ANALYSIS OF FIRST DAY RETURNS OF GRADED IPOs

Dr. Chandrashekhar. R*

*Assistant Professor, Department of Business Administration, Mangalore University Mangalagangothri – 574199, D K, Mangalore, Karnataka, India.

ABSTRACT

IPO grading is an independent and unbiased opinion of a credit rating agency. IPO grading is assigned on a five point scale with a higher score indicating stronger fundamentals and poor fundamentals for lower score. Grading is not a recommendation to subscribe an IPO or not. The investor needs careful analysis of the risk factors to make decision regarding investment. This study examine the first day returns of below average grade and above average grade IPO's for the period 2005 to 2011. I find insignificant difference between the first day return of graded IPO. Further the average return of graded IPOs is less than the average return of non graded IPOs. This result reveals that higher grading as such, will not guarantee the superior performance of shares in the market.

KEY WORDS: IPO, Grading, Fundamental, Initial Return, Closing Return.

1.INTRODUCTION

As per SEBI guidelines IPO grading would be applicable to all IPO for which offer documents are filed after April 30, 2007. Grading is not a recommendation to subscribe an IPO or not. IPO Grading is intends to provide the investor with an informed and objective opinion of rating agency after examining the business and financial prospects, management quality and corporate governance practices, future plans etc. IPO grading can act as an

to understand the fundamentals of the companies in a single digit. Therefore IPO grading could be an added investment guidance tool to the investors to make an informed decision. Grading is not a recommendation to subscribe an IPO or not. However, the investor needs careful analysis of the fundamentals of the companies to make decision regarding investment.

2.OBJECTIVES

The evaluation of Indian IPOs is carried out to examine the listing return on Graded IPO investment and to compare the return of below average fundamental and above average fundamental companies.

3.SCOPE AND SAMPLE OF THE STUDY

The study on performance of IPO in India is carried out for the academic propose. We analyse the IPO return over a period of 2005 to 2011. The analysis compared the IPO return associated with IPO with grading and IPO without grading. This study analyse 119 numbers of IPO's issued during the period of 2005-2011. The initial sample consists of 223 IPO's reported in the *www.chittorgarh.com*.

4.SOURCES OF DATA AND SAMPLE

The study is purely based on the secondary data collected from various sources. The IPO details are collected from chittorgarh.com. The share price details were collected from BSE India.com and NSE India.com .the literature relating to earlier research is collected from the Inflibnet data base of UGC. Other literature relating to IPO is collected from different SEB web site and other websites.

5.METHODOLOGY

Two sample z - test is used to analyse th**e** first day return on graded IPOs issued in India. The following two hypotheses are

tested to examine the return on graded and non-graded IPO.

- There is no significance difference between first day opening return of above average grade and below average grade IPO's.
- There is no significance difference between first day closing returns of above average grade and below average grade IPO's.

6.LITERATURE REVIEW OF IPO

Previous studies examined the first day return of IPO in various financial markets. Most of the researchers examine short term and long term performance of IPO in the market.

McConnell and Gary (1987) report that stocks listed on a major exchange have experienced negative returns over the four- to six-week period following listing since at least 1926. They opine that this pattern of returns is vexing because of its persistence and because the data are not consistent with any obvious explanation. Further they report that unlike other security return anomalies, the puzzling pattern in post-listing stock returns cannot be due to the improper specification of an asset-pricing model. They also report that in the four- to six-week period following listing, stock prices, on average, actually decline in value. Dharan and David (1995) find stock returns are generally poor after firms move trading in their stock to the American or New York Stock Ex-changes. They find that post-listing performance is not entirely explained by the equity issuance puzzle although many listing firms issue equity around the time of listing. They reveal that poor post-listing performance appears related to managers timing their application for listing. Further they find that the managers of smaller firms, where initial listing requirements may be

more binding, tend to apply for listing before a decline in performance. They also find that poor post-listing performance is not observed in larger firms. Cogliati et al (2011) study the valuation of companies going public and defines a methodology to infer the growth expectations implicit in the prices of their Initial Public Offering. They find that the estimated growth in cash flow is much higher than its actual realization, with the median IPO firm overvalued at the offering by 74%. They report that the estimation errors increase with IPO firms' leverage and under pricing, and decrease with age, size, and book to- market ratios. Further their tests find that post-IPO stock returns are lower for issues whose implied growth is more upward biased.

