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IMPACT OF INFORMATION ASYMMETRY ON INITIAL PUBLIC OFFERING (IPO) PERFORMANCE: A CONCEPTUAL REVIEW

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Abstract : Underpricing in new issue market can be called as omnipresent occurrence in almost every country. Though the price performance of an IPO is influenced by various factors, information incoherence is focus of interest in this paper. The paper compiles the theories and suggestion concluded through different empirical results done in this subject. The review categories the theories based on the relationship between main parties involved in the IPO process and how they affect the quality and flow of information among them.

***Index Terms* - Initial Public Offering (IPO), underpricing, information asymmetr**y.

I. INTRODUCTION

When an entrepreneur comes up with a novel idea, and is able to give it a form, a business is born. But only having an innovative mind is not sufficient to make a business successful. Survival of any kind of organizations needs resources. One of them is monetary resource. Now in today's time, entrepreneurs have varied avenues to raise such capital. Deciding which source they are going to utilise becomes part of the financial decision of a company. A business needs constant supply of money for its sustenance and growth. It can raise this money in form of debt or equity.

Raising money through equity means selling the shares of business to public. By doing so, a company becomes a "public" company and gets itself listed on a stock exchange form where the general public can trade its share in secondary market. there are many consequences a company faces once it decides to go public. By selling shares, the originals owners dilute their ownership and get money in return, which they can utilise for the business growth. in this way, they also forgo some of their control over the business decisions. The investors who buy the shares also get some additional rights in regards to the company, as they are the share owners. A company's stakeholders increase once it goes public.

The process of issuing shares is guided by some regulations, generally decided by the government of the country where the company is registered or wants to raise funds from. These legal restriction are put on a company going public to safeguard the interest of potential investors. In India, SEBI is the nodal agency for deciding such rules. A public company has to publish more information regarding its operations. Such public information also needs to be validated by an independent authority like an auditor, to make the information trustworthy. Such information is used by the prospective investors while they decide if they want to invest in the company or not. All the relevant information is published by the company in form of Prospectus.

The issue process of shares involves multiple parties. Key participants of this process are the issuer firm, the underwriter and the investor. These three parties play an influential role in deciding whether an issue is going to be successful or not. Issuer firm hires an underwriter to run the issue. The underwriter or the merchant bankers are responsible for creating the Prospectus, pricing the shares, promoting the shares and accountable for all the legal compliance related to the issue. The investors are divided into two wide groups: retail investors and institutional investor. Retail investors are the smaller investors, while the institutional investors have bigger amounts to invest.

Deciding the price for each shares is the crucial task of this whole process. Pricing decision is made by the underwriters. The pricing efficiency of an issue depends on various factors. It has been an interest of study for quite some time now. It has been noted that, majority of times, an IPO is underpriced. This means that the share issue price is lesser than its listing price. Underpricing is seen as one of the biggest cost for a firm deciding to go public *(Ritter, 1987).* By underpricing its shares, the issuer loses money while the investors gain, as the shares the bought at cheaper price can be sold for profit in secondary market. Though the pricing is decided by the underwriters in consultation with the issuers, the factors affecting this decision are multitude.

In an IPO, the mass of information at hand with the issuer and investors is quite disparate. This circumstance is known as information asymmetry. The issuers have an upper hand in this case. They have more knowledge about the actual position of the company (*Carter and Manaster,1990; Leland and Pyle, 1977).* This information disparity exists between all three players: issuer and underwriter *(Baron, 1982)*; issuer and IPO investors (*Welch, 1989)* ; among different category of investors (*Rock, 1986)*, further leading to IPO underpricing. This phenomenon of different access to information has an effect on the pricing efficiency of th IPO *(Bradley et al., 2004*), leading to higher degree of underpricing *(Ljungqvist, 2007).* Additionally, it has been observed that emerging countries suffer from larger degree of underpricing when compared against the developed economies. It can also be due to the fact that, in developed countries, like European markets, most of the firms deciding to go public are already established businesses with good enough prestige, also the method of pricing decision is similar to auction, leading to less underpricing *(Loughran et al., 2004).*

