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Investment strategy for initial public offers: An empirical evidence

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Abstract
This paper is an endeavor to frame the strategy regarding investment in Initial Public Offers. On the grounds of the price behaviour of Initial Public Offers of fifteen years, study suggests the exit timing from Indian IPO market. Study covers IPOs offered through BSE during years from 1993 to 2007. The price behaviour of IPOs has been examined by using price performance indicator i.e. wealth relative (WR). The study examines the price behaviour of selected IPOs in India up to three years from the listing day. A sample of 488 IPOs offered during the year 1993 to 2007 has been considered to study the price behaviour of IPOs.

Keywords: Wealth Relative, Initial Public Offers, Price Behaviour, Price Performance, Investment Strategy, Primary Market.

Introduction

Capital Market can be categorized in two segments, primary market & secondary market. Primary market mobiles the savings of the economy and provides funds to enterprises. In developing countries like India, companies need huge size of capital for expansion and diversification. Initial Public Offer (IPO) has been considered the most popular tool to pool the saving of general public. An initial public offer is the first sale of stock by a public limited company to the public. IPO market in India has displayed many ups and down during the last two decades. It has observed a sharp rise in the initial years of the liberalized era. The growth observed during the first half of the 90s is mostly credited to the financial liberalization of the economy. Capital market reforms boost up the confidence of investors. But for investors, it is almost unpredictable to decide the holding period generating highest rate of return for IPOs. The study has been conducted to find out the accurate holding period or the right point of time to exit from IPO to score higher capital gain. To attain the key objective of the study IPOs offered through BSE during January 1, 1993 to December 31, 2007 have been covered.

Activity of Indian Ipo Market

IPO market has showed a sharp rise from 692 issues for Rs. 7864 crore during 1993-94 to 1239 IPOs for Rs. 16572 crore during 1994-95. There was a marked decline in the number of IPOs and amount raised through them in 1996-97, mainly as a result of stricter eligibility criteria for public issues imposed by SEBI. The number of IPOs declined to 717 amounting to Rs. 5959 during 1996-97. The number of IPOs further declined in 1997-98 to 52 amounting to Rs1048 crore. The decline in the share of IPOs can be partly attributed to the decline in industrial activity in the country and partly due to strict entry point norms, which disallowed green field projects without track record from accessing the market (Annual Report, SEBI, 1997-98). That’s why, year 1997-98 considered as a part of cold or slump period of Indian IPO market.

For the year 1998-99, only IPOs 18 for Rs. 404 crore were issued. The deficiency of issues of good quality, lack of confidence of investors in new companies and depressed secondary market, were some of the reasons, which slowed down the growth of IPOs (Annual Report, SEBI, 1998-99). There was a recovery in the market the number of IPOs during 1999-00 to 51 for Rs. 2719 crore from 18 IPOs for 404 Rs. crore and their successful subscription indicated the restored enthusiasm and confidence of investors to invest in new companies especially in knowledge based industries particularly in information technology and healthcare IPOs(Annual Report, SEBI, 1999-00). This tendency continued for 2000-01 when number of IPOs increased to 114 amounting to Rs. 2722 crore. The number again declined to 7 IPOs amounting Rs. 1202 crore during 2001-02. The number of IPOs is very low in 6 and 21 for the year 2002-03 & 2003-04 respectively. In 2004-05 Indian IPO market experienced a boom like situation 23 IPOs collected Rs. 13749 crore. In 2005-06 number of IPOs increased to 79 but amount raised declined to 10936.The momentum witnessed in the primary market as compare to 2005-06 increased in 2006-07.

Strong macro-economic fundamentals, favorable investment climate, encouraging corporate results, and buoyant secondary market performance supported by institutional investors encouraged a number of companies to raise capital from the primary market (Annual Report, SEBI, 2006-07). Boom also continued for year 2006-07 and 2007-08. In 2006-07 number of IPOs increased to 77 amounting Rs. 28504 crore. The upward trend in primary market activities continued in 2007-08. The buoyancy in the secondary market coupled with strong macro-economic fundamentals, active institutional support led by FIIs and mutual funds encouraged large number of companies to raise resource from the primary market (Annual Report, SEBI, 2007-08).

IPO market touched its leaps and bounds in 2007-08, 85 companies collected Rs. 42595 through their IPOs. The Indian securities markets displayed downward trend in 2008-09. The downswing in the domestic equity markets was in consonance with the downward spiral in global equity markets triggered by the international financial crisis. Sharp fall in the benchmark indices, across the board fall in share prices, decline in market capitalization, turnover and soaring volatility characterized the stock market behavior during 2008-09(Annual Report, SEBI, 2008-09). But, the Indian primary market again remembered its golden era. The continuous growth has observed in Indian IPO market for the year 2009-10, 2010-11, and 2011-12. The number as well as amount raised by IPOs has witnessed a constant expansion during these years.

