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Factors that determine IPO returns: Literature review

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Abstract
Initial public offerings (IPOs) generate enormous curiosity both in investors and researchers in finance, for varied reasons. Investors, being true to their interests, would look at an IPO as an instrument to increase their returns, on the other hand researcher look at each IPO to determine if it is following the established pattern or is it defying. Research on IPOs begun in early 1980s and since then researchers could not comprehend fully and explain the IPO firm's stock market performance, including its valuation.

Keywords: IPO, underwriter reputation, long-run performance of IPO stocks, valuation, differential information and investment decisions

Introduction

Initial public offerings (IPOs) generate enormous curiosity both in investors and researchers in finance, for varied reasons. Investors, being true to their interests, would look at an IPO as an instrument to increase their returns, on the other hand researcher look at each IPO to determine if it is following the established pattern or is it defying. Both the parties will be analyzing the determinants of IPOs from the time it is announced to the listing day. The average time for the approval process from the setting of the offer price to the issue date is generally two to three months (Wethyavivorn& Koo-Smith, 1991) [1]. However, it could be as long as a year.

Research on IPOs begun in early 1980s and since then researchers could not comprehend fully and explain the IPO firm's stock market performance, including its valuation. Researchers point that information asymmetry, between investors and owners, is the most important reason for failure to ascertain the fair price of an IPO. One of the most significant challenges investors face when evaluating a new issue is the lack of publicly available information about the firm and deriving reliable estimates of the firm's future prospects for growth. Since firms at IPO have little operating history, investors cannot rely upon an extensive track record of earnings, cash flows, or sales to judge a firm's health and potential for growth (Igor, Bell, Moore 2008) [2].

The Initial Public Offering is considered to be one of the most significant events in the life cycle of a company (Celikyurt, Selvilir, and Shivdasani, 2010; Latham and Braun, 2010) [3, 4]. Going public allows firms to raise and access funds necessary to accelerate growth in order to achieve market leadership. While other studies such as Pangano, Panetta and Zingales (1998) [54] propose that deleveraging balance sheets could be a strong motivation for firms go for IPOs. Some other authors feel that companies aim to gain intangible benefits such as brand image, prestige and credibility through an IPO.

Some studies conclude that competing in international markets (Prasad, Vozikis, Bruton and Merikas, 1999) [5] could be an important objective of a company to go for IPO. However, the largest risk factor faced by a firm during the IPO concerns the external conditions, most likely because they are out of the control of senior executives (Latham and Braun, 2010) [6].

Researchers argue that the IPO returns (measured by the 1st day closing price) are determined by different variablesin different markets. And, that these variables vary across time in the same market. Though the variables may not be similar, two characteristics are well documented across markets:

1. The short-term underpricing of IPOs,
2. The hot issue market phenomenon. In the other words, success of an IPO is impacted by the extent to which the offer has been underpriced compared to its market value – higher the difference, higher the subscription as investors stand to gain more in the short run. The timing of the IPO has a bearing on the outcome – in time of optimism if IPOs flood the market every offer is likely to be oversubscribed, as the theory of animal instincts would suggest.

There are many variables affecting initial return on IPO as a many researchers suggest, such as: auditor reputation (Beatty 1989) [7], underwriter reputation (Carter, Dark, Singh 1998 [8]; Bansal and Khanna, 2012)[8]; governance change & ownership structure (Ehrhardt and Nowak 2003) [9]; corporate governance (Gugler, Mueller and Yurtoglu 2004); signaling (Allen & Faulhaber, 1989)[4]; asymmetric information (Ibbotson, 1975) [10]; Offer size (Megginson & Weiss, 1991) [11]; age of the firm (Muscarella & Vetsuypens, 1989) [12]; market capitalization, (McDonald & Fisher, 1972) [13], (Baker & Wurgler, 2000) [14] and pricing mechanism (Bansal & Khanna, 2012) were suggested to be major determinants of IPO.

Investors are not sure about the true value of new issues coupled with that asymmetric information make IPO generally more risky compared to an already listed stock for investors (Firth, 1998) [15]. This risk associated with IPO force underwriters to deliberately price their new issues under real value – known as underpricing. Underpricing averaged over 65% of IPOs in Europe (Dolvin & Jordon, 2008) [16] and the situation across other markets is also similar. It is also argued that underpricing represents an opportunity cost to preexisting owners of the firm (Loughran, Ritter & Rydquist, 1994, [50] p.170). This is in line with the argument of Chan *et al*. (2004) that many time firms deliberately underprice their issue in order to gain confidence.

Some studies, such as Lowry (2002) [17] and He (2007), attribute success of an IPO or the failure to the general macroeconomic conditions at the time of offering. That also explains ‘hot periods’ and ‘cold periods’. Firms issue equity following period of high stock market valuations to take advantage of the associated low cost of equity.