Pricing of an IPO can be done through various established method, like book-building, auction and fixed price (open offer) method. Each of them also has various forms which may differ from country to country, as the regulators decide. Also some firms may use combination of varied methods for pricing their IPO. In India, SEBI introduced SEBI in 1995, for making the price discovery of IPOs more efficient. Scores of research has also been done in regards to factors that make a company tilt towards the chosen pricing method. Comparing fixed price method with book-building, it was observed that a firm will go for fixed price method if they suspect high risk, but will opt for book-building if they want to collect bigger size of capital by going public *(Benveniste and Basadba, 1997)*. Also noted through a study that auction method is suitable for bullish market and fixed price method fitting for bearish market trends *(Vandemaele, 2003).*

II. OBJECTIVE

This paper attempts to put forward a comprehensive exploration of information asymmetry theories. A systematic view of the relationship between information asymmetry and IPO underpricing is presented through this paper. All the key parties and their role in information heterogeneity is taken into account while discussing the various theories. each outlook is supported by relevant research work concluded in that regard.

III. INFORMATION ASYMMETRY THEORIES

Multiple theories related to information heterogeneity in IPO market will be discussed in a systematic order, by aiming to categorize them in a way of relationship shared by different key parties and how they play their role in IPO performance.

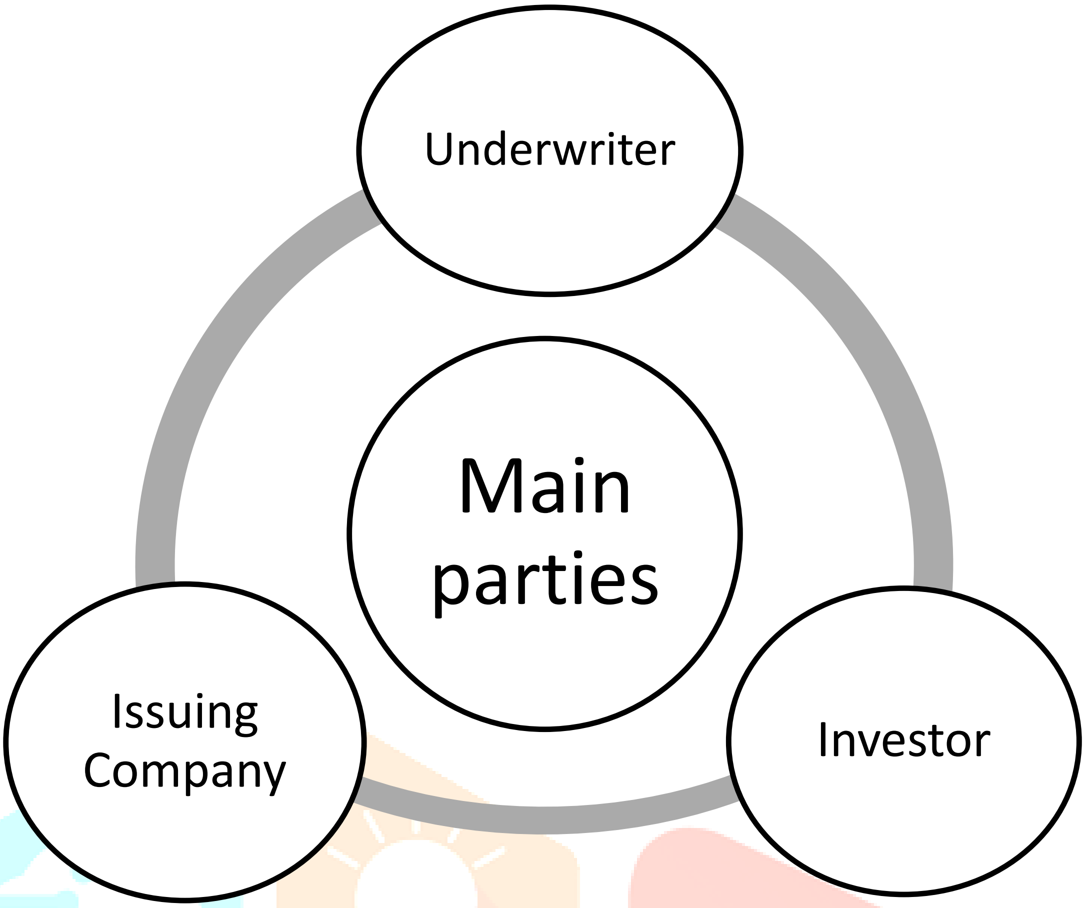

figure 1

A. Information asymmetry between Issuer and Underwriter

Merchant bankers play a key role in primary market. Their job involves making the prospectus, marketing the IPO and act as bridge between the issuing company and the investors. Their clients mostly include large businesses and high net worth individuals, to whom they provide wide varieties of services like consultancy, raising of funds, underwriting etc.*(Kumar,2016).* Investment bankers also underwrite the issues. As these merchant bankers and investment bankers provide an array of financial services, they have various clients like institutional investors and venture capitalists.

