



# Conceptual Framework of Corporate Governance on Initial Public Offerings Price Performance: An Evidence from Indian Capital Market

Neetu Goyal<sup>1</sup>, Dr. Vikas Deep<sup>2</sup>

1. Author: Research Scholar, School of Management Studies, Punjabi University, Patiala, Punjab

2. Co-Author: Assistant Professor, University School of Business Studies, Punjabi University, Regional, Campus, Talwandi Sabo, Punjab

**Abstract:** Initial Public Offerings (IPOs) are unique economic and governance events as privately held firms issue common stock or shares to the public for the first time. The governance issues surrounding IPOs are relatively unexamined compared to more established, and usually larger, firms. As such, they provide a unique context to study corporate governance and its development around the world. The end result is a broad and deep assessment of governance practices and IPO activity for an array of economies that represent tiny portion of the global economy. This paper provides new insights into what a global theory of corporate governance might look like and offer guidance to policy makers and academics regarding national governance configurations.

**Key words:** *IPO, Corporate Governance, Board of Directors, Indian Capital Market*

## 1. Introduction of the Study

Corporate governance has emerged as an important field of research and concern for finance discipline as well as management of the markets from the last decade. It has become a central issue in developing countries for the effect of financial crisis in developed global market in 2008. Corporate governance influence the companies to manage their organization in such a way to achieve the long term strategic goals to satisfy the shareholders, creditors, employees, customers, suppliers and complying with the legal and monitoring requirements, apart from meeting environmental and local community needs. The concept of corporate governance primarily hinges on complete transparency, integrity and accountability of the management. There is also an increasingly greater focus on investor protection and public interest. The concept of corporate governance is to some extent a similar to the quality practices adopted under the ISO standard. It is administered to provide the maximum benefit to the shareholders.

In an initial public offering (IPO), an entrepreneurial firm offers a portion of its shares to the public or potential investors to meet its financing needs. As suggested by Certo et al (2001), an IPO represents an important transition point in a firm's development since the firm moves from being privately held toward being publicly-held. In the so called "financing hierarchy" formulated in pecking-order theory. The IPO appears to be a firm's financing source after internal financing and debt (Myers, 1984). A firm may enjoy a number of advantages from going public, which enables it to obtain additional funding without exposed to risks that may otherwise arise from debt, encourage greater transparency and accountability and leverage its visibility and reputation in the market (Caselli, 2010).

The board of directors, which represents one of these mechanisms, ensures that the information communicated before the issue is credible. A Properly structured board then has a certifying effect on firm value, similar to the certification effect of underwriters, auditors or venture capitalists. In other words, high quality board of directors can convey the intrinsic value of the firm (certify the firm's value) more credibly to potential investors, thus reducing the information asymmetry facing the issue firm and resulting in lower underpricing in the IPOs of these firms. The fact is that, board itself serves as an important signal for potential investor participation in an IPO. The board composition, i.e., leadership structure, reputation, involvement, and size have significant bearing on pricing. However, IPOs firm board characteristics and its effect on IPO pricing performance, including price risk (volatility) and subscription rate received little attention. Precisely, a few studies focused on maturity of the board and underpricing.

## 2. Review of Literature

**Pentescu (2019)** studied the link between ownership concentration and corporate performance in the manufacturing sector in the European Union in an economic environment stressed by the global financial and sovereign debt crises. Ownership concentration is measured by the number of shareholders and the percentage of their individual and collective holdings, while performance is measured by accounting-based and market-based indicators. Overall, there is a positive link between ownership concentration and corporate performance in the case of Western companies, but not for Eastern-based companies. Moreover, ownership concentration has supported business recovery in EU, but particularly for Western companies. The results suggested that market investors' assessment of corporate performance is not so significant and do not acknowledge the role of ownership concentration (either beneficial or detrimental) for performance assessment.

**Agus et al. (2018)** has taken 182 IPOs in Indonesia Stock Exchange from 2006–2015, it investigated IPO underpricing using agency theory framework. There are two dimensions of agency theory: ownership concentration and institutional ownership. Institutional ownership seems to be able to monitor IPO underpricing, leading to smaller loss from IPO underpricing. Paper found that institutional ownership does not moderate the effect of ownership concentration on IPO underpricing, While the negative effect of institutional ownership on IPO underpricing is stronger than the institutional ownership. Higher level

of institutional ownership seems to increase principal-principal agency conflict and to reduce monitoring effect of institutional ownership. This study highlights the importance of ownership in company affairs.

