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Role of Market Structure in Explaining Underpricing of IPOs in India

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Abstract

The study examines the nature of underpricing of IPOs and also its explanation in terms of the imperfection of the primary market from the perspective of its rational economic agents- sellers (issuers and underwriters) and buyers (investors) in the context of Indian IPO market over the last one and half decades. We observe that underwriters face localised competition and they have oligopoly power across different industries. However, the oligopolistic nature of underwriters fails to explain underpricing phenomenon. Further, from the point of view of issuers segment, we observe that the objective of issuers (i.e., to minimize underpricing of their IPOs for collecting fresh capital as much as possible) is fulfilled. Hence, in presence of market imperfection, big issuers would be more successful in fulfilling this objective in comparison to smaller issuers.From the estimated results, we have also seen that large institutional investors (i.e., FIIs) could concentrate generall on underpriced IPOs.

I. Introduction

ONE OF THE recent ongoing debates in Corporate Finance is on the magnitude of mispricing of Initial Public Offerings (IPOs) and its possible explanations. From the studies of notable scholars, it is witnessed that IPOs are in general significantly underpriced across the globe. In India, Bhattacharya and Cakraborty (2015) reported 15% underpricing in the year 2010-11, Deb and Marisetty (2010) witnessed 21% underpricing for the period for 2006-2009. Other studies, like, Shah (1995), Narasimhan and Ramana (1995), Madhusoodon and Thiripalraju (1997), Ghosh (2004) and Mishra (2010) have also documented the similar picture. Our estimate of underpricing of IPOs in India during 2003-04 to 2015-16 is 24.27 percent.

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We have reported a number of findings on the basis of the behaviour and features of these three segments of the IPO market. Firstly, it is documented that underwriters enjoy localized competition in different industries but they do not have any significant impact on underpricing phenomenon in any situation. In search of prevalence of imperfection in the IPO market, we consider issuer and investor segments as well. We have observed the evidence of market imperfection in regard to the issuers segment, implying that bigger issuers are more successful in fulfilling their objective of minimizing underpricing of IPOs compared to small ones. Further we have found that investors segment is also an imperfect one because FIIs remain successful in selecting more underpriced IPOs. From the analysis of the impact of all the segments of IPO markets jointly on underpricing phenomenon, we have again observed that big issuers, big underwriters and big investors are related to each other and their joint interaction might becaus of observed underpricing of IPOs in India. In other words, our study establishes that underpricing of IPOs is significantly influenced by the overall imperfection in demand and supply sides of the primary market.Thus, the policy conclusion of the study is that to arrest underpricing of IPOs, imperfections in the Indian primary market are to be corrected.

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