Article

Perspective on Underpricing of IPOs in Emerging Economies

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Abstract

Pricing of initial public offerings (IPOs) has received considerable attention from the perspective of asymmetric information theories, among others. Specific aspects of emerging markets have been incorporated into models to explain the varying degrees of underpricing. Using three features that are deemed to be important for such economies, that is, principal–principal conflicts, disclosure norms and legitimacy of the top management, and two different classes of investors, institutional and retail, two frameworks have been designed to explain the expected levels of underpricing under various pair-wise combinations of these parameters. The state of the secondary market, which is an important determinant of the decision to go public, is incorporated into the framework.

JEL Classifications: G3, G14, G15, G18

Keywords

Underpricing, IPOs, principal–principal, market sentiment, firm quality, disclosure

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1. Introduction

A significant amount of research in the domain of information asymmetry, some of which is reviewed later, has been generated to explain the underpricing of initial public offerings (IPOs). Whether the features associated with emerging markets lend themselves fully to an interpretation along these lines is the motive for undertaking this study.

The notable article on information asymmetry is based on the work by Rock (1986). His model decomposes investors into informed and uninformed. The asymmetric information between the two parties is responsible for issues to be underpriced so as to attract the uninformed into the market. Dolvin, Hogan, and Olson (2008) while studying equity carve outs have concluded that 'information asymmetry forces issuers to offer shares at a discount, thus suggesting a positive relation between information asymmetry and money left on the table'. Marisetty and Subrahmanyam (2010) studied Indian IPOs during 1990–2004 to test whether group affiliation affects the extent of underpricing. They found that group affiliation results in lower underpricing. This points to the fact that 'valuations of group firms exhibit the effects of higher information asymmetry'. Kong, Xiao, and Liu (2011) in a study of Chinese firms found that 'the degree of information asymmetry on the stock market has a remarkable diminishing effect on the sensitivity of firm investment to the stock price; and sensitivity of stock to stock price will increase with the increasing of information asymmetry in stock market'. The role of corporate governance in underpricing was examined by Akyol, Cooper, Meoli, and Vismara (2014). In their study of European IPOs they found that by improving transparency and the quality of financial statements, information asymmetry is reduced leading to reduced underpricing. When studying IPOs offered by banks in Italy, Regalli and Soana (2013) found that information asymmetry between the issuers and underwriters is a key factor that can explain underpricing. Banerjee, Dai, and Shrestha (2011) have reported that 'levels of insider–outsider information asymmetry and outsider–outsider information asymmetry are both positively associated with IPO underpricing'. Chemmanur, Hu, and Huang (2010), using transaction-level institutional trading data, found that institutional investors 'possess private information about IPOs and that underpricing is a mechanism for compensating them to reveal this private information'. The findings by Chemmanur et al. (2010) suggest that 'management quality and reputation are indeed important dimensions of firm quality even for firms that have matured beyond the IPO'. The findings are 'consistent with the ability of better and more reputable firm management to convey the value of their firm more credibly to outsiders, thus reducing the information asymmetry facing the firm in the equity market, even in the context of an SEO'. The study by Lee, Kuo, and Yen (2011) establishes that 'dividing market states will provide more insights and a greater variety of information as investors make decisions'. It is thus important to look at the bearish, bullish and range-bound markets.

2. Initial Public Offering Pricing in Emerging Markets

2.1 Factors Influencing Pricing of Initial Public Offerings

Literature on the pricing of IPOs in emerging markets in the recent past has identified a few factors that are relevant in this context. Three factors that merit attention are as follows:

1. Principal–principal (P–P) conflicts that reflect asymmetric information among the investors of the firm;
2. Legitimacy of the top management that relates to the quality of the firm; and
3. Role of disclosure norms as stipulated by the regulator, which reflects the amount of information that is mandated to be made available by the firm to the investors.

When formal institutions are not developed to the desired extent and when there is an allegiance of managers to controlling shareholders, P–P con‡icts arise. As Lin and Chuang (2011) have stated, '… controlling shareholders engage in the expropriation of minority shareholders'. They have argued that increases in P–P con‡icts are likely to accentuate IPO underpricing. As regards firms with high quality, they tend to underprice to a greater extent than firms of low quality in order to signal their superior status (Hameed & Lim, 1998; Zheng & Stangeland, 2007). As Shi, Pukthuanthong, and Walker (2015) have mentioned, 'Regarding the agency cost arising from con‡ict of interest between minority and controlling shareholders, the new minority shareholders will likely price-protect themselves by demanding a deeper discount when they purchase new issues at the IPO'. They further state, at another point, in their article, 'More stringent disclosure requirements are associated with lower IPO underpricing'.

