Research Paper

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Management

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Is Institutional Participation in Initial Public Offerings a Better Signal for Investing?

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ABSTRACT

IPOs that debut in a bull market get premium valuations on high demand. But post listing when market condition changes, the stocks get de-rated. Exit of the institutional investors from the shares makes the stock underperform, in which case the signaling of the IPO subscription made by institutional investors can be detrimental for the investments made by other investors. This research is aimed at can their participation be taken as a signal of a good stock, and what is level of participation by rest of the investors and knowing the correlation of their interest with short and long term gain. Test result shows that the active participation of the institutional investors is cannot be taken as a healthy signal for the rest of investors to grow up their interest in the said stock. Above research be done using data set of IPOs listed from Jan 2008 to Oct 2012.

INTRODUCTION:

The primary market in India is unique by world standards in many ways it has been shaped by an unusual history of regulation, the institutional details of how IPOs take place are singular, the sheer size and scope of the primary market is enormous and the large scale direct participation in the primary market by millions of retail investors is unlike that in any other country in the world. Since the current market sentiments are not positive many investors are exploring other options such as bond, mutual funds and security markets as demand for raising IPOs has been subsiding a great deal," the ASSOCHAM analysis said. "FIIs are pulling out of IPOs because of high inflation, and alongside, the debt and bond markets are growing phenomenally," ASSOCHAM president Sajjan Jindal said. "The price band of IPO is also no longer attractive for retail investors. Under such circumstances, being optimistic about IPO market would not be realistic as the fear factor against the primary market is becoming more visible and pronounced," Jindal added. Sometimes retail investors who not informed investors like the qualified institutional buyers and non institutional investors invest in an IPO based on the level of subscription made by the institutional investors since retail investors were allowed one more day after the issues closes for the institutional investors.

The IPO mechanism in India is far more transparent. The transparency in the mechanism allows investors to observe two important pieces of information on a real time basis. First, investors can observe the cumulative aggregate investors' demand at different points of the offer price range. Second, investors can also observe the demand multiples of different investor categories for their respective portion of the offer.

Regulation requires Indian IPO firms to reserve and allocate pre-determined quota of shares to three different investor categories: qualified institutional investors (QIBs), non-institutional investors (NIIs) and retail investors (RIIs).

The transparency in the mechanism, coupled with fact that different investor categories

participate for separate quote of IPO shares, may have a number of important implications for the IPO process. First, information available from the transparent mechanism should influence participation of investors across all investor categories, which in turn should shape the extent of

information produced during the offer period. The transparency should also influence the timing of investors' participation in the IPO as some investors may prefer to participate early while others may prefer to participate at the end of the offer period. Existing evidence on the participation of institutional (informed) and retail (uninformed) investors suggest that the

information conveyed by the transparent allocation mechanism should influence investor categories differently. Second, since prior research suggests that information produced during the offer period significantly influences IPO offer prices (Cornelli and Goldreich, 2003, Degeorge et al., 2010), the nature of information produced in a transparent mechanism could have significant influence on IPO offer prices. Further, since reputational capital is important for financial intermediaries, it would be plausible to assume that in a transparent mechanism the use of underwriters' discretion in pricing should be consistent with maintaining or enhancing reputation as offer prices which deviates significantly from the information contained in investors' bids will be detected by the market participants. More importantly, the transparency in the mechanism should leave less opportunity for the underwriters to engage in a quid-pro-quo relationship which has been documented in less transparent IPO mechanisms.

REVIEW OF LITERATURE:

Starting with the Rock (1986) model, institutional investors have played an important role in the theoretical literature on the pricing and allocation of initial public offerings (IPOs). Rock (1986) argues that these institutional investors with private information about the true long-run value of the shares of firms going public bid only on undervalued shares, leaving retail investors with a disproportionate share of overvalued IPOs. Thus, in the Rock (1986) setting, IPO underpricing is a mechanism to mitigate the adverse selection faced by retail investors, ensuring that they do not withdraw from the IPO market.

A second strand of the literature is the bookbuilding literature (e.g., Benveniste and Spindt (1989)), which builds on the Rock (1986) assumption of informed institutional investors, and argues that the IPO bookbuilding process is a mechanism for extracting information from these institutional investors in order to use it to price shares in the IPO at the appropriate level. In their setting, underpricing is a means of compensating these institutional investors for truthfully revealing all value-relevant information useful in pricing shares in the IPO.

