CHAPTER 1: INTRODUCTION

1.1 General Background

Initial Public Offerings (IPOs) underpricing i.e., a positive gain of a new stock on the listing day compared to its IPO offer price is a commonplace phenomenon in many markets. The dominance of positive first day returns for IPOs has puzzled many finance academics for decades. A large body of finance literature has proposed various models and hypotheses to explain this so-called underpricing phenomenon. In other words, on average, an investor who subscribes new IPO issues at the offer price and sells them at the closing price on first day can make positive returns. Hence, the investigation of IPO pricing and performance is one of those market anomalies that continuously attract the attention of many researchers in finance.

Several theories have been put forward to argue that underpricing of IPO is an equilibrium occurrence in an efficient capital market. In fact, to a certain extent, deliberate IPO underpricing by the issuers and underwriters is needed for different reasons. It is understandable that if the IPO subscription price is set at a lower valuation than the expected valuation of new shares, then IPO subscribers would be able to earn a positive rate of initial return on the first trading day upon listing.

The short run and long run performances of IPOs are the most frequently research topic on IPO studies which gives rise to a vast body of empirical research on the two main anomalies in IPOs. There are two well-known findings that have been the focus of substantial theoretical and empirical research in the IPO literature for many years. Firstly, it is the presence of underpricing in IPOs. Investors who subscribe for IPO shares and sell them during the first day of trading earn a positive return where closing price on the first day of trading is higher than the offering price. Secondly, new stocks generally decline or underperform the market for three to five years following the offering date. Investors who buy IPO shares at the end of the first trading day will earn a long run return far less than that of comparable stocks. These two persistent anomalous behaviours that characterize IPOs—the first-day underpricing and the long-term underperformance of certain IPOs—have intrigued academics and scholars over the past two decades and have generated considerable research aimed at providing explanations and reasoning behind this phenomenon.

This anomalous behavior is observed in many countries. Ritter (1984, 1991), has confirmed the existence of IPO underpricing in the United States. This is surprising when it is a fact that underpricing can be very costly to company shareholders, in that the 'money left on the table' amounts to billions of dollars. From the 1960s onwards, the price discount has averaged around 19%. However, the price discount fluctuated considerably, achieving an average of 21% in the 1960s, 12% in the 1970s, 16% in the 1980s, 21% in the 1990s and 40% in the 4 years since 2000 (Ljungqvist, 2005). The level of underpricing was even more evident in the late 1990s and in the beginning years since 2000, where market sentiment was bullish with the Internet IPO boom.

In another study, Ritter (2003) provides an interesting study, covering 38 countries in the worldwide empirical regularity of IPO positive initial returns ranging from an average of 5% for Denmark to 257% for China. This means that around the world, IPO investors on average make positive initial return by buying IPO shares at the offer price and then selling them at the closing price on the first day of trading. Ritter (1987) also demonstrates that IPO underpricing, whereby the share price increases on the first day of trading compared to its offer price, represents a substantial cost of going public.

This is a very interesting topic because it has always been a puzzle why the IPOs are underpriced in a way that results in large positive average initial returns. When a company issues an IPO for the first time, it follows different patterns of share price fluctuations. Such anomalous price behaviour violates the efficient market hypothesis (EMH) and those IPO investors who have an advantage in gaining information, prior to IPO listing, generally exploits this opportunity and make profits via arbitrage.

Rock (1986) offered a popular explanation for the positive initial return which is the ‘winner’s curse’ theory. It is an equilibrium model for large underpricing of IPOs that relies on information asymmetry. According to Rock (1986), he hypothesizes that information about the value of the IPO share is distributed unequally or asymmetrically among underwriters and issuing companies and among informed and uninformed investors. Based on this theory, an informed investor is a person who has perfect information regarding the intrinsic value of the new issue compared to the other investors. Thus, informed investors will only subscribe to IPOs in circumstances where positive initial returns are available. On the other hand, uninformed investors, who do not possess perfect knowledge on the intrinsic value of new issue, will subscribe to every IPO even though the pricing of the IPOs may have been overvalued. As a consequence, uninformed investors are said to face a ‘winner’s curse’ in which they may obtain all the shares they subscribe because informed investors do not want the shares Therefore, having to face with this adverse selection problem, the uninformed investors will buy only if IPOs are under-priced in order to compensate them for the bias in the IPO allocation.

