two months. In accordance with SEC rules, the company's financial statements must be audited by independent accountants during this particular time. The review than that of usual accounting, this particular audit is quite more formal and provides a much higher degree of assurance to the investors with about the financial position of the company.

The company also begins making controlled efforts to market the offering, throughout the SEC review period—which is sometimes called the "cooling off" or "quiet" period. The preliminary prospectus is been distributed by the company to the potential investors, and also for the owners of small business and top managers travel around in order to make the personal presentations of the material in what are known as "road shows." During the SEC review period, It is important to note however that management cannot disclose any further information beyond that which contained in the prospectus. Other activities taking place during this time include holding a due diligence meeting to review financial statements one last time and filing various forms with different states in which the stock will be sold (the differing state requirements are known as "blue sky laws").

The SEC provides comments on the initial registration statement, at the end of the cooling off period. Agree to a final offering price for the shares, and file a final amendment to the registration statement, the Company then must address the comments. The actual sale of stock is supposed to become effective 20 days after the final amendment is been filed technically, but the SEC usually grants companies

acceleration so that it becomes effective immediately. Over a 20-day period, this acceleration grows out of the SEC's recognition that the stock market can change dramatically. Beginning on the official offering date and continuing for seven days, the actual selling of shares then takes place. The public sale of the security is been supervised by the lead investment banker. By purchasing shares in the secondary market the investment bankers are permitted to "stabilize" the price of the security, during the offering period. This process is known as pegging, and after the official offering date it is permitted to continue for up to ten days. The investment bankers may also support the offering by selling up to 15 percent more stock during the time of high demand , or by through overallotment.

The underwriter meets with all parties to distribute the funds and settle all expenses, after a successful offering. In order to forward the securities to the new owners, at that particular time the transfer agent is provided with the authorization. With the transfer of the stock an IPO closes, but the terms of the offering is not completed yet. The filing of a number of reports pertaining to the appropriate use of the funds which is described in the prospectus, is been required by the SEC. The underwriter returns the funds to the investors, if the offering is terminated for any reason.

1.2 Objectives of the Study:

- To analyze the different IPO issues in the Indian context.
- To empirically test the underpricing of IPOs in Indian primary market.

1.3 Data Collection and Research Methodology

- The descriptive and exploratory is the research design maintained for this particular study of which the approach of quantitative is been used.
- Study is based on the secondary sources of data and is collected from the capital line data base and other internet sources such as BSE and NSE.

1.4 Review of Literature:

David R. Williams, W. Jack Duncan and Peter M. Ginter (2010) have analyzed the relationship among secondary-market, Pre-market, and the primary-market characteristics. Signalling theories and the agency theories have been utilized in the study. Study examines the high-technology firms which are seeking for an IPO for the agency and market signals which is related to a sample chosen for the study. For the purpose of examining for IPO offer process in high-technology firms a model have been tested. The results of the study indicates the secondary market factors have not affected the offer price of the IPO but the offer price is affected by certain primary market and Pre-market factors which is received by the entrepreneurs and the investors.

Anlin Chen and Lanfeng Kao (2006) investigate to mitigate the winner's curse; a simple way in the process IPO is to lessen the number of investors who are informed in IPO markets. As the study signify that the institutional investors in Taiwan are not permitted to subscribe to IPO's of fixed price. So excluding the institutional investors it raises the uninformed investor's allocation rates. The winner's curse is still present in the Taiwan's fixed price IPO markets as the results which are obtained from the study, even without the institutional investor participation. Underpricing of IPO is reduced by at least 4 percent because of alleviating the winner's curse, as institutional investors are excluded from the fixed price offerings as shown by the study.

Onur Aruğaslan, Robert Kieschnick and Douglas O. Cook (2004) have examined earlier researches which is based on the determinants of the IPOs initial returns which has tended to put emphasize on the uncertainty or the asymmetric information. According to the observation of recent research which suggests that the incentives are created for managers by the monitoring considerations in order to underprice the firm's stock in the process of IPO. Stoughton and Zechner (1998) and Brennan and Franks (1997) in order to underprice the firms' IPO's it provides a contrasting arguments that why monitoring considerations creates an incentives for the managers. Smart and Zutter (2003), study have examined these arguments using a sample size of U.S. IPO's and the evidence obtained for the study suggests that the determinants of initial returns .

Juseong Kim (1999) has made an examination that capital market imperfection, such as the information asymmetry, increases the cost of external funds compared to that of the internal funds. And quite obviously this phenomenon creates financing constraints which limits the availability of external funds and makes the corporate investment excessively sensitive to the cash flow. The study has made an attempt to analyze the effect of financing constraints on the investment decisions by making the comparison of the financial behaviour of Korean firms before and after their stocks which is newly listed in the stock exchange. The results of the study suggested that the sensitivity of investment to the cash flow will be higher during the period before IPO's than after IPO. The study has also shown that the effect of financing constraints relaxation by IPO is more prominent in small than in the large manufacturing firms.

Qiming Wang and James A. Ligon (2009) have examined the extant literatures which documents that insurance IPO's are less underpriced compared to that of non-insurance IPO firms. For the regulated firms the observed difference is attributed towards the lower asymmetry of information. Study finds that for the purpose of the file price adjustment when one controls for the IPO's of insurance, both the mutual as well as the stock, are no less underpriced than the other offerings of non-insurance IPO's, by signifying that the process of book building resolves any such type of asymmetries of information's. Study also have found that the mutual IPO's appear to be more underpriced compared to that of stock insurance IPO's, but the difference which is arising is connected to the difference in the pre-issue managerial ownership.

1.5 Data Analysis and Interpretation:

Descriptive Statistics

Table: 1 shows the value of skewness

Table: 2 Shows the frequency of companies

Mean	3.659635512
Standard Error	1.641473467
Median	0.25
Mode	20
Standard Deviation	22.32645295
Sample Variance	498.4705015
Kurtosis	17.74082333
Skewness	1.130004402
Range	249.089899
Minimum	-97.14545455
Maximum	151.9444444
Sum	677.0325697
Count	185
Mean	3.659635512
Standard Error	1.641473467
Median	0.25
Mode	20

Bin	Frequency
-90	2
-65	1
-40	2
-15	4
10	138
35	29
60	7
85	0
115	1
More	1

Table 1: Shows the value of positive skewness representing the presence of underpricing for the invested investors for which the invested investors get the positive returns because of the presence of phenomenon underpricing.

Table 2: Shows the no of companies scattered and we can observe there are around 138 frequencies in bin 10.

Graph - 1: Shows histogram for the IPO issues for the years 2012 to 2017

Interpretation:

- The value of skewness obtained from the data analysis for the different years, which is from 2012 to 2017 histogram is 1.13.
- The value obtained is positive which represents the presence of positive skewness.
- Hence it can be concluded that there exists a phenomenon of underpricing as the returns obtained by the investors are quite positive.

1.6 Conclusion:

So finally in the study, by analysing the data for various years of public issues between years 2012 to 2017, it can be observed that in the presence underpricing in the Indian equity market exists. This is because of the presence of positive value of skewness obtained through the analysis. So from the analysis it has been observed that, there is a presence of underpricing in Indian equity market, which is also a widely documented phenomenon as observed in the various extant literatures. Study has considered a data set of around 185 IPO's between the periods 2012 to 2017 for the purpose of analysis. The argument of the Ritter is been accepted by the study, in order to compensate the risk undergone by the investors who are uninformed, underpricing is a pre-requisite. As it is known fact that uninformed investors don't posses any information relating to the company prior to the public issue.

1.7 References:

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