A third strand of the literature (e.g., Chemmanur (1993)) views underpricing as a way of inducing information production by institutional and other investors about the firm going public. This information is reflected in the secondary market price of the firm's equity as a result of post-IPO trading by these informed investors, moving it closer to the firm's intrinsic value. It addressed the following empirical questions for the first time in the literature. First, do institutional investors really have private information about IPOs? Further, if indeed they possess private information, is all their value-relevant information incorporated into the IPO offer price, or are institutional investors left with residual information that they can profitably use in post-IPO trading? Second, are institutional investors able to realize significant profits from their participation in IPOs, thus getting compensated for the role they play in the IPO process, as postulated by the bookbuilding literature? While it has been documented (see, e.g., Aggarwal, Prabhala, and Puri (2002), and Hanley and Wilhelm (1995)) that institutional investors receive significant allocations in underpriced IPOs (where a consider-able amount of money is "left on the table"), the ability of institutions to fully realize this money left on the table has not been studied. A related question is whether, even if institutions realize superior profits from selling their IPO allocations, they dissipate these profits (partially or fully) in post-IPO trading.2 Finally, how do institutions sell their IPO share allocations? While it has been documented that institutions sell about 25.8 percent of the shares allocated to them during the first two days of post-IPO trading (Aggarwal (2003)), the selling of IPO allocations by institutions beyond the immediate post-IPO period has not been studied. The answer to this question is not only important in its own right (since it has implications for the desirability of institutions as investors in IPOs), but is also essential to establish the amount of profits realized by institutions from their participation in IPOs.

OBJECTIVE:
To analyze whether institutional investors interest in an IPO can be considered as a sign for investment

To study the performance of the shares in which institutional investors shown more interest

DATA ANALYSIS:

1. Return is computed as the difference between the offer price and the closing price of the day.

Offer price and 1st day closing price is considered for listing day return and for the next short term gain closing price of the said stock after one month is considered.

Return=(P1-P0)*P0/100
P1 = Price prevailing on the listing day/day that is considered
P0 = Issue Price

2. Participation/Interest is analyzed through the level of subscription made by the investors

METHODOLOGY OF THE STUDY:
Study is conducted with the secondary data collected from stock exchange websites. Companies considered for the study falls in the time period of Jan 2007 to Dec 2012 of which the stocks listed through SME platform was excluded.

Data's were collected from stock exchange websites. 133 stocks were considered in this research paper.

HYPOTHESIS OF THE STUDY:
Following hypothesis are formulated and tested

1. Relationship between current return and institutional investor interest
2. Relationship between current return and non- institutional investor interest
3. Relationship between current return and retail investors interest
4. Relationship between QIBs interest and RIs interest
5. Relationship between all the investors interest

ANALYSIS AND INTERPRETATION
Table No.1: Table showing the number of stocks in which various investors shown more interest and the returns made by the stocks in which they shown more interest.

Particulars	QIB	NII	RI
No. Of IPO each investor highly subscribed	41	73	19
Positive Listing Gain among their subscription	26	44	7
Positive 1-Mon Return among their subscription	20	39	6
Positive current Return among their subscription	12	22	8

Following inferences were made from Table No.1:

Of the 41 IPOs in which Qualified Institutional Buyers shown more interest, only 12 were trading at positive returns which work out to approximately 30%. Similarly out of the 73 stocks in which Non Institutional Investors shown more interest, only 22 are trading above the issue price which works out to 30% again and finally 19 IPOs in which retail investors shown more interest, 8 are trading above the issue price which is approximately a 42% success.

Return from stocks in which Qualified Institutional Buyers and Non Institutional investors shown more interest have not performed well in long run compared to the retail investor interested IPO stocks.

Table No.2 Table showing descriptive statistics of the variables under consideration

		SIZE	QIB SUBSCRIPTION	NII SUBSCRIPTION	RI SUBSCRIPTION	LISTING DAY RETURN	1-MON RETURN	CURRENT RETURN
N	Valid	129	133	133	133	133	133	133
	Missing	4	0	0	0	0	0	0
Mean		584.0283	13.1789	21.0115	5.3639	8.8467	-2.4974	-5.2802
Median		133.8700	1.7420	4.2100	2.6300	3.7240	-2.0200	-35.0000
Std. Deviation		1774.994	26.1431	37.6135	8.1638	32.8610	40.85594	125.664
Skewness		6.568	3.652	2.561	3.564	.771	.795	3.671
Std. Error of Skewness		.213	.210	.210	.210	.210	.210	.210
Kurtosis		47.337	17.094	6.563	15.610	1.395	1.876	17.208
Std. Error of Kurtosis		.423	.417	.417	.417	.417	.417	.417
Range		15176.19	180.72	190.00	55.14	198.22	235.26	893.00
Minimum		23.25	.00	.02	.08	-68.72	-87.40	-99.00
Maximum		15199.44	180.72	190.02	55.22	129.50	147.86	794.00

Companies like Jubilant Foods in which Qualified Institutional Buyers shown more interest has a return of around 800% now. And in the flip side stock like NuTek India Ltd trades 99% below its issue price.Companies like Aanjaneya health in which Non Institutional Investors shown more interest are trading at 216% higher than the issue price. And in the flip side stock like Raj oil Mills trades 96% below its issue price.

