

## 1.1 INTRODUCTION

'It took Coca-Cola USD 100 billion to make USD 25 billion while Pepsi took USD 14 billion to make USD 7.9 billion.' The Malaysian Investors' Association (MIA) president quoted an example of soft drinks giants.

By that analysis, he reckons Second Board company to be more dynamic than Main Boarders. 'In terms of price and earnings, Second Board companies out performed Main Board companies by 50 percent and 20 percent respectively.' he declares.

Average trading volumes of KLSE in 1996 were comparable to 1993's superbull run, with a daily average volume of around 350 million shares. The interesting point though was that the KL composite Index component counters, consist of a basket of Main Board stocks, was only around 150 million shares while during the superbull, it was around 450 million shares.

Reason : a lot of action has been on the Second Board, whose index has turned in such a spectacular performance that the KLCI pales in comparison. From the 250 point

level of end 1995, it has sky-rocketed and the 600 point barrier was ripped through by the supersonic Second Board bull.

Just take a glance at the number of Second boarders listed since its establishment in 1989. It started with just two counters in 1989, added with another 13 in subsequent year and remained at an average of 20-30 counter for the three following year (1991-1993). In 1996, there were 27 counters listed in the KLSE Second Board just for the first six months.

Due to the nature of the Second Boarders, such as less units offered (usually less than 10 million shares) and comparatively lower offer price, the IPOs (Initial Public Offers) of Second boarders has been overwhelming. Most of these new issues were oversubscribed by above 40 times for 1995-1996. Some counters were even hitting above 100 times by the aggressive support of IPOs investors.

As for the rate of initial return, it was obvious that most IPOs fetched a very lucrative premium over the listing price as compared to their offer price (further elaboration in literature review).

From the number of application received from IPOs, especially Second Board counters, it can therefore be concluded that the interest of the investing community for IPOs is substantial. The oversubscription rate of these new issues is further compounded by the new share application financing facilities provided by several major banks. As such, only a small portion of IPO investors are lucky enough in the IPO balloting, whereas the majority of them would have to purchase such shares in the open market after listing.

All the statistics mentioned above clearly indicated the IPOs have been the major concerns of investors, especially they are being trusted as a mean to reap quick return, while the risk is literally zero.

As such , the aftermarket performance of the new issues would be of great interest to eager investors. How would IPOs perform when compared with the market over a longer period? Would an investor gain by investing in such issues after its listing? Would the high initial returns significantly above average aftermarket or is the underpricing of new issues detrimental to the long term well being of the companies? Does the degree of the establishment of the company seeking listing has any effect

on the long run performance of the IPOs? How would the size of the initial market capitalization of the firms as relate to their aftermarket performance?

As mentioned earlier, even though the market capitalization and number of counters of the Second Board is far below that of Main Board, but the trading volumes of Second boarders are tremendous and may even exceed Main boarders. There have been many studies conducted by researchers with regards the performance of IPOs of Main Board counters so far due the fact that it is commonly used to measure overall performance of KLSE, as well as an economic indicator of the country.

Since the Second Board has drawn great attention from the investors lately, the various performance parameters of the Second Board IPOs and their after listing behaviour will be addressed in this study. At the same time, their performance will also be compared to the KLCI, the major indicator of the Main Board performance.

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## 1.2 OBJECTIVE

This study will examine the performance of Second Board IPOs measured against the market. The KLCI would be used as a proxy for the KLSE. The study will concentrate on various parameter of Second Board IPOs, such as initial return, degree of establishment (NTA per share is used here), market capitalization, cumulative average adjusted return (CAR) and holding period return of two years after listing.

The first objective is to examine the year one and year two aftermarket performance of the Second Boarder IPOs listed between 1989-1993. This periodic return will be adjusted against the market performance. The KLCI will be used as an representative indicator of overall KLSE performance.

Next, the correlation of aftermarket performance of Second Board IPOs and their initial return, the degree of establishment of the listing firms, the market value of the time of listing will be studied.

The initial performance of the IPOs from the offering date (date of issuance of prospectus) to the day of official listing will also be monitored in order to test for its

market efficiency. The negative results suggest that the positive initial performance is attributed to a downwards bias in the offering price or so called underpricing.