**Chowdhury et.al. (2016)** investigated that due impact of post-ipo changes in corporate governance mechanisms on firm performance as they are transforming themselves from private domain to public domain through initial public offerings (IPO). By using Australian data for young firms over the period 2002-2007, results are found to be consistent with the hypothesis that corporate governance has an impact on firm performance following an IPO. It demonstrate that the presence of original board of directors and top management members have a positive influence on firm value when an operating performance measure is used. But these findings are not replicated when a performance measure is used.

**Sahoo (2014)** examines the relationship between board structure and IPO pricing. In this study regression results obtained for a sample of 176 IPOs issued in India during 2007-2011 indicate that board attributes significantly affect IPO pricing performance taking the cue from signaling theory, this study postulates that the properly structured board of directors has proved to be a useful signal of quality of the issue from potential investor's perspective. The study documents an inverse association between underpricing and board structure i.e. board maturity, diversity, reputation and leadership.

**Heran (2013)** focused on the performance effects and specifically under pricing of IPO firms arising from board structure, namely board size, establishment of nominally independent oversight and monitoring committee and ratio of independent non executive to executive directors and board characteristics, represented by the ratio of both foreign and indigenous high society executives to total board size and board diversity in terms of ethnicity and nationality. A sample of 62 IPO firms from (2000 to 2009) across the Sub Saharan African has taken for the purpose of the study. It found considerable evidence for conflicting motivators behind under pricing between higher numbers of foreign executives in relation to total board size and those of indigenous high society.

**Bell, et. al. (2012)** investigated that stock market response to different constellations of firm level corporate governance mechanism by focusing on foreign initial public offerings (IPO) in the United States. By using fuzzy set theoretic methodology and by applying different combination of monitoring and incentive based corporate governance mechanism. It was found to be same level of investor valuation of firms. It contributed to the sociological perspective on comparative corporate governance and the dependencies between organizations and institutions.

**Darmadi (2012)** aimed to examine whether board structure and corporate ownership influences the level of under pricing of Indonesian IPO firms. Sample of 101 firms IPO of Indonesian equity market from 2003 to 2011 was taken for the purpose of the study. The empirical evidence suggested that corporate governance structure matter, to a particular extent to the level of under pricing of IPO firm.

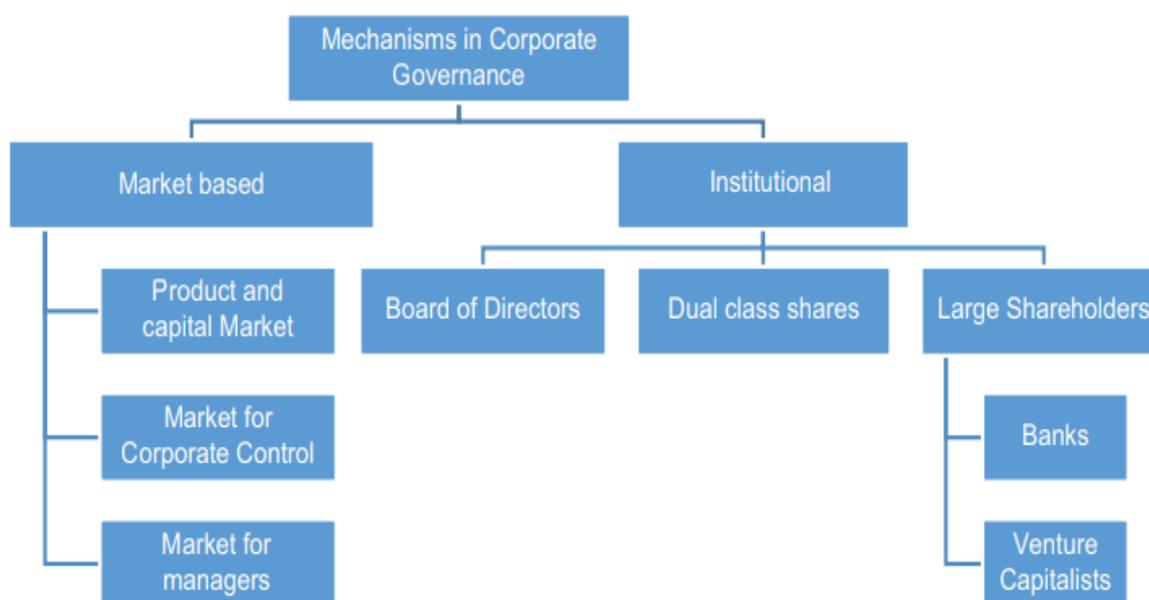
### 3. Objective of the Study

This paper examines the association of corporate governance variables and IPO pricing. It study the impact of corporate governance on IPO underpricing by using six group corporate governance variables including (i) ownership structure (ii) Board-related ,(iii) CEO-duality, (iv) ownership concentration and (vi) underwriter's reputation for determining the IPO underpricing. It also studies the impact of firm level control variables.