Another important dimension in the discussion of IPO successes has been the age of the firm. Younger IPO firms versus more established IPO firms, which fare better. Research on this dimension suggests that information asymmetries will be inversely related to firm age for several reasons, hinting that young firms have less chances to succeeded with IPOs compared to established firms. However, it is often hypothesize that financial constraints are more likely to exist for younger IPO firms compared to more established IPO firms, thus young firms might have an edge at IPO success.

Barry and Brown (1985) [18] show that firms with a longer history have more to offer to the investors about their internal operations and external environment, whereas young IPO firms with short track record typically portray a complex picture for the investors. Further as Carter *et al.*, (1990) [19] observed young firms would not have developed networks. This might be either because they do not have the slack resources or developed administrative capabilities (e.g., Leiblein and Reuer, 2004) [20] or because they lack the support of other firms that can enhance their legitimacy (e.g., Baum, 1989; Zimmerman and Zeitz, 2002) [21, 22]. Established firms have a better standing in this arena and therefore established firms go for IPOs to finance their expansion and growth (Pagano, Panetta, and Zingales, 1998[54]; Ritter and Welch, 2002) [23].

Corporate governance had been one of the chosen areas of research in relation to the success of IPO. As Robert Gregory Bell (2008) [24] constructed “A firm’s legal environment holds a preeminent place in corporate governance. The important functions of a legal system include holding managers accountable to shareholders, ensuring shareholder voting privilege, preventing self-dealing by managers, and protecting creditors. For countries found lacking in these elements, majority shareholders have the ability to divert resources from the corporation in an attempt to avoid sharing benefits with minority investors.”

In continuation of the construct Demirgue-Kunt and Maksmimovic (1998) [25] found that in a country with strong legal system, firms find it relatively easy to raise external finance, by extension it can be said that a strong legal environment generally contributes to success of IPOs. In addition, Aggarwal, Erel, Stulz, and Williamson (2007) [26] suggested that corporate governance of a firm will have a strong bearing on IPO’s performance, supporting the argument that greater transparency instills confidence in investors. Various theoretical models trace the underpricing of IPOs to information asymmetries about the new issue’s value between various IPO market participants such as issuers, underwriters, and differentially informed investors (e.g., Baron, 1982; Rock, 1986; Grinblatt and Hwang, 1989; Chemmanur, 1993) [27, 60, 31, 28].

Transparency that leads to proper information dissemination might contribute to success of an IPO as it reduces information known to the insiders and outsiders. As the fact the executives and other insiders in an IPO firm will typically know more about the “true value” of their firm than will outsiders (Anderson, Beard, and Born, 1995; Keasey and Short, 1997; Lawless, Ferris, and Bacon, 1998) [29, 30] will adversely affect the IPO returns. Outsiders often rely on cues such as past sales, earnings projections, industry competitiveness among others to form a composite picture of a firm. Methods adopted by the investors to circumvent such information asymmetry are described by signaling theory (Spence, 1973) [31]. Two central criteria of signaling theory are: (1) signals be known in advance and be observable, and (2) they must also be costly or difficult to imitate (Spence, 1973; Ross, 1977; Certo *et al*., 2001) [32, 33, 34]. The signaling models by Allen and Faulhaber (1989) [4], Grinblatt and Hwang (1989) [31], and Welch (1989) [64] argue that underpricing can – in analogy to Spence's (1973) [35] job market signaling – be a signal for a high `quality' of the firm. Ritter (1998) [36] point out that traditional finance theory has assumed historical accounting measures, cash flow, book value, earnings and revenue can all be incorporated to help predict the value of a firm at IPO.

According to Gillan and Starks (2003) [37] for institutional investors a firm’s corporate governance practices are as important as financial performance to evaluating IPOs, if not more. Investors place high confidence on strong independent boards comprising individuals with diverse skills and experiences (Useem, Bowman, Myatt, and Irvine; 1993) [38] as it is generally believed that a strong independent board results in better governance that stimulates higher performance (Millestein and MacAvoy, 1998) [39].

Many authors critically analysed the role investment banks in IPO performance. Booth and Smith (1986) [40], for example, put forth a theory of investment bank choice. Investment banks as repeated players have reputational capital at stake and can thus certificate the value of a firm. Other theories stressing the role of investment banks include Benveniste and Spindt (1989) [41]. Benveniste and Spindt designed a mechanism in which banks use underpricing and rationing to elicit investors' information prior to an IPO.

Corporate finance research has produced enough evidence to state that financial constraints of a firm will have a greater impact on the performance of its IPO (Stein, 2002 [42]; Myers and Majluf, 1984) [43]. Empirical studies on firm investment found that firms' capital expenditures are sensitive to cash flows (e.g., Fazzari, Hubbard, and Petersen, 1988) and Baker and Nelson (2005) [44, 45] described possible approaches small firms in resource-poor environments might consider, including bricolage – making do with means and resources at hand (Lévi-Strauss, 1967)-or resource-seeking behaviors, such as attempting to raise capital (e.g., Berger and Udell, 1994) [46].

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