Aspects relating to firm quality and market sentiment in in‡uencing Indian IPO investors are discussed at length (Neupane, Paudyal, &

Thapa, 2014). The authors argue that it is important to look at the two classes of investors, retail and institutional, separately in an emerging market such as India since each category is guided by a different set of factors. While institutional investors base their decisions on flrm quality, retail investors are in‡uenced by market sentiment (consisting of an active grey market).

2.2 Proposed Frameworks to Explain Underpricing in Emerging Markets

Drawing on the work cited in Section 2.1 and taking into account certain differences between developed and emerging markets, interactions relating to flrm quality (that represent legitimacy of the top management), disclosure norms and P–P problems are discussed under two situations. The flrst framework presumes that institutional investors are the key players in‡uencing IPO prices and the second framework is suggested in the backdrop of retail investors playing the dominant role in the pricing IPOs on the listing day and flrst few days of trading.

3. Framework for Underpricing Under Different Types of Investors

3.1 Understanding Underpricing When Institutional Investors Have a Significant Role

The relation between P–P con‡icts and disclosure, flrm quality and P–P con‡icts and Firm quality and Disclosure when institutional investors are the dominant players on the listing day (or flrst few days of listing) is summarised in Table 1. This depicts the nature of underpricing resulting from the pair-wise interaction of characteristics and this is in line with most of the explanations advanced in the studies of underpricing undertaken in developed economies. Some of the emerging economies are likely to be moving into this status in the near future and the framework can help assess the expected level of underpricing based on the predominance of factors. This is captured in a three-dimensional diagram given in Appendix A.

What distinguishes these emerging markets at this juncture, however, is the role played by the secondary market in driving prices in the IPO market.

Table 1. Underpricing Levels Expected in the Presence of Institutional Investors

Panel 1: Relation Between Disclosure Norms and Principal–Principal (P–P) Conflicts				
Disclosure Norms (1)	P–P Conflicts (2)	Nature of Underpricing	Resultant Situation of Underpricing	Symbol
Low	Low	More due to (1) Less due to (2)	Average This could be above average since firms would like to have institutional investors' advantage of more underpricing	***
Low	High	More due to (1) More due to (2)	High	ΔΔΔ
High	Low	Less due to (1) Less due to (2)	Low	○○○
High	High	Less due to (1) More due to (2)	Average This is likely to be below average since institutional investors may be dissuaded from participating actively in the IPO market	□□□

Panel 2: Relation Between Disclosure Norms and Firm Quality				
Disclosure Norms (3)	Firm Quality (4)	Nature of Underpricing	Resultant Situation of Underpricing	Symbol
Low	Low	More due to (3) Less due to (4)	Average This could be above average since disclosure norms outweigh participation by institutional investors	***
Low	High	More due to (3) More due to (4)	High	ΔΔΔ
High	Low	Less due to (3) Less due to (4)	Low	○○○
High	High	Less due to (3) More due to (4)	Average This could be above average since institutional investors are active participants	***

(Table 1 continued)

(Table 1 continued)

Panel 3: Relation Between Principal–Principal (P–P) Conflicts and Firm Quality				
P–P Conflict (5)	Firm Quality (6)	Nature of Underpricing	Resultant Situation of Underpricing	Symbol
Low	Low	Less due to (5) Less due to (6)	Low	○○○
Low	High	Less due to (5) More due to (6)	Average This could be above average if institutional participation is high	***
High	Low	More due to (5) Less due to (6)	Average This could be above average since P–P conflict is dominant	***
High	High	More due to (5) More due to (6)	High	ΔΔΔ

Source: The author.

It is conjectured that if the secondary market is on the upswing, then the P–P con‡ict and disclosure norms gain prominence (over flrm quality) and accordingly one has to focus on the triangle RPD to understand the extent of underpricing. If the secondary market is range bound, then disclosure norms and P–P con‡ict gain importance (over flrm quality), and the section RPD is relevant. However, when there is a downswing in the market, flrm quality and disclosure norms are more important (than P–P con‡icts) and the triangle RVD will be useful to understand the extent of underpricing.

