An Empirical Study of Underpricing in Initial Public Offerings

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Abstract:

IPOs have prompted several researches since they are one of the most important business procedures. With the aim of identifying the most tenable explanation from the available research, this study reviews the widely accepted theories for the underpricing of initial public offerings (IPOs) and divides the most recent literature into two categories: informative and uninformative.

Keywords: Initial Public Offering, Asymmetry, Underpricing.

Introduction:

An initial public offering (IPO) is one of the most prominent methods used by cash-strapped companies to raise capital. Initial Public Offerings (IPOs) have been in high demand on the primary stock market, making it challenging for businesses to identify what a reasonable IPO pricing should be. Every piece of information that is readily accessible to investors has a significant role in determining whether an IPO is overpriced or underpriced. Investors now create long-term plans for their portfolios using a number of data sources. Investors are now needed to carefully study the IPO prospectus since issuing corporations must now abide by the facts and figures disclosed in it because they are compelled to do so by law.

The IPO documentation is a legally-binding document for the company, investors, and underwriters, ensuring that all necessary and correct information is included and presented to the potential investors in line with the requirements established by capital market regulatory bodies. An initial public offering (IPO) is when a firm offers its stock to the public for the first time. A company can access the equity capital of the investing public by going public.

Initial public offerings hit a historic low in 2008 as a result of the financial crisis. Following the economic collapse that followed the 2008 financial crisis, IPOs ceased, and new listings were uncommon for a period. Unicorns, or firms valued privately at more than $1 billion, have recently risen to the forefront of much of the IPO discussion. Whether a business will do an initial public offering (IPO) or not is a topic of intense curiosity among investors and the media.

Asymmetry of Information:
Both the corporation issuing the securities and the investors has access to a sizable but extremely diversified pool of information during an initial public offering. This knowledge gap is referred to as "information asymmetry." This lack of transparency has an impact on all three parties involved—the issuer, the underwriter, and the IPO investors.

It depends on how difficult it is for the issuer to gauge how much underpricing resulted from information asymmetry. Investors can be categorized into two groups based on how much information is lacking: those who are informed and those who are not. Therefore, the amount to which an issuer/underwriter purposefully undervalues an offering in order to entice investors, to eliminate out any risk of a failed issuance.

Objectives:
This study's primary goal is to assess existing underpricing ideas and assess their strengths and weaknesses.

IPO Underpricing:
Underpricing in an IPO occurs when the issuer and investors disagree on the value of the company's shares. A range of endogenous and exogenous factors may have an impact on this, and those factors may either serve to reduce the perception mismatch or aggravate it. By gathering and categorizing information on many traits from earlier study, we want to elaborate on a variety of them in this work.

Earlier Reilly and Hatfield's paper "Investor Experience with New Stock Issues" is frequently considered as the first instance of IPO underpricing evidence in the literature. Using a short dataset, this study examined 53 new stock offers between December 1963 and August 1964, as well as between January 1965 and June 1965. They evaluated the IPO's early success by contrasting the offer price with the closing price on the first Friday following listing. The information revealed that 31 equities, or more than half of the issues, had short-term returns that were, on average, 18.3% greater than the market. The study discovered that new issues perform very well by comparing the returns on the first Friday, the fourth Friday, and one year after issuance. There were two issues with the study, though.
First, the authors acknowledge that the market was booming at the time of the study, which indicates that there was a brisk demand for new issues. Second, the authors compared the excess return of the study to the excess return of the price-weighted Dow Jones Index. The observed excess returns, they added, are much lower than the Over-the-Counter Industrial average. The most recent stocks offers are underpriced, according to Reilly and Hatfield, who provided various tautological justifications for this finding. Their initial justifications Centre on the standard practice where the issuer and underwriter work together to set a price. They argue that

1) Because new equity offerings are unseasoned, underwriters are unable to assess investors' perceptions of them, which might lead to the observed underpricing.
2) The underwriters overpriced the issuance, resulting in higher first-day returns, which is why it will succeed.
3) Because their capital bases are proportionately diminished by the quantity of underwriting they conduct, underwriters seek a quick sale to lower their risk.
4) Underwriters would underprice since successful offerings do not require their involvement and would result in a higher price for investors because they are permitted to take stabilizing action in case of higher volatility under Securities and Exchange Commission (SEC) oversight, which ties up their cash and resources.
5) Since a portion of their fees are paid in shares or they have the opportunity to buy a sizable block of stock at a price near to or below the issue price, brokers immediately profit from a successful issue.

The issuer, on the other hand, is prepared to accept less cash in order to appease the investors and guarantee the success of any subsequent offering.
This information is essential for the firm to have because a single share offering is rarely enough to cover a company's financial demands. In the hopes that the new owners will contribute to any additional capital requirements, the corporation issuing the securities would prefer to take lower proceeds.

Theories of Underpricing:

1. Non informational Theories of Underpricing:
The non-informational theories of underpricing face the danger of being ineffective since prices are constant. Because the price determined is never entirely precise, the market price of a company's shares is probably too low. Going public necessitates filing numerous 'self-revelatory' disclosures from the standpoint of Legal Expenses, as Ibbotson attempted to explain in 1975. Prospect theory predicts that people place a considerably larger value on avoiding loss than they do on acquiring something. As a result, if the price decreases, discontent develops. If shareholders are happy, the business may not need to spend as much on legal bills.
The alternative non-informational hypothesis was developed by Booth and Chua in 1996. They claimed that the low selling price was a strategy used by the current management to stave off a hostile takeover by a group of shareholders hoping to gain control of the firm by collecting a sizable number of shares. Managers may be able to share the possession if they underprice. As a result of the cost of the data, their findings suggest that underpricing is linked to ownership heterogeneity. Similarly, there is not much evidence to support this position.

2. **Informational Theories of Underpricing**:
When it comes to the contribution that asymmetric knowledge makes to underpricing, there are three different schools of thinking. The first group of parties engaged consists of investors and issuers. In the second, underwriters and investors are involved. The third is between knowledgeable traders and uninformed financiers.

Ibbotson contends that high value organizations would accept lower IPO price to "leave a good taste in investors' mouths" for future offerings where there is a disparity in the quantity of knowledge accessible to each side. As a result, the exact same issuer can underwrite rates in later underwritings that are more enticing. Only high-quality businesses can pay the signaling costs after demonstrating their value through later, more expensive IPOs. The idea so provides justification for underpricing as a way for a good firm to differentiate itself from a poor one. Additionally, underpricing can make it easier for businesses to go public in an effort to get more attention. 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: Investor knowledge asymmetry is a topic that has been well studied. Some investors have more expertise than others. As a result, research on IPO underpricing is necessary, and this article focuses on its many hypotheses. They have a far better understanding of which companies are undervalued and which are overpriced. The Winners Curse Model was developed in 1986 as a result of articles by Rock, Beatty, and Ritter. In the future, the researcher can examine how underpricing in IPOs affects other sectors.

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