CHAPTER NO. V

INTERNATIONAL SCENE

CHAPTER NO.5

5.1 INTRODUCTION :

A brief review of international practices in the pricing of IPOs is also made The international practice is for the regulators to approve the disclosure of informations made by companies in their prospectus Pricing of the issue is left to the market forces, with the scrips being valued by underwriters and investment bankers. In the case of listed companies principal bench mark for pricing the securities is it's current market price In such issues the underwriters price new issues at a discount of 10% to 20% to prevailing market price in order to render the issue attractive to the prospective investors

In foreign countries be it a developed or developing country, there do not exist concept like share premium It is only in India that offer price is divided in to two components i e face value and premium.

According to the available informations from the Bombay Stock Exchange, in countries like USA, Japan, Australia, U K , Germany, there is a concept of free pricing only. In all these countries, there are more than one stock exchanges The list of such stock exchanges is given in Annexure no.12.

In this chapter an attempt is also made to review the practices of some of the stock exchanges located outside India briefly

5.2 U.S.A. STOCK EXCHANGE SYSTEM :

In U S A , prices in primary markets are evolved over a period of time An issue is first test marketed and views are soliocited from the institutional investors like mutual funds and pension funds Based on the response, the prices are fixed which more than often turns out to be close to the market prices Undersubscription as well as oversubscription are not seen in good light in the U S.A. markets An undersubscription means inadequate appraisal of the project and oversubscription means underestimation of the issue by the lead manager Broadly it can be said that the pricing of issues in the U.S A is based on the basic premise of supply and demand.

In the U.S A , appraisal of the project is the foremost concern of the company and they have the skills developed for doing justice to the project Due diligence is absolute and uncompromising in the U S A

In the U S A there is a well entrenched system where stock exchange authorities are immediately informed of abnormal volatility of prices They do not have the bell shaped curve just before the Right issue which has been a trademark of the Indian Market

In U S A disclosure norms are very strict There one can not get the prospectuse cleared even though 50% of the project costs are applied towards intengibles like pre-operative expenses, miscellaneous expenses and contingencies In the U.S A , company reports and total information on the company are available at the press of the button from the company itself or the consultant or even from a broker

The American market is purely driven by the fundamentals and not on sentiments unlike the Indian markets because on average U S investor is more informed and calculated due to sheer availability of the informations.

In the U S A , prospectuse do not carry projections because of the simple reason that the future is too uncertain to be predicted It is not the absence of relevant techniques which stops a company from having projections in a typical U.S A. propectus. It is the hazard of misleading an investor which stops them

The public issues handled and the role played by the investment bankers in the USA is more or less similar to that played in India The USA market is more sophisticated and mature in the sense that it has more built-in-checks and balances which to a large extent minimise mishaps that often take place in the Indian market

When a company in the U S A. wants to widen it's base and reach out to a larger circle of stockholders they normally seek out the services of an investment banker - One who provides the best advice as well as the best terms and the lowest total cost for handling the new issue The underwriters or the investment bankers as they are called abroad, specialize in raising the kind of money that business needs for long term use.

Before committing itself to underwrite an issue of common stock or any other security, an investment banker conducts a thorough investigation of the company, utilizing the help of outside accountants, engineers and other specialists. Underwriting means the investment banker buys all the new stock from the company, then resells it at a set price to individual buyers The underwriter there has total control over the sale of the stock he/she commits to buy, unlike the case in India where the underwriter has no say in the promotion nor the subscription to the issue. In U.S.A , "Issue Failure" seldom happens because the underwriter is sure of the sale to the extent of his commitment. Once the offering is over and the stock is in public hands, regular trading begins in the over the counter market or on one of the exchanges, and the stock's price is determined by the market forces

The supply and demand of security is also very much in the mind of the investment bankers when they set the offering price of the security.It is particularly crucial when the company does not have actively traded stock to serve as guide. The investment bankers carefully weigh all the investment aspects of the company like the going market price for similar companies, the status of the industry and the general market.

Whenever a company wants to raise capital by floating a new issue of stocks or bonds, it must comply with federal law that governs the sale of the issue offerred to the public. It is said that in the boom days of twenties, many a new stocks was sold with few facts and lots of flattering promises were made in U.S.A. like it now happend in India. S.E.(Security Exchange) Act was passed in 1934 and Security Exchange Commission repeatedly came with regulations aimed at making listed companies and stock traders tow the line.