All studies mentioned above are geared towards generating an overview of Second Board IPOs performance within two years after listing as compared to Main Board. Hopefully the resultant analysis will act as a general guideline for Malaysian investors on the feasibility of investing in IPOs and aftermarket trading of Second boarders.

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### 1.3 LITERATURE REVIEW

A study conducted by Capital Dynamics Sdn Bhd (1995) indicated that on average, Main Board companies posted a more consistent earning pattern as compared to Second Board, especially in the third, forth and fifth years after listing. Considering the period covered is the same which means the macro-economic background facing the companies is the same, investors in Second Board companies based on earning faced a higher chance of disappointment. But based on price, the chance of profit were quite high for Second Boarders. This study compared the five years earning period after listing between Main Board and Second Board companies and found that Second Boarders only out perform Main Boarders in the first year after listing.

In USA, the widely documented underpricing of initial public offerings seem to be a short-run phenomenon. Study done by Ritter (1991) showed that issuing firms during the period 1975-1984 substantially underperformed a sample of matching firm from the closing price on the first day of public trading to their three-year anniversaries. The average holding period return for the sample in the three year after going public was found to be 34.47% whereas that of a

control sample of 1526 listed stock matched by market value and industry was found to be 61.86% over the same three years holding period.

In the same study, Ritter found that there was a tendency for firms with high adjusted initial returns to have the worst aftermarket performance and this tendency was more obvious in the smaller issues than the larger ones. By categorizing the sample IPOs, the long run performance of IPOs vary widely.

There was considerable variation in underperformance from year to year and across industries, with firms that went public in high volume years faring the worst. The patterns are consistent with on IPO market in which : (1) investors are periodically overoptimistic about the earning potential of young growth companies. 'Older' IPOs was found to perform significantly better than younger IPOs. (2) Firms take advantage of these so-called 'window of opportunity'. The finding that IPOs underperform on average, implies that the cost of raising external equity capital are not inordinately high for these firms.

A review of studies on the unseasoned new issues in the developed stock markets, particularly in the US and Britain,



have documented convincing evidence of 'underpricing' of new issues at the offering time. The studies available for review have so far indicated that in the US, Britain, Canada and Hong Kong, the average initial returns are around 10 to 15 percent. Australia has an average underpricing of between 20 to 30 percent while studies of new issues in Singapore gives returns of around 35 to 45 percent.

However, from the study of DR Rokiah Hassan (1992), the performance of new issues listed on the KLSE in the period between 1980 and 1988 showed that the average rate of returns from the offer to the first day of trading was around 140 percent. further analysis of the performance of new issues in Malaysia offered during 1980 to 1988 appeared to show that new issues have higher average premium during a rising market compared to a declining market (refers to period when the market index in KLSE is moving upwards or downwards).

In 1994, Dawson measured the cost of IPO underpricing which include 223 Malaysian IPOs during the 15 years period from 1979 through 1993. He examined the issues of underpricing from the viewpoint of original shareholders instead of the new investors. He found out of 223 IPOs sold between 1979-1993, only 4 were not underpriced. for the same period,

IPOs involving offers for sales of existing shares had less underpriced and were smaller in size than public offers of new shares. Nevertheless, it was the original shareholders selling shares in offers for sale who incurred the greatest loss from IPO underpricing, an average of 32.5 percent for offers for sales as compared to 13.6 percent for public offers.

In Dowson's (1987) investigation of IPOs in three Asian stock market - Hong Kong, Singapore and Malaysia during the period of 1978-1984, he found that although underpricing at issues by 13.8 percent in Hong Kong and 39.4 percent in Singapore, the average market adjusted price changes over the following year were not statistically different from zero. These results provide strong support for the existence of an efficient secondary market in these two country. For Malaysia IPOs, in contrast, after an unusually large initial increase of 166.6 percent, share prices continued a gradual upturned over the following year.

