VALUATION OF INITIAL PUBLIC OFFERINGS (IPOs) IN INDIA – AN EMPIRICAL STUDY

Abstract Submitted to the University of Delhi for the Award of the Degree of

DOCTOR OF PHILOSOPHY

By

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JULY, 2012
ABSTRACT

1. BACKGROUND
The Initial Public Offerings (IPOs) are fresh source of capital that is critical to the growth of a company and provide the founder/promoters and other shareholders, a liquid market for their share. From an investor’s perspective, IPOs provide an opportunity to share in the rewards of the growth of company. It is, therefore, important that the quality of the IPOs in terms of its efficiency, enhanced transparency, price discovery process, etc. is brought at par with the international standards so as to inculcate a fair degree of confidence among the investors in the market.

In 1980s and 1990s, there was an increasing realisation on the part of the policy planners in India that an efficient and well developed IPO market is essential for sustained growth in an emerging economy like India. Accordingly, extensive reforms have since been taken for the IPO segment of Indian market, inter alia covering reforms in the legislative framework, trading mechanisms, institutional support, etc. As a result, IPOs have emerged as one of the major source of funds for Indian companies as well as an important avenue for common investors to channelise their savings for higher return. An analysis of the trends in the IPO market in India show that although, there are fluctuating trends, this market will continue to remain an important source of funds in India.

2. RELEVANCE OF THE STUDY
In view of the past studies indicating short-run abnormal initial returns resulting out of underpricing of IPOs and the fact that this segment of market is now a major source for investment especially by the Indian retail investors, there is a felt need to analyse the factors influencing this phenomena and suggest a model the predicting the possible level of underpricing in the country. It is important that the pricing of IPOs truly reflects the intrinsic value of the company. This will enable the potential investors to make informed investment decisions vis-à-vis available opportunities. Beatty & Ritter (1985) their study have hypothesised that underwriters whose offerings have average initial return not commensurate with their ex-ante uncertainty will lose their
market share. This needs to be tested in case of India so that suitable policy suggestions could be made regarding the role of merchant banks in the IPOs process. Previous studies also show that in the long run initial returns become negative over time. Accordingly, a study of factors influencing the long run performance of IPOs and its comparative analysis vis-à-vis short-run factors could be a pointer to important policy change(s).

3. OBJECTIVES OF THE STUDY
Keeping in view the background and the rationale of the research, this study had the following objectives:
- To analyse the pattern of IPOs underpricing across time, issue size and market segment and identify factors affecting short-run underpricing of IPOs in India.
- To suggest a model which could explain the possible level of underpricing for Indian IPOs.
- To examine the relationship between mispricing of IPOs managed/co-managed by investment banks vis-a-vis change in their market share during a given period.
- To identify the factors influencing the long run performance of IPOs.

4. EMPIRICAL FINDINGS
- Although the initial return on Indian IPOs has come down significantly over time, it still seems to be high as compared to other countries.
- The Indian IPOs market is largely speculative in nature where the investors are looking for a very higher return on the investment on the very first day of the listing of IPOs.
- The period of higher market return is subsequently followed by period of high volume IPOs.
- Large offers are expected to have less initial underpricing because they tend to be better priced and are less risky.
- A high level of initial return for market segment like IT & ITeS is on account of difficulties in valuation of their assets which are largely intangible nature. This also indicates that industries with shorter and less information history will be more under-priced.
As far as banks and financial services are concerned, since their projected cash flows depend on the future direction of interest rates, this results into higher uncertainty leading to a high degree of underpricing.

The valuation for infrastructure, power, oil & gas segment is again based on their discounted cash flows and research and development. This makes the valuation relatively uncertain resulting into higher underpricing.

The model suggested for determining the possible level of short run underpricing consist of 9 significant variables, namely, time subscribed, company size, investor sentiment, Uses, listing delay, industry PE ratio, investment bank reputation, private companies IPOs and companies representing the new economy such as IT & ITeS, telecom, biotech, etc. Based on the suggested model, the predicted short-run underpricing comes out to be 26.11 % which is higher than actual short-run underpricing of 24.93%. This shows that the market for Indian IPOs are overpriced and the difference of (-) 1.18 is recovered through price correction over a period of about 6 months.

In the long-run (up to a time frame of 3 years) the returns on Indian IPOs becomes negative. The results show that the first day initial return of 24.93% becomes negative in the subsequent periods up to 6 month before marginally going up to 2.30% at the end of 1 year. However, the returns thereafter become negative at the end of second year (-9.94%) and this trend still continue even up to 3 years (-11.63%).

If an investment bank misprices an IPO during a given period, it will be penalised by the market players in terms of decline in its market share (proxy for investment banks reputation) in the subsequent period. This precise relationship may be noisy in terms of statistical findings, however, the directional change in the market share as a result of mispricing is not ruled out totally.

An analysis of the parameters influencing the long term return shows that factors like inflation, industrial growth, GDP growth, interest rate become significant factors in determining the return over long term period. However, there are other industry/market related factors and company/issue related information which may also influence the long term return at different point of time depending on the diffusion of the information at different point of time.