Procedure for IPO :-

Before the company makes a public offering of new stocks or bond, the SEC requires full disclosures of all the pertinent facts This is done through a lengthy registration statement that the company must file with the SEC (See Annexure No.11). The SEC staff reviews the material submitted and often requests additional informations or clarifications. Assuming the data appears to be complete and accurate, the SEC then gives a green signal to the new issue. During the period, when a new issue is under regulation, no broker or dealer can provide the public with any additional informations or opinion about the new issue or any outstanding issues related to it.The banker is free to publish the prospectus or a detailed summary of it as an advertisement. But apart from that the only kind of permissible advertising of the issue is the so-called tombstone announcement This is an advertisement in which no information is provided beyond the name of the issue, it's price, it's size and the names of the underwriters and dealers who have it for sale. And above even this austere announcement the underwriters usually insert a precautionary note to be interpreted as an offer to buy or sell the security, since such offer is made only through the prospectus

Even if a company satisfies all the requirement of the SEC on a new issue, the company's regulatory task may not end there, in view of the different laws of individual states

Also, once a company has sold securities to the public, it has an ongoing obligation to file, annual and quarterly reports as well as prompt notice of any material development that might affect the stock, with the Commission and the Exchange on which the securities are listed

5.3 PRICING IN DIFFERENT COUNTRIES :

5.3.1 U.S.A. :

In the U.S A , firms issuing stock use either a firm commitment or best efforts contract With a firm commitment contract, a preliminary prospectus is issued containing a tentative offering price range After the issuing firm and it's investment banker have conducted a marketing campaign and acquired informations about investor's willingness to purchase the issue and after the Securities and Exchange Commission (S E C) approves the offering price, a final offering price is set. The final propectus is then issued and the firm goes public. Under a firm commitment contract, the underwriter agree to bear the risk of the issue by purchasing the shares of the offer, less an underwriting discount, at the time of the offer. Only, when the final prospectus is issued (to be precise, five business days later) does the investment banker gurantee to deliver the proceeds to the issuing firm, whether or not the offer is fully subscribed If demand for the issue is weak, the investment banker is permitted to sell any unsold shares at a lower price This is referred to as "breaking the syndicate" for normally the managing or co-managing investment bankers have formed a syndicate that attempts to "stabilize" or "support" the market price by buying shares that investors are immediately reselling. The investment banker must sell all of the shares in the offering at a price no higher than the offering price once the offer price has been set.

With a best efforts contract, the issuing firm and its investment banker agree on an offer price as well as minimum and maximum number of shares to be sold. Following S E C approval, a " selling period " commences. During the selling period, the investment banker makes it's "best efforts" to sell the shares to investors. If the minimum number of shares are not sold at the offer price with in the specified period of time, usually 90 days, the offer is withdrawn and all investors' money are refunded with the issuing firm receiving no money

5.3.2 JAPAN :

At Tokyo Stock Exchange, the division of secondary capital market, Ministry of Finance, Japan, in conjuction with the surveillance department of the T.S.E. conducts a "stock price check", whenever Japanese companies plan to issue new shares; to make sure that company's new issues are priced at market value.

In Japan, the IPO process works as follows First roughly half the shares being issued are sold through an auction The public issue take place after the auction is completed The auction works as follows

Employees of the issuing company and similar interested parties are prohibited from participating in the auction. Bids cannot exceeds 5000 shares. At the auction, there is no "offer price" or "suggested price" Participants are required to select a price for the company using their own information and analysis.

The bids are sorted by price and shares are allocated to the bidders at the price they quoted until the auctioned portion of shares are exhausted Those allocated share by this mechanism can charge their own bidding price

The non auctioned shares are priced at the weighted average price of the auctioned. Within this constraint, the underwriter is free to place the unauctioned part as he/she pleases, e.g. through private placement or public offer etc. In this system, price discovery takes place through the auction The restriction disallowing bids above 5000 shares reduces the role for strategic behaviour at this auction. Once the auction is complete, a market determined price is known and the details of placement at this price are left to the underwriter

5.3.3 NIGERIA :

In Nigeria, there do exist some kind of control over price fixation of securities The capital issue committee attempts to set price of publicly, traded securities in order to protect the investors and to prevent price manipulations by market participants.

Several factors are considered while setting the prices of equities The price is set so that the ratio of average annual earnings (over the preceding five years) to share prices stay at 20% to 30% depending upon the industry. Another measure that is determined by the Government of Nigeria is the Net Asset Value per share. The NAV is calculated by deducting liabilities from assets and then dividing the figures by number of outstanding shares. Another factor being considered is E/P Ratio. The lower of the price implied by the earning price (E/P) ratio and the net asset value per share (NAV), becomes the price at which the stock may be sold.

5.3.4 SOUTH KOREA :

In South Korea things are different. The authorities have an obsession with par values and often companies have been forced to issue new shares either at par or atleast at a price nearer to par value. But according to Security Exchange Commission officials, companies are encouraged to issue new shares at current market price. Issue is being vetted by SEC to see that the valuation has been properly done. However, the companies hesitate to price new issue freely for fear of failure of issue.