### 4. Conceptual Framework of the Study

There are several models analyzing the implications of market competition for managerial slack and good governance, like the product market (Hart, 2001; Schmidt, 1997), the market for managers (Fama, 2017), the capital market (Baker and Kennedy, 2002) or the market for corporate control (Manne, 2013), where the latter two are assumed to play a pivotal role for IPO firms. Capital markets, in particular, stock markets, play a crucial role in governing IPO firms in several ways. First, because access to the stock market is not without cost, bearing these costs could be a quality signal for outside investors, clients, or suppliers. Secondly, stock market prices serve as a quality signal for internal governance systems like the board of directors or external governance mechanisms like the market for corporate control (Allen and Gale, 2004). Finally, the capital market serves as an efficient mechanism to reallocate resources within a short time period and with low costs. Below figure 1 shows the conceptual framework of the study:

**Figure 1 Conceptual Framework of Corporate Governance**



The corporate governance influence on IPO underpricing is explored by various models and theories. Including winner's curse theory, the ex ante uncertainty theory, the signaling theory and also the underwriters' theory. These have been developed from the asymmetric information theory. According to asymmetric information between parties including

1. Informed investors and uninformed investors
2. Underwriters and investors
3. Underwriters and issuers
4. Issuers and investors.

Some studies explicitly identify corporate governance mechanism variables such as ownership structure, board characteristics, CEO –chairman duality, ownership concentration and the underwriter reputation as variables there impact on IPO underpricing.

#### 4.1 Asymmetric Information Theories

Asymmetric theories of information assume that information asymmetry among individual IPO transaction stakeholders comprises issuing company, underwriters and investors. The IPO would help any stakeholder who holds a data advantage. The underlying premise is that more information is available to stakeholders than to other stakeholders. Rock (1986) is the founder of the (winner's curse model) concept based on the assumption of asymmetric knowledge between various investors. Informed investors are better aware of the true worth of the company and are in a better or winning position to determine whether to sign a new offering or not. Only selective shares are awarded to knowledgeable buyers, whilst the uninformed indiscriminately bid for all shares.

This imposes the curse of a winner on uninformed investors in that they receive all the shares they have offered in an unattractive offering while receiving the shares in an attractive offering only partially. With the problem of the winner's curse, underpricing is needed to compensate investors for the risk they bring in the allocation of new issues. Underpricing is a premium that decreases the participation of uninformed investors in the IPO game and preserves market liquidity

- **Ex-ante uncertainty Theory**

Knowledge asymmetry will cause ex-ante confusion about the IPO company's value, which will underprice internally and IPO. The greater the asymmetry of data between informed and uninformed investors, the greater the difference in the company's valuation or valuation uncertainty. Higher IPO underpricing will be induced by greater ex-ante uncertainty coupled with the winner curse problem.

IPO research on the US market by Michaely and Shaw (1994) shows that the theory of the winner's curse is supported and IPO underpricing can be explained as a way to encourage less educated investors to engage in the IPO market. The positive relationship between ex-ante uncertainties and IPO underpricing using various proxy measures of uncertainty has been reported by many studies Asymmetric information between underwriters and investors

- **Underwriter's Reputation Theory (Asymmetric Information between underwriter & issuer)**

Underwriters have superior knowledge on the future investor demand for shares being sold. Underpricing is used by the issuer to induce the optimum selling influence of the underwriter. Underpriced shares require less marketing activities to persuade investors to subscribe to the IPO offering on the part of the underwriters. Carter & Manaster (1990) indicates that the prestige of the underwriter affects the immediate IPO aftermarket returns. The issuing firms signal the high value of their IPOs to outside investors by selecting a prestigious underwriter. In order to preserve their credibility, these well-established