Many issuing companies hire multiple underwriters for their issue. In many researches, it has been concluded that underwriters play an active role in pricing efficiency of an IPO. Underwriters have some amount of power in underpricing or overpricing of an issue. Underwriters have better knowledge regarding the market conditions as compare to the issuing firm, thus they wield the power to reward their regular clients through underpricing*(Baron and Holmstrom,1980).* This phenomenon is known as *principal-agent conflict theory* related to information asymmetry leading to higher underpricing of IPOs. When the agent(underwriter) who has control over the assets invested by the principal(owner) are in conflict, it leads to major pricing problems*(Fama,1980).*

Plenty of research work have indicated that substantial number of institutional investors are interested in short gains that they can achieve through underpricing of the shares *(Jenkinson and Ljungquist,2002)*. Investment banks may have closer relationship with such institutional investors as they are mostly their longer-term clients when compared to issuing company. This may lead the investment banks to underprice th issue in order to reward their buy-side clients*(Baron,1982)*

Apart from maintaining the relationship, investment bankers also want to entice the institutional investors with underpricing as they want to motivate them to invest in their future issues as well *(Pollock, Porac and Wade, 2004)*. Underwriters would like the institutional investors to keep on investing in their future IPO issues as well. In a study, it was found that underwriters allocated more than 81% of IPO share to institutional investors and considerable number of shares were sold after the initial offering *(Aggarwal,2003)*

Apart of maintaining their ties, underwriters also have other strong reasons for underpricing. Shares with lower price are likely to face less chances of under-subscription. Under-subscription is avoided by underwriters as it may force them purchase the share themselves as part of their commitment. Through underpricing the underwriters also decrease the probability of them having to to price stabilization in the aftermarket (Logue et al, 2002). Also underwriters have an opportunity to gain through overallotment, by buying shares at lower price and selling it at higher listing price *(Jenkinson and Ljungquist, 2002)*.

Underwriters through their superior information have the power to underprice the issue and enjoy gains at the cost of the issuing firms. But to reduce this conflict, the company going public can have board members who have good knowledge related to the company's worth and have past experience related to public issue of shares. Experienced directors on board reduce the information asymmetry which takes away the ability of underwriters to underprice the issue *(Baysinger and Horkisson, 1990)*.

B. Information asymmetry between Issuer and Investor

Certification acts as an evidence, proving the valuable status of a thing. When a company decides to go public, it has to gain their confidence about the values of the firm. In order to do so, the company will try to look for various ways, which can signal towards its high reputation. There are many ways to get such validation.

Well esteemed underwriters are sought after by the companies to run their issue. Such underwriters with their influencing power and recognition allure the investors, both institutional as well as retail. The company may utilise such reputation of their underwriters to convey that the pricing of the issue is fair and depicts the actual value of the firm *(Booth and Smith,1986)*. Many studies done till now support this phenomenon.

There was noticed a positive relationship between the reputation of the underwriters and the intensity of underpricing in Japan *(Davis and Kirkulak,2005).*

Institutional investors are the big investors, who have sufficiently more knowledge about a new issue. These investors are also utilised by the company to indicate towards the justified pricing of their IPO. Underwriters may also mention the names of well known institutional investors interested in their issue as a marketing tool. The issuer and the underwriter are aware about the power of attraction these investors hold towards luring in the retail investors. Retail investors look towards the institutional investors as well informed counterpart, thus follow their path ultimately, if they get a clue about such investors investment in an issue. Firms with less institutional investors performed comparatively worse as compared to firms which were able to attract more big investors *(field and Lowry, 2009).*

Auditors hired by the issuing firm too get involved with how the investors may perceive the pricing of the IPO, base on the prestige of the auditors. Auditors role in the IPO process is to complete the independent valuation of the company's financial position. Such information also becomes a part of the prospectus. As the prospectus is used by the potential investors as an information tool, thus the work done by auditors becomes substantial in influencing the investor decisions. Researches with keeping Auditing firm as a variable and noting its effect on underpricing has been carried on. One of them, done by *Titman and Trueman(1986*), took into account the reputation of the auditors as a signal in their model.