5.3.5 TAIWAN :

At Taiwan stock exchange issue price are decided by the company and it's underwriter The Stock Exchange authorities check the fact. The companies can now-a-days list their securities at a premium to bookvalue. Share underwriter use a combination of assets value and earnings to decide worth of a company's issue. The local SEC will usually not put its approval on the prospectus without reducing the underwriter's valuation.

5.3.6 SINGAPORE :

In Singapore there do exist Government control over pricing of the issue. Here securities are not issued at market prices but issued at considerable discount to it's true worth The details of procedure of pricing was not available. This is also a guided capitalism practiced with official distrust on the market mechanism. Such a paternalistic attitude towards the development of the primary capital market result in rampant speculations and manipulation

5.3.7 MALAYSIA :

The Malaysian new issue market is not free. There also exist Government rules which have to be observed while issuing new securities, eg companies are allowed to issue or list shares at prices ranging from only 4 to 8 times their pre-tax earnings. Such a type of systematic underpricing of shares often result in massive oversubscription of new issues Companies are not free to issue shares on the basis of purely net worth and earning capacity.

5.3.8 PAKISTAN :

Until recently in Pakistan concept of share premium collection was prevailing. The premiums were fixed by the Government (Regulating Authoroties). But now the Government of Pakistan has abolished control pricing

5.4 UNDER PRICING - INTERNATIONAL PHENOMENA :

The pricing of initial public offering is difficult because there is no observable market price prior to the offering and many of the issuing firms have little or no operating history. If the price is set too low, the issuer does not get the full advantage of its ability to raise capital. If it is priced too high, then the investor would get an inferior return and consequently might reject the offering Investors would be unwilling to purchase offering from an investment banker with a record of overpriced offering.

Periodic overoptimism by investors creates "windows of opportunity" during which many firms rush to market, which results in disappointing returns to long term investors when the issuers fail to live to overly optimistic expectations In contrast, firms that issue during low volume periods typically experience neither high initial price run-ups nor subsequent long run underperformance These patterns are much more pronounced for smaller, younger companies going public than for their older, more established counterparts

The best known anomaly associated with the process of going public is the frequent incidence of large initial returns (the price change measured from the offering price to market price with in a few weeks of the offering date) accruing to investors in IPOs of common stock[1]

Various empirical studies using U.S.data reveal that simillar offerings are underpriced more on average than larger offerings. Table No.6 provides international evidence of underpricing based on various studies

5.5: REASONS FOR NEW ISSUES UNDERPRICING:

A number of reasons have been advanced for the new issues underpricing phenomenon, with different theories focusing on various aspects of the relations between investors, issuers and the investment bankers taking the firms public. In general, these theories are not mutually exclusive.Further more, a given reason can be more imoportant for some IPOs than for others Some of the reasons are:

1 The winner's curse hypothesis,
2. The costly information acquisition hypothesis,
3 The cascades hypothesis,
4. The Invesment banker's monopoly power hypothesis,
5 The law suit avoidance hypothesis,
6. The signalling hypothesis,

[1] The market problems with the pricing of initial public offers by A.G.Ibbotson and J.L.Sindetar and J R Pitter

7 The regulatory constraint hypothesis,

8 The wealth redistribution hypothesis,

9 The market incompleteness hypothesis

Since most theories of new issue underpricing imply that firms with greater uncertainty about the value per share will be underpriced more, issuing firms have incentives to reduce the amount of uncertainty. One way by which an issuer may reduce the degree of information asymmetry surrounding its initial public offering is to hire agents who clerify that the offer price is consistent with inside informations

It is also documented that in the long run, IPOs are overpriced i e. the returns on the IPOs after 3 years of offer are negative This is shown in Table No.7

The above listed reasons for underpricing are based on different studies. But none of the studies individually provide explanations for widespread underpricing.

5.6:MARKETING OF I.P.O.s.:

In other countries, various institutional arrangements exist for marketing the IPOs. The practice in Japan is similar to that in the U.S A. with firm commitment offerings, an offer price is set and underwriters have considerable latitude in the allocation of shares. In the United Kingdom most firms going public use either an "offer for sale " or a "placing" In an offer for sale, the offering price is generally set 10 days before the date of the offering and the investment banker involved bears the risk that market demand may fall before the offering is consummated. In the placing which is very similar to a firm commitment offering in the U.S A., the shares are generally sold to institutional investors In France, the contractual mechanisms for going public are much more explicitly auctions than is true in the U S A In Netherlands, firms that use a procedure similar to that used in France are not underpriced at all, whereas those using a fixed price offering (similar to firm commitment offering in the U.S.A.) do underpriced the securities