Indian IPO market has witnessed boom in 1993-94 to 1996-97. But 1997-98 to 2002-03 can be considered as a cold period for Indian primary market. Although, in year 1999-00 and 2000-01 IPO market tried to recover but again failed in 2001-02 & 2002-03. During 2004-05 to 2007-08, again Indian IPO market experienced its golden days. These ups and downs attract the researchers to study the Indian IPO market. The study covered the pricing behavior of IPOs up to 36 months from the date of issue listing, that is why, IPOs issued up to 2007-08 are considered.

Review of Literature

In India numerous studies have been conducted to determine the extent of underpricing & after market price performance but the framing investment strategy for IPOs is uncovered. The study is an attempt to frame investment strategy for IPOs. The present section enlightens the views of various studies conducted in India regarding IPOs.

Sehgal Shikha & Singh Balwinder (2008) [1] has conducted a study to check underpricing and long run performance of 438 Indian initial public offers listed on BSE during june1992-march 2001. The mean underpricing has been found to be 99.2 percent, which is very high if compared with international evidence. Age of the firm, listing delay at IPO and number of times the issue is subscribed have been found to be the significant determinants of underpricing. Indian IPOs do not tend to underperform in the long-run. Average BHAR after 60 months of listing was 90.13 percent.

Sahoo Seshadev & Prabina Rajib (2010) [2] covered 92 Indian IPOs issued during the period 2002-2006. It is reported that on an average IPOs are underpriced to the tune of 46.55 per cent on the listing day. The long run performance of IPOs upto a period of 36 months are measured by using wealth relative (WR) and average buy and hold abnormal return (BHAR), both being adjusted with market index, CNX-Nifty. The average BHAR after 3 years reported 41.9 per cent on offer price.

Jain Neeta C & Padmavathi (2012) [3] study on 227 book-built IPOs for the period of 2004-2009 found that the average underpricing during this period was 28 percent while the maximum underpricing was around 242 per cent.

Kumar Vinod & Dhanda Neelam (2013) [4] cover 488 IPOs offered through BSE during 1993 to 2007; study proves existence of underpricing in Indian IPO market. Average market adjusted return & wealth relative are used as price performance indicators, both being adjusted with BSE index-Sensex. The average market adjusted abnormal return has been reported 82.67 per cent on the listing of IPOs. All the twenty three sectors have shown existence of underpricing with more than one value of wealth relative.

Kumar Vinod, Dhanda Neelam (2013) [5] compared at par (170) & premium (318) IPOs, the degree of underpricing for at par IPOs reported significantly higher as compare to premium IPOs.

Kumar Vinod, Dhanda Neelam (2013) [6] proved through multivariate regression model that level of subscription has significantly positive impact on underpricing of initial public offers on listing day. It has been also reported that offer price and offer size have negative impact on underpricing.

Kumar Vinod, Dhanda Neelam (2013) [7] tested the different multivariate regression models related to level of subscription of the 488 IPOs. In total, three models of subscription have been tested. The strongest model is based on Offer Price and Index Return (one month before the IPO Sensex return). OP & IR have significant positive impact on level of subscription. The contribution of AGE, Offer Size & Post Issue Promoter Holding is insignificant; therefore these determinants have been excluded by stepwise method of multivariate regression. It is concluded; companies going for public with high premium and at the time of hot market or boom (secondary market is performing well) can get higher level of subscription.

Research Methodology

Objectives of the study

The study has been carried out to frame the investment strategy for Indian IPOs and also to present the comparative position of fifteen years' IPOs highest WR at different points of time after listing.

Sample Plan of the study

This study is based on equity shares initial public offers offered on BSE during 1993-94 to 2007-08. For the years from 1993-94 to 1996-97, it was not feasible to cover all the IPOs offered due to their large number. Therefore, systematic random sampling is used and 400 companies are selected for the study, but due to non-availability of data 166 are companies finally considered for the study related to this time period. 322 companies have been taken for the years from 1997-98 to 2007-08.Thus, in total a sample of 488 companies has been constituted. The companies which issued right issue, bonus issue & who changed the face value of the share during first three years of the IPO listing have been excluded to maintain the accuracy level of the computations of the return.