In Indian context, SEBI launched *IPO grading* in 2006, as a way to validate them. Later in 2007, it was made a mandatory exercise to be followed for all the upcoming issues. This whole effort of grading was done so that the retail investors, who are generally the lesser informed investors, could get a better idea about the fundamental success of the company, whose shares they are interested to invest in *(Khurshed, Palean, Pande and Vismara).* Altogether, this was to help with reducing the information asymmetry related to the new issue market. Through a study done by Tripathi and Pandey came to the conclusion that higher grades lead to less underpricing , by studying the short term effect of the grading. They also included in their result that retail subscription reduces as the grades get lower which is in contrast to the result put down by *Jacob and Aggarwalla(2012),* who state that grading raises the subscription level from both institutional as well as the retail investors. SEBI eventually made this process of grading voluntary in 2014, as through a review process it found that the objective of this whole exercise was not met.

Another big factor that investors use as information for making their investment decision is the *ownership structure* of a firm. Such information plays more salient role in emerging market than the developed markets *(Laporta et al, 1999).* If the owners or the original shareholder retain their shares, it signals as high value to the investors. Therefore ownership concentration leads to influence the underpricing of the issue.

Apart from ownership, the top executives of a firm also influence its issue's attractiveness. *Credible executives* with successful ventures and prestige act as a valuable information for the investors to gauge the potential success of a company *(D'Aveni,1990; Podolny,1994*). Investors have faith in the expertise of top management, as they believe well-known and successful executives won't attach themselves with a venture which is prone to fail.

*Media i*n current times has become a powerful source of information, influencing every kind of consumers. Primary market investors are also one of them. Institutional investors have more ways to gain information, many a times much more private information regarding a company going public. But such is not the same for the retail investors. Thus, they are prone to get affected by the news float in by the different types of media sources they consume *(Bhattacharya et al,2009; Engelberg and Parsons,2011)*. A study measured the influence of Wikipedia pages of a firm going public and its subsequent underpricing, found that firms with a page faced higher degree of underprincing than the firm who didn't own one *(Boulton, Francis, Shohfi, Xin, 2021).*

C. Information asymmetry between different categories of investors

Winner's curse is a well established and frequently tested theory, introduced by *Rock* in his 1986 paper, where he talks about the different types of investors and how the knowledge they possess determines their faith in the IPO market. Primarily, he differentiates between informed and uninformed investors. With informed investors, they know the facts related to the firm raising funds through shares, thus can easily discover whether the price being charged for the share is fair or not. They will make sure that the shares they buy are underpriced. This step makes them a winner when the shares are listed on the stock exchange and trade for higher price than what they had paid. While the uninformed investors are not well aware about the realities of a firm, thus unsuccessful in differentiating between a underpriced and overpriced IPO. As the informed investors subscribe more for the underpriced IPOs and get allotted more of its share, most of the uninformed investors get allotted for overpriced shares. Thus, increasing the chances of uninformed investors facing losses while investing in issue market. This phenomenon is also known as adverse selection model. With making a loss in issue market, the informed investors might start ignoring the future IPOs, which is surely not helpful for issuers. This prospect makes the issuers to underprice their share consciously in other to draw the uninformed investors and keeping them satisfied. Altogether it can be said that winner's curse theory looks at information asymmetry between the two types of investors: informs and uninformed; and concludes how this difference leads to IPO underpricing.

IV. CONCLUSION

Underpricing in IPO market has been a centre of curiosity for many decades. Though multiple theories have been propounded to support the reasoning, still lot of scope exist as the financial market environment changes every day, leading to more factors influencing the pricing efficiency. Also, as more and more countries strive to safeguard their investors, the upcoming regulations are paving way for a better information reach and accountability of the issuing firms and the underwriters. This paper aims at giving a precise viewpoint of different theories and relate asymmetric nature of information to IPO performance. Through the study of different conjectures, the information relationship between the investor and the issuer firm stands out, as information gained by the investor is used to decide the value of the firm, making the investors the ultimate judge in new issue market.

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