Companies like One Life Capital in which Retail Investors shown more interest are trading at 575% higher than the issue price. And in the flip side stock like Taksheel trades 93% below its issue price.

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Findings from table no.2:
1. Retail Investors participation is much lower in spite of many privileges given which is evident from just a mean of 5.36 which is lower when compared with institutional and non-institutional investors
2. Standard deviation of 37 by Non-Institutional Investors and 26 by Qualified Institutional Buyers show their selective interest in the IPOs
3. There are some IPOs in which participation by the QIBs and NIIs are almost Nil whereas Retail Investors try in all IPO issues.
4. Listing Day returns ranges between a negative 68% to positive 130%
5. 1-mon return ranges from negative 87% to a positive 147%
6. Current return ranges from negative 99% to positive 794%
7. Average listing day return is approximately 9% and current return is negative 5%.

Test of correlations:
1. Correlation between Qualified institutional investors interest in an IPO and the current return from said stock stands out to be 0.076 which implies QIBs interest can't be a signal for a sound stock
2. Correlation between non institutional investors interest in an IPO and the current return from said stock stands out to be 0.030 which implies NIIs interest can't be a signal for a sound stock
3. Correlation between retail investors interest in an IPO and the current return from said stock stands out to be 0.012. which is much less than the earlier tested correlations
4. Correlation between QIBs and RI interest is better with 0.628 which signals RI takes QIBs interest as a criterion to invest

Table No.3: Comparison between investors and the subscription

		Rank			Total
		Comparatively High	Comparatively Medium	Comparatively low	
Investor	QIB	41	31	61	133
	NII	73	52	8	133
	RI	19	50	64	133
Total		133	133	133	399

H0: There is no significant difference between the investors in the interest towards a stock in an IPO

H1: There is significant difference between the investors in the interest towards a stock in an IPO

Table No.4 Table to test the relationship between the investor and there interest through Chi-Square

	Value	df	Asymp. Sig. (2-sided)
Pearson Chi-Square	84.090(a)	4	.000
Likelihood Ratio	99.176	4	.000
Linear-by-Linear Association	3.516	1	.061
N of Valid Cases	399		

a 0 cells (.0%) have expected count less than 5. The minimum expected count is 44.33.

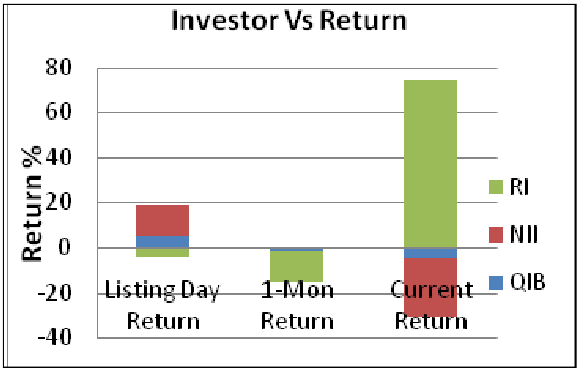
Since the Significance is less than .05 we reject the null hypothesis and prove that there is significant difference between the investors in the interest towards a stock in an IPO.

Table No.5: Mean return of the stock in which respective investors shown more participation

Mean Return Investor	Return		
Listing Day Return	1-Mon Return	Current Return	
QIB	4.62	-1.37	-4.57
NII	14.61	-0.19	-26.35
RI	-4.18	-13.82	74.12

Average returns made by the stocks in which QIBs and NIIs shown interest provided only negative return in long run when compared with the stocks in which RI shown interest making a positive return which implies the QIBs and NIIs participation can't be assign for better fortune in a stock.

Chart No.1: Chart showing comparison of investors interest and return made in such stock



CONCLUSION:
Almost 70% of the shares in which the qualified institutional investors shown more interest have wiped put the money from the investors hand which implies that the interest of the Institutional investors cannot be taken as a signal for a return on longer term. For an institutional investor investment in an IPO is a part of their portfolio management strategy which does not prove costlier when the said stock underperforms but in the case of individual investors that does not works out since shares through IPO is almost not for a portfolio management. So it's better for the retail and other investors not to consider the interest of Institutional participation as a the only signal for the investment. However the return made by stocks in which NIIs and QIBs shown more interest have provided good return on the listing day only in long term there was shift towards a negative return. So the time at which the institutional investors exit from the stock need to be analyzed to know the movement of the stocks after their exit and the shift in the price of the said stocks.

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