Data Collection

To achieve the objectives of the study, secondary data is used. Secondary data is collected from the different sources such as: annual reports of SEBI, Prowess, Prime database, The Economics Times, www.icicidirect.com, www.bseindia.com. & www.sebi.gov. in..

Analysis Pattern of the Study

Wealth Relative has been used to assess the price performance IPOs & to frame the investment strategy. The following pattern has been used to determine the value of Wealth Relatives.

<u>Raw Return/Return on a Stock</u>

$Ri = (Pi/Po)-1*100$

Where, Ri (in %) is the shareholders' raw return, Pi is the closing price on the first day of trading and Po is the offer price.

Return on Market Index

The return on the market index Rm (in %) during the same period is calculated.

$Rm = (Pm1/Pm0)-1*100$

Pm1 denotes the closing value of the benchmark index on the first trading day of the stock and Pm0 is the closing value on the benchmark index on the offer's closing day. The BSE Sensex is used as the benchmark index.

Wealth Relative

A wealth relative greater than unity implies that IPOs outperformed the benchmark index in that period, while a wealth relative below the value one indicates underperformance. Wealth relative is computed as follows:

$$WR=\frac{1+\frac{1}{N}\sum_{i=1}^{n} ri}{1+\frac{1}{N}\sum_{i=1}^{n} rm}$$

Where,

N= Total number of IPOs in the sample

Ri = Ri/100

Rm = Rm/100

Analysis & Results

Framing of investment strategy on the basis of WR

This section compares the highest WR of the concerned year. Table 1 shows the highest WR of the concerned year. WR is a parameter to evaluate the wealth of the investors.

Table 1: Framing of investment strategy on the basis of wealth relative

Year	Time Point of Maximum WR	Maximum WR
1993-94	After listing one year	2.0772
1994-95	After listing six months	2.7584
1995-96	After listing six months	1.1774
1996-97	Listing day	1.2880
1997-98	Listing day	3.1732
1998-99	After listing three years	2.7036
1999-00	Listing day	7.2974
2000-01	After listing one month	1.5086
2001-02	Listing day	1.5502
2002-03	After listing two years	3.4180
2003-04	After listing one year	3.9686
2004-05	After listing one year	2.1001
2005-06	After listing two years	1.5485
2006-07	Listing day	1.2070
2007-08	Listing day	1.2809

Table 1 shows the highest WR of the concerned year. WR is a parameter to evaluate the wealth of the investors. The maximum WR is 7.2974, which is related to year 1999-00 IPOs on the listing day of the issue.

It is found that IPOs of six out of fifteen years showing their highest WR on the listing day of the issue. Investors could earn the highest return by selling their IPOs on the very first day of IPO trading. Only one year IPOs (1998-99) reported highest WR after listing of three years. Moreover, only two years IPOs (2002-03, 2005-06) scored its highest WR after listing two years.

