Abstract

All over the world, bookbuilding in Initial Public Offerings (IPOs) has overtaken other mechanisms of offering IPOs like fixed price offerings and auctions (Kutsuna and Smith 2004, Sherman, 2005). In India bookbuilding in IPOs was introduced in 1999. The regulations framed for bookbuilt IPOs thereafter have ensured that the book building mechanism in India offers far greater transparency than what is observed in the developed capital markets of the US and those of the UK. The regulatory context and the unique data set allow us to make a distinct contribution to IPO literature. In India the investor demands are constantly displayed on the web sites of the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE) during the IPO bookbuilding process. In contrast, bookbuilding in the US and the UK is mostly behind closed doors and any information on the demand patterns of investors is not disclosed. This study makes use of the unique regulatory context in India to answer three main questions.

Firstly, it examines the determinants of IPO underpricing and in particular tries to find out whether the marketing efforts of the issuers and the reputation of the investment bankers have an impact on their IPO pricing decisions.

Secondly, it tries to find out whether underpricing of IPOs can be dissected into its constituents and whether the subscription pattern of any particular class of investors affects the investment decisions of the others and the first day initial returns of the IPOs.

Thirdly it examines whether the changes in regulations have had an impact on the underpricing of IPOs.

The data suggest that marketing efforts of the issuers and the reputation of the investment bankers do contribute to greater underpricing. Investment bankers can choose either to leave money on the table (underpricing) or to increase the marketing expenditure so as to attract a larger number of uninformed investors . Moreover the higher the reputation of the investment banker, higher is the underpricing. This could be presumably because more reputed investment bankers have stronger relationships with their institutional clients. We also find that underpricing can be dissected into its constituents-before and after the book has been built. The investment bankers program some underpricing into the issues by not fully utilizing the bookbuilding band available by regulation. After the book has been built, the investment bankers again leave 'money on the table' if the Qualified Institutional Buyers' (QIB) demand remains tepid. The results also suggest that market initial returns on the listing day are significantly determined by the aforementioned decisions of the issuers and investment bankers to leave money on the table. We also use a unique dataset to suggest that retail and non institutional investors follow the lead of the informed institutional investors during the bookbuilding process. However the data suggest that this behaviour doesn't replicate post listing. In the aftermarket, the unsatiated demand of the uninformed investors which includes the retail and non-institutional contributes the most to the initial returns. We infer that a large number of uninformed investors therefore must be buying up IPOs in the aftermarket.

This study also evaluates the impact of three very important regulations made for bookbuilt IPOs in the last few years. The first of these was the increase in retail allocation tranche. Our results show that after this change in regulation, the programmed underpricing and the QIB subscriptions in Indian IPOs increased whereas the first day returns came down. The second change in regulation was the end of investment banker discretion in allocation of shares. Although theoretically this should have resulted in higher underpricing and initial returns, our results suggest that this was not the case. Finally, we evaluate the most far reaching change in regulation –the advent of IPO grading in India. The results highlight that the IPO grading has not changed the underpricing and has not been able to reduce the ex-ante uncertainty surrounding the IPOs. In our results, this is because the transparency of the bookbuilding process in India provides a much stronger signal to the retail investors than the IPO grading.