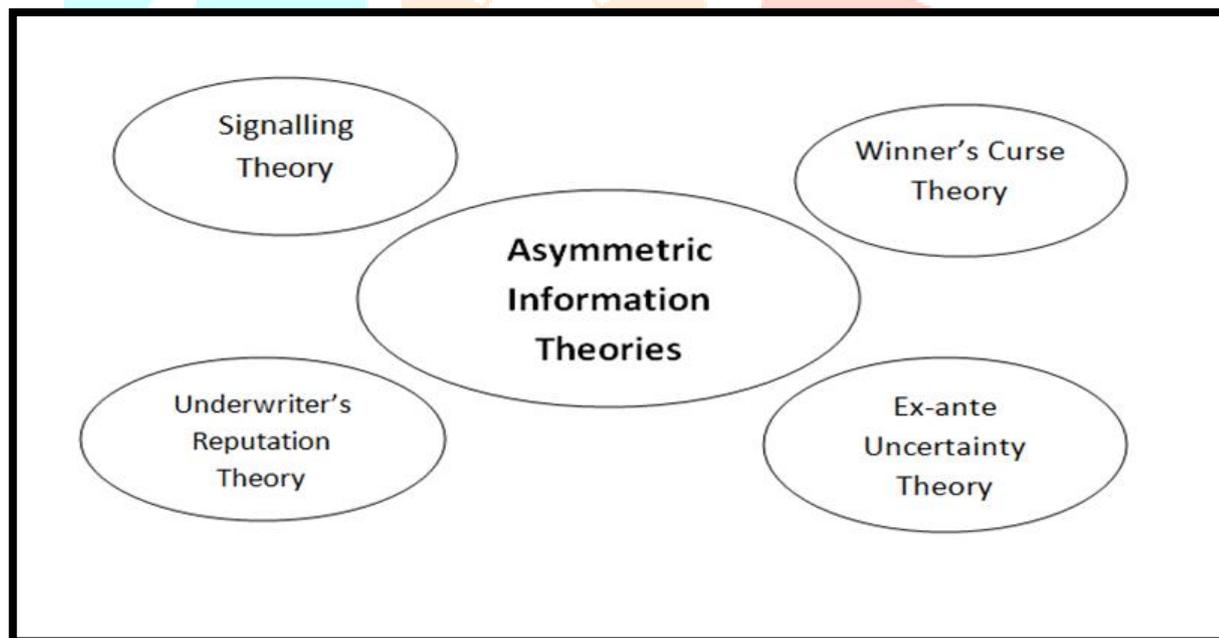
underwriters will keep the price of IPOs close to intrinsic value. Therefore the reputation hypothesis of the underwriter implies that a reputed underwriter will lead to lower IPO underpricing.

IPO deals made by two or more underwriters appear to be less underpriced, studies show. Crown & Schultz concludes that less underpricing is caused by the presence of more than one underwriter.

- **Signalling Theory (Asymmetric Information between issuer and investors)**

The first to associate underpricing with signaling theories were Ibbotson & Jaffe (1975). The issuers underprice the shares of the IPO because they want to "leave a good taste in the mouth of the investor. So that they can sell the stock in future deals or in the next Seasoned Equity Offerings at competitive rates again (SEO). Underpricing keeps investors happy and allows them to recall their good experience in order to inspire them at the next SEO to invest in the business again. "Allen & Faulhaber (1989) argue that through IPO underpricing, issuers want to "signal" the good quality of companies. Such study studies two rounds of fund raising for the SEO by the companies on the day of issue of the IPO & some day in the future.. In order to seduce investors to invest in the SEO business again the companies purposefully underpriced the issue by "leaving money on the table" in the first round of fund raising to demonstrate their efficiency.

**Figure 2 Asymmetric Information Theories**



## 5. Findings of the Study

The past and recent research on corporate governance and link it to IPO firms has been summarized in conceptual. IPO firms as defined as young firms, based on intangible rather than physical assets, where the founder of the firm often serves as the key inventor and the CEO. While corporate governance of large and public companies is an established field in business, management, finance, and economics, corporate governance mechanisms in entrepreneurial firms are rather underestimated and lack theoretical and empirical evidence. The motive is more of a broad call for research that examines the rationales of the different types of stakeholders and their role in governing the transition of firms that go public.

## 6. Limitations of the Study

The followings are the limitations of the study

1. This study is limited to previous papers and reviews.
2. This study is conceptualized based and no analysis has been performed.