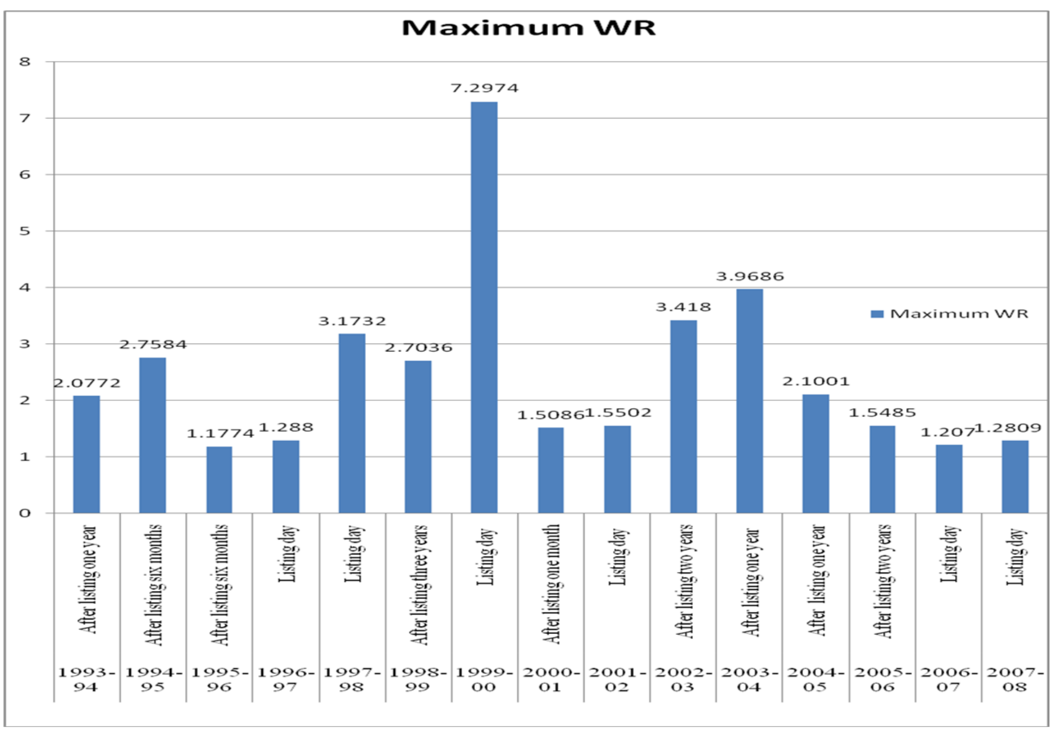

Fig 1: Framing of investment strategy on the basis of wealth relative

Table 2: Consolidated view of wealth relatives

Sr. No.	Time Point of Maximum WR	No. of Years
1	Listing day	6
2	After listing one month	1
3	After listing two months	Nil
4	After listing three months	Nil
5	After listing six months	2
6	After listing one year	3
7	After listing two years	2
8	After listing three years	1

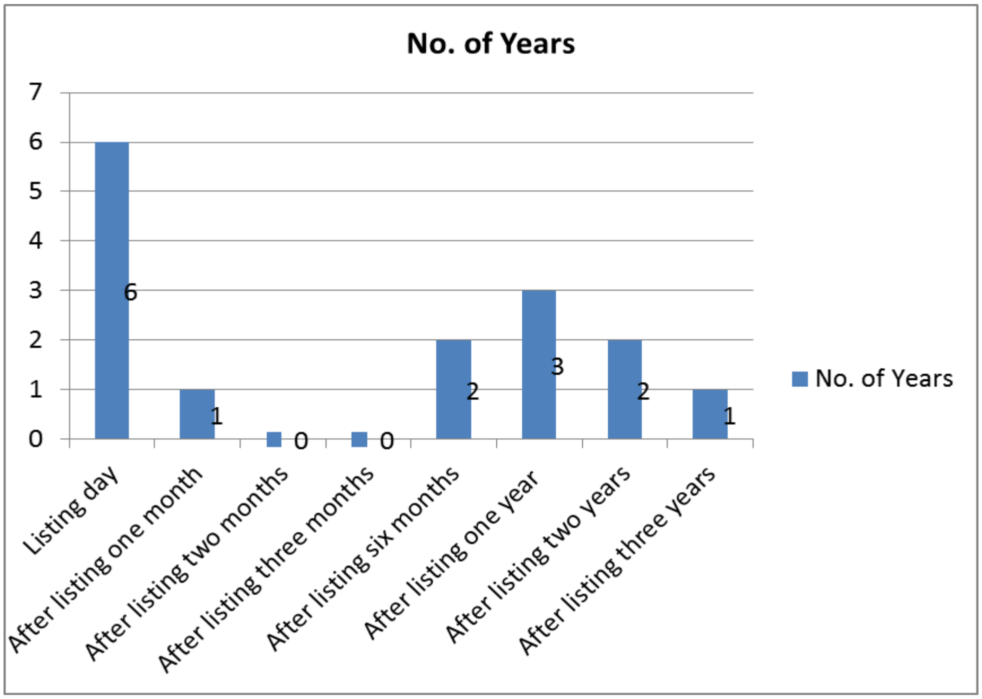

Fig 2: Consolidated view of wealth relatives

It is also evident that IPOs of nine years out of fifteen have their highest WR after listing six months or before it. It is concluded on the base of above argument that investors should exit before two years of the IPO launching. Even, Investors can earn an attractive amount by selling the share on the very first day of its listing. It is also noticeable that the WR for the all 488 IPOs is highest on listing day of the issue. No doubt a short-run investment in IPOs is more attractive rather than long-run, but it does not mean that there is underperformance in IPO market upto 36 months of the listing. The level of underpricing declines in long run but there is no negative returns or underperformance. WRs for the all 488 IPOs are greater than one for short-run as well as long run.

Conclusion

It is evident that short run investment is advisable in Indian initial public offers as compared to long run. It is noticeable that investors can earn considerable capital gain by selling IPOs on the very first day of trading or listing day. Wealth Relatives of six out of fifteen years have been scored the highest level on listing day of the Initial Public Offers. Although, in Indian IPO market there is no clue of underperformance in long run, suggested by various studies. Study proved that price performance of IPOs declined continuously after listing but no sign of underperformance in Indian IPO market.

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