Gasbarro et al (2003) find that the initial under pricing is positively related to financial strength as peroxide by cash flow and sales. Further they state that the aftermarket performance results indicate that net income is more highly valued for strong firms. They also find that dividends are valued more highly than earnings retained for firms Mauritius, when net income is separated into dividends and earnings retained. Loughran and Jay (2004) reveal that the average first-day return on initial public offerings (IPOs) was 7% in the 1980s. They also find that average first-day return doubled to almost 15% during 1990-1998, before jumping to 65% during the internet bubble years of 1999-2000 and then reverting to 12% during 2001-2003. They attribute much of the higher under-pricing during the bubble period to a changing issuer objective function. They argue that in the later periods there was less focus on maximizing IPO proceeds due to an increased emphasis on research coverage. Derrien (2005) explores the impact of

investor sentiment on IPO pricing.Using a model in which the aftermarket price of IPO shares depends on the information about the intrinsic value of the company and investor sentiment, he show that IPOs can be over-priced and still exhibit positive initial return. Further he reveals that a sample of recent French offerings with a fraction of the shares reserved for individual investors supports the predictions of the model. Individual investors' demand is positively related to market conditions. He opines that large individual investors' demand leads to high IPO prices, large initial returns, and poor long-run performance. Pastor and Pietro (2005) argue that the number of firms going public changes over time in response to time variation in market conditions. They developed a model of optimal initial public offering (IPO) timing in which IPO waves are caused by declines in expected market return, increases in expected aggregate profitability, or increases in prior uncertainty about the average future profitability of IPOs. Further they test and find support for the model's empirical predictions. They also find that IPO waves tend to be preceded by high market returns and followed by low market returns. Brau and Stanley (2006) conducted survey of 336 chief financial officers (CFOs) to compare practice to theory in the areas of initial public offering (IPO) motivation, timing, under writer selection, under pricing, signalling, and the decision to remain private. They find the primary motivation for going public is to facilitate acquisitions. They also opine that CFOs base IPO timing on overall market conditions, are well informed regarding expected under pricing, and feel under pricing compensates investors for taking risk. They reveal that most important positive signal is past historical earnings, followed by underwriter certification. CFOs

have divergent opinions about the IPO process depending on firm-specific characteristics. They also find that the main reason for remaining private is to preserve decision-making control and ownership. Ellul and Marco (2006) opine that the under pricing of initial public offerings (IPOs) is generally explained with asymmetric information and risk. they complement these traditional explanations with a new theory where investors worry also about the after-market illiquidity that may result from asymmetric information after the IPO. They also reports that the less liquid the aftermarket is expected to be, and the less predictable its liquidity, the larger will be the IPO under pricing. Their model blends such liquidity concerns with adverse selection and risk as motives for under pricing. Using various measures of liquidity they find that expected after-market liquidity and liquidity risk are important determinants of IPO under pricing. Cai et al. (2007) examine under pricing of initial public offerings (IPOs) and seasoned offerings in the corporate bond market. They investigate whether under pricing represents a solution to an information problem or a liquidity problem. They find that under pricing occurs with both IPOs and seasoned offerings and is highest among riskier, unknown firms. Their evidence suggests that information problems drive under pricing, with support for both the book building view of under pricing and the asymmetric information theory. They do not find evidence in favour of the Rock model of under pricing or any evidence that illiquidity causes under pricing. Demers and Philip (2007) explore the factors associated with historical IPO failures by developing an IPO failure prediction model that includes account information as well as proxies for the role of information

intermediaries and other IPO deal-related characteristics. They document statistically significant differences in failure models applicable to non tech versus high tech IPOs and these structural differences are largely driven by accounting-based proxies for firms' investments in intangible assets, operating performance, and financial leverage. They also develop parsimonious, predominantly accounting-based, strictly out of-sample (i.e., no hindsight) IPO failure forecasting models for each of the two sectors. Their forecasts are negatively associated with one-year post-IPO abnormal returns. Further they reveal that a pseudo-hedge strategy of going short (long) in high (low) failure risk portfolios yields returns of economically significant magnitudes over the one-year horizon, and is robust to alternative returns methodologies. Further their results suggest that IPO long-run returns anomalies may persist, but they take different forms for high-tech and non tech IPOs. He (2007) opines that during the IPO market, investors coordinate on acceptable IPO price based on the performance of past IPOs, and this generates an incentive for investment banks to produce information about IPO firms. Further he opines that during hot periods, the information produced by investment banks improves the quality of IPO firms, and this allows ex ante low quality firms to go public and increases the secondary market price, thus synchronizing high IPO volumes and high first day returns. He also reports that when investment banks behave asymmetrically in information production, the "reputations" of investment banks are interpreted as a form of market segmentation to economize on the social cost of information production. Zheng and David (2007) find that IPO underpricing is positively related to post-IPO growth in sales and EBITDA, but is not