3.2 Underpricing Framework When Retail Investors Have a Significant Role

The nature of relationship between the extent of underpricing under different degrees of P–P con‡ict and disclosure norms is as discussed in Section 3.1. The crucial difference in this case is the extent of underpricing that is linked to flrm quality. The argument advanced is that in emerging markets, there could be occasions when retail investors are the signifl-cant players on the flrst day (or flrst few days) in the market for IPOs. Firms that are of high quality will not resort to the signalling mechanism through underpricing. On the contrary we expect high-quality flrms to underprice to a lesser degree, since underpricing has a cost which these flrms would not want to incur. The relation between P–P con‡icts and disclosure, flrm quality and P–P con‡icts and flrm quality and disclosure when retail investors are the dominant players on the listing day (or flrst few days of listing) is summarised in Table 2. This table depicts the nature of underpricing resulting from the pair-wise interaction of characteristics and is advanced owing to the unique nature surrounding businesses

Table 2. Underpricing Levels Expected in the Presence of Retail Investors

Panel 1: Relation Between Disclosure Norms and Principal–Principal (P–P) Conflicts				
Disclosure Norms (1)	P–P Conflict (2)	Nature of Underpricing	Resultant Situation of Underpricing	Symbol
Low	Low	More due to (1) Less due to (2)	Average. This could be below average since retail investors do not demand too much of a compensation owing to the low level of P–P conflicts.	□□□
Low	High	More due to (1) More due to (2)	High	ΔΔΔ
High	Low	Less due to (1) Less due to (2)	Low	○○○
High	High	Less due to (1) More due to (2)	Average This is likely to be above average owing to the actions of the controlling shareholders.	***
Panel 2: Relation Between Disclosure Norms and Firm Quality				
Disclosure Norms (3)	Firm Quality (4)	Nature of Underpricing	Resultant Situation of Underpricing	Symbol
Low	Low	More due to (3) More due to (4)	High	ΔΔΔ
Low	High	More due to (3) Less due to (4)	Average This could be below average since retail investors are active participants	□□□

(Table 2 continued)

(Table 2 continued)

Disclosure Norms (3)	Firm Quality (4)	Nature of Underpricing	Resultant Situation of Underpricing	Symbol
High	Low	Less due to (3) More due to (4)	Average This could be above average since the firm, on account of its quality and stringent disclosure norms to be followed, would like to have its issue sold out	***
High	High	Less due to (3) Less due to (4)	Low	○○○

Panel 3: Relation Between Principal–Principal (P–P) Conflicts and Firm Quality

P–P Conflict (5)	Firm Quality (6)	Nature of Underpricing	Resultant Situation of Underpricing	Symbol
Low	Low	Less due to (5) More due to (6)	Average This could be below average since retail investors do not demand too much of a compensation owing to the low level of P–P conflicts	□□□
Low	High	Less due to (5) Less due to (6)	Low	○○○
High	Low	More due to (5) More due to (6)	High	ΔΔΔ
High	High	More due to (5) Less due to (6)	Average Underpricing is likely to be below average if the CEO is a professional and does not belong to controlling shareholders. Underpricing is likely to be above average if the CEO is from the family that runs the business.	□□**

Source: The author.

operating in emerging economies. The retail investors here may not act similar to institutional investors. This is a significant departure from the earlier framework and contribution to an understanding of the underpricing phenomenon in such economies. Most of the emerging economies are likely to be in this situation and the framework can help assess the expected level of underpricing, based on the predominance of factors. This is captured in a three-dimensional diagram given in Appendix B.

As in the earlier framework, the status of the secondary market is mapped to the various regions of the figure and using a similar analogy, we can understand the expected underpricing during an upswing and/or normal secondary market condition. The region of relevance is now ACD. The downswing in the market corresponds to the region ABD.

Let us consider the situation where the secondary market is expected to be on the upswing or is range bound. When we compare the regions RPD and ACD, we notice that irrespective of the nature of investors (retail or institutional) who are expected to be the significant players in the aftermarket, the expected underpricing for the two scenarios, that is, high disclosure norms and low P–P con‡ict, and low disclosure norms and high P–P con‡ict, is similar. In the case when both disclosure norms and P–P con‡icts are high, the expected underpricing is below average when institutional investors are the main players, while it is above average when retail investors are in the majority. The extent of the P–P con‡ict has to be probed to understand this better, even more than the nature of disclosure norms. Categorisation of P–P con‡icts across emerging markets lends itself to being classified in buckets that can be mapped on to the amount of underpricing. Given that markets for corporate control are inactive (Luo, Chung, & Sobczak, 2009), and considering hypothesis 2 (Lin & Chuang, 2011), the amount of family ownership is proportional to the degree of IPO underpricing. In the other scenario wherein disclosure norms and P–P con‡icts are low, Framework-A (with institutional investors) posits an above-average degree of underpricing compared to Framework-B (with retail investors). Since P–P con‡icts are not significant, firms would like to take advantage of the prevailing regulatory setting to attract institutional investors who are expected to remain with them for a longer period.