Shamsher, Annuar & Mohd's (1994) attempted to test the accuracy of common perception of excessive underpricing in the KLSE new issues by analyzing 65 new issues over 16 years to 1990. Their study suggest that the average excess return on the first trading day is lucrative at 135 percent, which

is the largest reported for any country. However, this high return is only 78 percent over the offer prices net of opportunity cost. Since the rate of return accrues to speculators while the investors holding new issues over the three years obtained only 21 percent per annum, they concluded that the Malaysian new issues market does not generate excessive returns in the long run.

Comparatively, new issues in Australia, United Kingdom, US and other developed markets and in Malaysia, Singapore and other developing markets are substantially underpriced because offer prices appear to be a deep discount of the initial listing day market prices. But the extent of underpricing is smaller in the developed markets compared with the developing markets.

Australia's underpricing of 22 percent is 1.7 times the return in its secondary market is 13 percent, the ratio for United Kingdom and US are 1.75 and 1.32 respectively. Those numbers work out to an average ratio of 1.6 for developed markets. The short-run underpricing of 135 percent in Malaysia is 7.5 times the normal secondary market return of 18 percent. The corresponding ratio for Singapore is 2.60. Hence the gain in the new issues market in Malaysia appears to be high.

Rock (1986) presented a model for the underpricing of initial public offerings. He explained that the argument depends upon the existence of a group of investors whose information is superior to that of the firm as well as that of all other investors. If the new shares are priced at their expected value, these privileged investors crowd out the others when good issues are offered and they withdraw from the market when bad issues are offered. The offerings firms must price the shares at a discount in order to guarantee that the uninformed investors purchase the issues.

Seha (1988) shared the same view with Rock. He developed and tested the hypothesis that underpricing serves as a form of insurance against legal liability and the associated damages to the reputations of investment bankers.

As from the viewpoint of investment bankers, Beatty & Ritter (1986) demonstrated that there is a monotone relation between the underpricing of an initial public offerings and the uncertainty of investors regarding its value. They also argued that the resulting underpricing equilibrium is enforced by investment bankers, who have reputation capital at stake. An investment banker who 'cheat' on this underpricing equilibrium will lose either potential

investors (if it does not underprice enough) or issuers (if it underprices too much).

In his study of unseasoned new issues marketed by Malaysian companies from 1979 through 1985, Dawson (1985) found that on the average, the issues were overbid by 44 times and the average price increase over the offer price on the first day of trading was 149 percent. This was compared with that in Singapore where the price increase was only 34.6 percent, IPOs in Malaysia again, seem overly underpriced.

Dawson is of the opinion that underpricing has a negative repercussion on the market price of stock. This concurs with that by Ritter where it was found that firms with high initial returns have the worst aftermarket performance. A low issue price seems to reduce the risk of undersubscription and benefits only the new investors but it has the negative effects upon the owners' control position, earning per share, dividends and net asset backing.

A study by Ong (1987) indicated that an investor will gain by purchasing the new issues at the offer price. The initial excess return measured from the offering price to the first trading day closing price as determined using the market-adjusted model, risk-adjusted market model and

modified RATs model are 97.14%, 99.5% and 98.42% respectively. The results of his study also showed that the IPOs outperformed the market by 13.65% at the end one year when it is purchased on its first trading day.

His study also indicated that the timing of the flotation exercise is also an important factor. The mean excess returns for issues during a bullish market is 191.2 percent as compared to 62.2 percent during a bearish stock market. Thus he concluded that the new issues in Malaysia are also underpriced as in other markets and that the timing of the issue is a more important factor than picking an underwriter.

Another study done by Tay (1992) examined the 71 new issues listed on the KLSE main board from Jan 1974 to Dec 1989. His result showed that the overall aftermarket performance of IPOs is positive though the monthly abnormal returns is not significant. The aftermarket performance of IPOs partitioned by size of initial returns, net tangible asset backing per share and market capitalization at the time of listing is also studied. Generally the results showed that portfolios of IPOs with lower initial returns, higher NTA per share and smaller market capitalization outperformed the market in the long run.

In the same study, the underpricing phenomenon of IPOs in Malaysia is also briefly examined and the size of the initial returns is found to be negatively related to the percentage of capital issued, its NTA per share and gross earnings per share. The regression results showed a positive relation between initial returns and the number of times the issue is oversubscribed, its gross dividend per share and times dividend covered.