In competitive bidding, the idea that since some buyers will underestimate the value of an item and others will overestimate it; the high bidder will usually be one of the people that overestimated. Therefore there is a good chance that the 'winner' paid too much for the item. This problem exists when informed investors crowd out uninformed investors when good issues are offered. As a result, across many offerings uninformed investors are likely to receive an average return that is skewed towards overpriced offerings. Due to this potential loss, they may not be willing to bid for IPO shares. In order to make the IPO shares attractive enough for them to purchase and to ensure their continued participation in the IPO market, most IPOs should then be underpriced.

Rock (1986) argues that when some investors have more information than others, underpricing is necessary to attract uninformed investors. Otherwise, uninformed investors face the “winner’s curse” and will not participate in IPOs, which could lead to the failure of fair-priced IPOs.

1.2 Objectives of Study

This study is exploratory in nature and investigates whether there is an existence of underpricing for IPOs listed on Bursa Main Board from the year 1998 to 2008. Although there is a great deal of research that investigates these issues in most developed stock markets, only a few studies have been undertaken in the Malaysian context, particularly in the aftermath of Asian financial crisis that gripped much of the Asian region in 1997. Hence, this paper aims to examine the initial and long run performance of IPOs listed in Bursa from the period 1 January 1998 to 31 December 2008.

The aim of this research paper is to provide an empirical review of short run and long run performance of IPOs. The objectives of this study are set out as below:

1. To investigate the evidence of IPOs' underpricing
2. To analyze the initial and short run performance of IPOs
3. To analyze the long term performance of IPOs subsequent to listing
4. To investigate four main possible determinants for IPOs' underpricing

1.3 Significance of the Study

This study aims to provide some practical insights into the short run and long run IPO performance in Malaysia. This study will be of great interest to investors, analysts, stock brokers, fund managers and academicians. It will enlighten our understanding of aftermarket performance of the new issues and would be of great interest to eager investors.

Specifically an attempt is made to address the following questions: *How would IPOs perform when compared with the general market over a longer period? Would an investor gain more by holding such investment after its listing? Should we sell our stocks immediately after the listing? Would the high initial returns significantly above average after market or is the underpricing of new issues detrimental to the long term well-being of the companies?*

It is hoped that the results of this paper add to the growing number of international evidence and shed additional light into the behaviour of IPOs in the long run with data from the Malaysian market. In computing long run performance, this study incorporates returns up to three years after listing to facilitate comparison with the majority of studies done previously. The long run performance of Malaysian IPOs is measured based on the methodology proposed by Ritter (1991). One of the benefits of studying the long run performance of IPOs is that it allows the investors who missed out or were rejected on the initial period due to over-subscription to gain further insights on the long run performance of IPOs.

1.4 Organization of the Study

Chapter 1 introduces the definition of IPO and sheds some light as to why such underpricing phenomenon occurs. Underpricing of IPOs is characterized with stock prices closed higher than its offer price on the first day of trading, which represents a substantial cost of going public. It also outlines the objectives and significance of the study.

Chapter 2 looks into an overview of Bursa Malaysia, in particular its history, its index calculation and the latest development in Bursa with regards to its new market structure via the adoption of internationally accepted standards. The listing process is also discussed in this chapter. More importantly, this chapter also discusses literature of previous studies by past researchers on IPO underpricing and the aftermarket performance of IPO.

Chapter 3 outlines the research methodology, data collection procedures and criteria, and the methods used to analyze the data. The empirical design, the definition and measurement of explanatory variables used to test the existence of underpricing of IPOs are discussed here. The measures for both short run and long run of IPO performance are also being explained here.

Chapter 4 presents the findings and the summary of research results obtained from the analyses. It also touches on the explanations for the behavior observed.

Finally, *Chapter 5* concludes with a summary of the findings of this study, its limitations and made some recommendations for further research.

Figure 1: Organization of the Report