# THE ECONOMICS OF AN INITIAL PUBLIC OFFERING (IPO)

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## ABSTRACT

*We are always excited by the newness of a thing. Even when it comes to investing we are excited by the new, that is a new Initial Public Offering (IPO) of shares. When we are thinking of a sound wealth building strategy, we have to understand the pit falls that besiege us in the stock markets. A lot of investors have made huge gains in stocks bought through IPOs. However, evidence suggests that such winners are very few and are outnumbered by the losers. In stock markets most of the profits and losses arise out of emotional buying and selling. While the primary market has become an important source of mobilizing funds for Indian issuers, the ability of the primary market to provide resources to issuers has varied. The equity market is slowly entering the IPO season. This study highlights the returns of IPOs listed in Bombay Stock Exchange and National Stock Exchange in 2011.*

## INTRODUCTION

An initial public offer as the name suggests, is the first public offer of securities by a company, in order to seek listing on the stock exchange. The investors who invest in an unlisted company that is in the 'private window' are either the promoters or strategic long term investors or pure financial investors who come in for a time bound period. When a company makes an IPO, What it actually creates is a second ownership opportunity that can be termed as the 'market window'. In order to serve the interests of retail investors, the market window also performs the function of validating the company's worth on a continuous basis through an organized trading mechanism called stock exchange which provides market quotes for the company's stock. This brings us to the discussion on how exactly an IPO should be perceived. They are:

a. IPO can be a source of finance if it is meant to finance a specified end use.

b. b. IPO creates a new ownership opportunity called the retail window and a class of investors called the 'retail investors'.

c. IPO creates market capitalization for the company, which is the aggregate value of all its issued shares multiplied by the current market price.

d. IPO creates a listed company, it can open up the gates for hostile takeover attempts on the company.

e. Listing brings with it additional costs of regulatory compliance

Timing an IPO is a strategic, financial and investment banking decision.

1. The strategic dimension:

Strategically speaking and given a choice, a company should go for an IPO only when it is matured enough for it and would depend on the following:

a. Does the company mature enough to unlock its value? The only way the corporate grow to become the citadels of wealth creation is to unlock its value by sharing its wealth with a wide section of investors and growing bigger with their support thereafter.

b. Does the business model of the company is retail oriented with strong brand presence so as to identify with the retail investor?

c. Does the company need the IPO as a liquidity event for its existing investors? In other words, are there no private exit options available so that the IPO can be pushed further into the future?

2. The Financial Dimension:

In some industries going public may not be a decision of choice. For example capital industries such as steel, shipping, cement etc.

The second financial dimension relating to IPO decision is to evaluate, if unlocking value through an IPO is the need of the hour or whether other options are available, like private equity or private placement etc.

3. The investment Banking Dimension:

The merchant bankers take a call on the IPO proposal based on market conditions, their own placement strength and the main selling points in the issue, like the additional contribution to IPO, by the promoter to shore up his stake.

Thus the notion that the IPO is for the benefit of the investors to make money on listing is a big mental heuristic.' Heuristics are simple efficient rules of the thump which have been proposed to explain how people make decisions, come to judgments and solve problems, typically when facing complex problems or incomplete information. These rules work very well under most circumstances, but in certain cases lead to systematic cognitive biases'-Daniel Kahneman

'Heuristics are the short cut the brain takes when processing information. This leads to cognitive biases'-Parag Parikh

The stock markets move very fast and the lure of making a fast buck before the neighbor does is so great that short cuts or the rules of the thump have become the innovations of the valuation game. These are so widely used that they have become the benchmark for the industry.

## HYPOTHESIS

The alternative hypothesis is that IPO is a mixed bag.

## LIMITATIONS

The study is limited to IPOs listed in 2011.

## OBJECTIVES OF THE STUDY

1. The objective of the study is to calculate the return on the IPOs listed in 2011.
2. Make the Investor to analyse varied kind of information rather than return on singular information.

## METHODOLOGY

The methodology is to find out the psychological errors made by the investors and the return enjoyed by the investor after the IPO. The common errors made by the investors are:

1. Round Trip Fallacy: The investors believe that all IPOs will result in listing gains. Thus investors rush for any IPO, to participate in the IPO boom. This is how the IPO bubble is formed.
2. Representative Heuristic: The herd mentality creates huge demand for IPOs and therefore the IPOs tend to be oversubcribed. In other words, when the crowd behavior is at work, there is no rationality.
3. Anchoring: The investors are so anchored to the past that they are unable to see the reality as it exists today. They blindly chase the IPOs.
4. Recency Error: IPOS make noise during their launch and investors get carried away by all the news on the IPOs and this recency effect makes them invest in the company.
5. Singular information: 'In bull markets, investors expect higher returns from the stocks and in bear markets they expect lower returns. When such extrapolation is unwarranted, then the resulting bias is called extrapolation bias' In bull markets, people relay on singular information of how investors in IPOs made money, wit out taking into consideration the base information or the historical statistics.

## RESULTS AND DISCUSSIONS

Now let us analyse the returns from the IPOs listed in 2011.

| Company | issue price | Market price as on 29/4 | Returns |
|---|---|---|---|
| Acropetal Technological | 90 | 41.90 | -53.44 |
| C Mahendra Expo | 110 | 284.20 | 158.36 |
| Omkar Speciality | 98 | 68.45 | -30.05 |
| Shilpi Cable | 69 | 31.05 | -55.00 |

From the analysis it is clear that, IPO is a mixed bag.

## RECOMMENDATIONS

The factors to be taken into account are to avoid the above pitfalls are:

1. Promoters' track record
2. Merchant bankers track record
3. Purpose of fund raising
4. Financials
5. Response by Qualified Institutional Buyers (QIBs)
6. Role of Venture Capital Funds(VCFs) / Private Equities (PEs)
7. IPO ratings
8. Pre- issue IPO price
9. Peer group price

## ABBREVIATIONS

1. IPO : Initial Public Offering
2. QIBs: Qualified Institutional Buyers
3. VCFs: Venture Capital Funds
4. PEs: Private Equities

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