## References

- Agus M (2012). Board of Directors and the Pricing of Initial Public Offerings (IPOS): Does the Existence of a Properly Structured Board Matter? *Evidence from France*. 8(9) .40-53.
- Allen, F. and Faulhaber, G.R. (1989), "Signalling by underpricing in the IPO market", *Journal of Financial Economics*, Vol. 23 No. 2, pp. 303-23.
- Bakar, N., & Uzak, K. (2014). An Empirical Study of Initial Public Offerings Underpricing For Shariah-compliant Companies: The Case of Malaysian Market. Vol. 1, No. 9(ISSN: 2327-8188), 262-262. Retrieved from <http://ijebf.com/>
- Baluja, G. (2013). Comparative Analysis of Listing Price Performance between Different Graded IPOs in India. *Pacific Business Review International*, 6(5), 1-7. Retrieved from <http://www.pbr.co.in>
- Bathula, H. (2008). Board characteristics and firm performance: Evidence from New Zealand (Doctoral dissertation). Auckland University of Technology, Auckland.
- Beatty, R. P., & Ritter, J. R. (1986). Investment banking, reputation, and the underpricing of initial public offerings. *Journal of Financial Economics*, 15(1–2), 213–232.
- Bell, R. G., Filatotchev, I., & Aguilera, R. V. (2013). Corporate Governance and Investors' Perceptions of Foreign IPO Value: An Institutional Perspective. *Academy of Management Journal*, 57(1), 301-320. doi:10.5465/amj.2011.0146
- Bruton, G., Chahine, S., & Filatotchev, I. (2009). Founders, Private Equity Investors, and Underpricing in Entrepreneurial IPOs. *Entrepreneurship Theory and Practice*, 1540-6520, 909-928. doi:10.11
- Carter, R., & Manaster, S. (1990). Initial public offerings and underwriter reputation. *The Journal of Finance*, 45(4), 1045–1067.
- Caselli, S. (2010), *Private Equity and Venture Capital in Europe: Markets, Techniques, and Deals*, Academic Press/Elsevier, Oxford.
- Certo, S. T. (2003). Influencing initial public offering investors with prestige: Signalling with board structures. *Academy of Management Review*, 28(3), 432–446.

- Chahine, S., & Filatotchev, I. (2008). The effects of information disclosure and board independence on IPO discount. *Journal of Small Business Management*, 46(2), 219–241.
- Chowdhury, B., Dungey, M., & Pham, T. (2014). The impact of post-IPO changes in corporate governance mechanisms on firm performance: evidence from young Australian firms. *Tasmanian School Of Business and Economics University Of Tasmania*, (ISBN 978-1-86295-940-8).
- Darmadi, S., & Gunawan, R. (2013). Underpricing, board structure, and ownership: An empirical examination of Indonesian IPO firms. *Managerial Finance*, 39(2), 181–200
- Darmadi, S., & Gunawan, R. (2012). Underpricing, Board Structure, and Ownership: An Empirical Examination of Indonesian IPO Firms. *SSRN Electronic Journal*. doi:10.2139/ssrn.2034623
- Fama, E. F., & French, K. R. (2017). Disappearing dividends: changing firm characteristics or lower propensity to pay?. *Journal of Financial economics*, 60(1), 3-43.
- Filatotchev, I. and Bishop, K. (2002), “Board composition, share ownership, and ‘underpricing’ of U.K. IPO firms”, *Strategic Management Journal*, Vol. 23 No. 10, pp. 941-55.
- Hearn, B. (2012). The contrasting effects of board composition and structure on IPO firm underpricing in a developing context. *International Review of Financial Analysis*, 21, 33-44. doi:10.1016/j.irfa.2011.09.004
- Hung, H. 1998. A typology of the theories of the roles of governing boards. *Corporate Governance: An International Review*, 6: 101–111.
- Lin, C. P. and Chuang, C. M. (2011), “Principal-principal conflicts and IPO pricing in an emerging economy”, *Corporate Governance: An International Review*, Vol. 19 No. 6, pp. 585-600.
- Mak, Y., Tan, R., Tan, Y., & Tee, H. (2003). *Corporate Governance and IPO Pricing*. Retrieved from bschool.nus.edu.
- Manne, H. G. (2013) “Mergers and the Market for Corporate Control”. *Journal of Political Economy*. 73(2): 110–120.
- Sahoo, S. (2014). The impact of corporate board structure on the pricing performance of initial public offerings. *The IUP Journal Of Applied Finance*, 20(4), 22-44.
- Sanders, G. W., & Boivie, S. 2004. Sorting things out: Valuation of new firms in uncertain markets. *Strategic Management Journal*, 25: 167–186
- Shleifer, A. and Vishny, R. W. (1997), “A survey of corporate governance”, *The Journal of Finance*, Vol. 52 No. 2, pp. 737-783.

## Websites

www.nseindia.com

www.sebi.gov.in

### Books

Balasubramanian, N. Leading from The Top Directors Who Make The Difference. Noida: Random House Publishers India Private Limited, 2013.