When we expect the market to be on the downturn, the predominant factors that contribute to underpricing are firm quality and disclosure norms. The relevant regions to be compared are RVD in Framework-A and ABD in Framework-B. When disclosure norms and firm quality are high, markets dominated by retail investors are expected to have issues that are underpriced to a lower extent while the presence of institutional investors in such markets is likely to witness IPOs that are underpriced to an above-average extent. The decision of retail investors to participate is perhaps guided more by indicators of sentiment than indicators of firm quality (Neupane et al., 2014). Firms do not want to convey their quality through the signalling mechanism on the account of costs which they are unlikely to recoup through a seasoned offering subsequently. However, the same high-quality firms would want to signal their quality to institutional investors. The motive for this can partially be explained through hypothesis 4 (Neupane et al., 2014) that posits 'Firm quality has limited in‡uence on offer price and initial returns but has a positive in‡uence on the long term performance of IPO firms'. When disclosure norms are high for low-quality firms, institutional investors show little interest on account of firm quality, and the high costs incurred by firms in meeting with disclosure requirements do not permit these firms to leave 'money on the table', resulting in a low degree of underpricing. However these firms do not mind underpricing to an above-average extent when confronted with uninformed investors (the retail segment). After having taken the decision of coming to the market at an inappropriate time (market downturn), they do not want to risk postponing the public offer since there may not be another opportunity to raise money after having made their intentions known to the market. High-quality firms confronting institutional investors, who operate in regulatory environments with low-disclosure norms, would want to signal their quality to these investors by underpricing their issues to a larger extent. However, these firms would want to sell their issue to uninformed investors by underpricing their issue to a below-average extent. When disclosure norms are less stiff for low-quality firms dealing with retail investors, they are very keen (bordering on desperation) to sell the IPO since there may not be another opportunity. In other secondary market environments (range bound or bullish), there could be IPOs of competitors that could make this issue less attractive. Hence they would like to underprice to a greater extent. These very firms when confronted with institutional investors would like their public issue to be lapped up since they would want to take advantage of the disclosure norms that they could hide behind and hence underprice their issues to an 'above-average' level. This is one notch lower than what would be witnessed if retail investors were to align with the firm.

Under what conditions would we expect flrms to operate in the region CBD in Framework-A and PVD in Framework-B? Firms in countries that are making a transition from planned to market-based economies are likely to witness IPOs being offered under a quota system. In their study involving institutional investors, Wan, Yiu, and Wang (2010) found that in environments plagued by little or no knowledge of the quality of issuers and information about the issue, compounded with the absence of an established market mechanism, the amount of underpricing is difflcult to establish. What the frameworks presented here suggest is that whenever transition is closer to completion, the anticipated level of underpricing can be gauged from the relevant section of the diagrams. For instance, in Framework-A, issuers offering IPOs to institutional investors are likely to underprice their offerings to a greater extent if they are of high quality and are beset by con‡icts between controlling and minority shareholders. Firms with similar characteristics in Framework-B (with retail investors who are the predominant players) have something interesting to offer. They will not be underpriced to a great extent, unlike their counterparts in Framework-A. Instead they are likely to experience above-average levels of underpricing if there is a family CEO at the helm of affairs. If a professional outsider is appointed, then there would be a tendency to underprice to a below-average level. This is re‡ected by the coexistence of symbols * and □ in Framework-B. In their study of venture capital investment strategies, Khoury, Junkunc, and Mingo (2015) state that the ‘challenges faced by developing country ventures seeking VC funding at various stages of development are likely to face risks’. Such flrms are likely to be confronted with certain sections of the regions CDB and PDV of the two frameworks.

4. Conclusion

After having surveyed the relevance of information asymmetry in attempting to understand IPO underpricing phenomena in developed economies, three factors that are characteristic of emerging economies were considered. These are related to asymmetric information between the investors (P-P problems), the amount of information mandated to be made available by capital market regulators (the role of disclosure norms) and the legitimacy of the top management sought to be conveyed to investors (flrm quality). Using two similar frameworks that differed in the types of investors participating—one institutional (representing the informed) and the other retail (representing the uninformed)—the anticipated amount of underpricing was sought to be explained alluding to the IPO literature of the recent past. Establishing a link between the position of the secondary market and interaction among the three characteristics pertaining to emerging markets is the major contribution of this study. In the absence of well-developed capital markets and an associated regulatory regime, transition economies are likely to see dominant interaction between firm quality and P-P problems in in‡uencing IPO pricing. This work has provided a divergent perspective for understanding the underpricing phenomena in emerging economies on which future research agenda can be generated. The framework introduced in this study is a pointer to the need for considering theoretical strands, besides information asymmetry, that can provide more relevant and meaningful interpretations of IPO pricing in emerging markets.