significantly related to growth in earnings. Their evidence suggests that accrual reversals or earnings management may cause this inconsistency. They interpret the growth rates of sales and EBITDA as measures of firm quality, and conclude by supporting the notion that IPO firms with greater underpricing are of better quality. Their tests on analysts 'earnings forecast errors show that analysts are less positively biased in their earnings forecasts for IPO firms that have greater underpricing. An and Kam (2008) examine the effects of credit ratings on IPO pricing. They report that the evidence from U.S. common share IPOs during 1986–2004 shows that when firms go public, those with credit ratings are underpriced significantly less than firms without credit ratings. They opine that credit rating levels do not have a significant effect on IPO under pricing. Lowry et.al. (2010) reveals that the monthly volatility of IPO initial returns is substantial, fluctuates dramatically over time, and is considerably larger during "hot" IPO markets. They also report that consistent with IPO theory, the volatility of initial returns is higher for firms that are more difficult to value because of higher information asymmetry. their findings highlight underwriters' difficulty in valuing companies characterized by high uncertainty, and raise serious questions about the efficacy of the traditional firm-commitment IPO process. One implication of their results is that alternate mechanisms, such as auctions, could be beneficial for firms that value price discovery over the auxiliary services provided by underwriters.

7.FIRST DAY RETURN OF GRADED IPOs

Table No 1. First day opening return of above average and below average Grading IPO's

Parameters	BSE		NSE	
	Above Average Grade	Below Average Grade	Above Average Grade	Below Average Grade
Average	0.09234926	0.0434546	0.088900815	0.043552497
N	66	52	64	44
STDV	0.16992753	0.107515366	0.130561075	0.136983178
Z	1.90350385		1.722876068	

*Table value of z for 1 per cent and 5 percent is 2.57 and 1.96 respectively.

The examination of above average grade BSE listed IPO's and below average graded IPO's reveals that the first day opening return of above average grade IPO's and below average grade IPO's are 9.23% and 4.34% respectively. The result of the study reveals that below average grade IPO's first day opening return is less than the above average grade IPO's first day opening return. However the Z test shows that there is no significance difference between average first day opening return of above and below average grade BSE listed IPO's. NSE listed graded IPOs earn 8.89% and 4.35% opening return respectively for above average grade IPO's and below average grade IPO's. Consistent with results of BSE listed IPOs, the first day opening return of below average grade IPOs less than the above average grade IPO's in NSE. Further, there is no significance difference between average first day opening return of above and below average graded NSE listed IPO. Therefore we accept both the

hypothesis which states that there is no significant difference between the first day opening return of above average and below average graded IPOs. This result reveals that grading per se will not guarantee significant return on any graded IPOs.

Table No.2. First day closing return of above average and below average Grade IPOs

Parameters	BSE		NSE	
	Above Average Grade	Below Average Grade	Above Average Grade	Below Average Grade
Average Return	0.080976	0.136059	0.079415698	0.131698356
N	67	52	64	44
STDV	0.267172	0.513344	0.270085509	0.466312861
Z	-0.70335		-0.670412979	

*Table value of z for 1 per cent and 5 per cent is 2.57 and 1.96 respectively.

The average closing return of BSE listed above average and below average grade IPOs are 8.09% and 13.60% respectively. I find superior closing return for below average grade IPOs compare to above average grade IPOs. The test result shows that there is no significance difference between mean first day closing return of above and below average graded IPO's. This result indicates that investors are not giving importance to IPO Grading. First day closing return of above average grade and below average grade NSE listed IPOs are respectively 7.94% and 13.17%. Consistent with BSE listed IPOs, the result of NSE listed below average grade IPOs first day closing return is greater than the above average grade IPOs first day closing return. The test result shows insignificant difference between average first day closing return of above and below average grade IPOs. Contrary to the first day opening return, the below average grade IPOs closing returns are more than the above average grade IPOs closing returns.

8. CONCLUSION

Companies always opt for IPO to raise fund for their long term requirements. Issuers of securities can better market its IPOs with favourable grading and they can fix high price for the securities. Since high grading indicates strong fundamentals of companies, it is expected that the return on IPO investment is also high over the investment period. The examinations of the first day return of graded Indian IPOs reveals that the return on above average fundamental company is greater than below average fundamental companies. I find insignificant difference between the first day return of graded and non graded IPO. This result reveals that grading as such, will not guarantee the superior performance of shares in the market. I suggest that, the investors should cautiously use these gradings before investing in IPOs.

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