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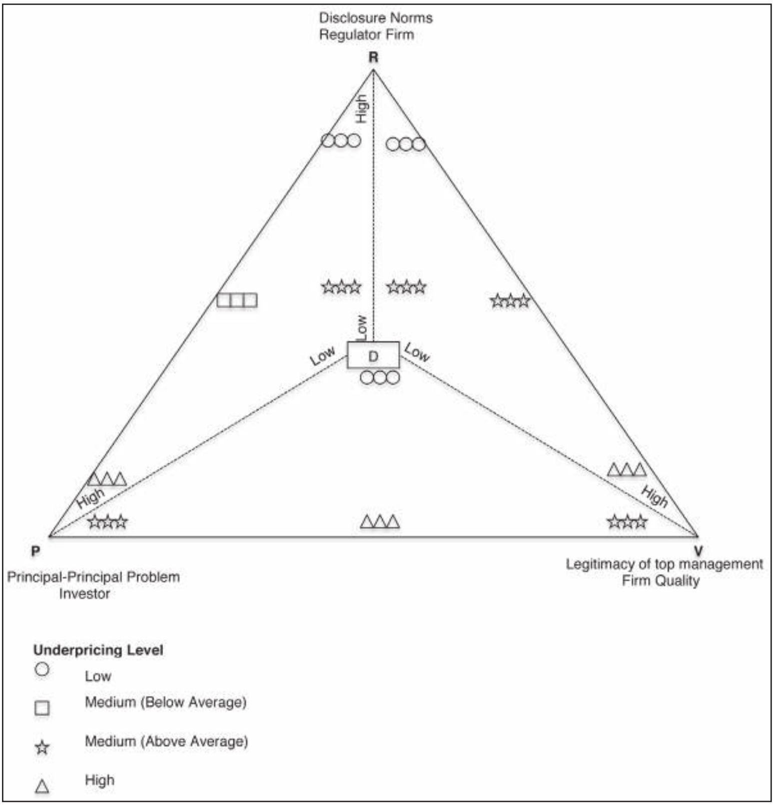
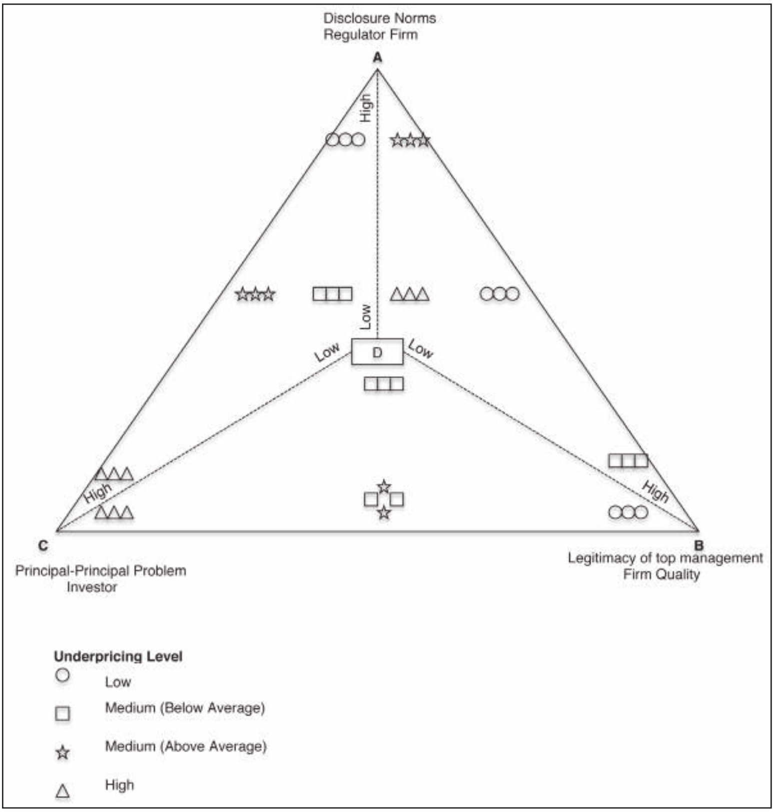
Appendix: A


Disclosure Norms
Regulator Firm
R
High
Low
D
Low
Low
High
High
P
Principal-Principal Problem
Investor
V
Legitimacy of top management
Firm Quality
Underpricing Level
Low
Medium (Below Average)
Medium (Above Average)
High

Appendix: B



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