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Price performance of selected IPOs in Indian capital market using book building and fixed price strategies

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Abstract

The choice of pricing mechanisms holds significant importance when it comes to launch of IPOs. It plays a pivotal role in determining the success or failure in IPOs life. The selection of pricing mechanism should be based on individual preferences and market conditions. A diversified approach, thorough research, and risk management, can help investors to optimize their IPO investments in the Indian capital market. The study concludes that under book building mechanism, pricing accuracy of IPOs during periods of remarkable returns in 2020 though it is Covid19 as well as phases of underperformance in 2016, displayed a mixed track record, characterized by instances of both underpricing and overpricing. Market activity for Book Building IPOs shows significant fluctuations, reflecting shifts in market dynamics and investor sentiment. Henceforth, this mechanism offers the potential for higher returns; it also comes up with greater volatility and associated risks. Conversely, the Fixed Pricing Mechanism of IPOs demonstrates relatively stable performance, with returns closely aligning with the issue price and instances of notable underpricing or overpricing. Market activity in Fixed Price IPOs remains relatively steady, experiencing fewer fluctuations compared to the Book Building approach. Thus, the mechanism provides for investors with albeit moderate returns while carrying lower associated risks.

Keywords: Initial public offerings, book building, fixed price and MAER

Introduction

Extensive research has delved into the comparative performance of book building and fixed-price of IPOs, with both methods consistently resulting in underpricing. This underpricing phenomenon, acknowledged as a prevalent anomaly in primary markets worldwide, signifies the positive initial returns observed between the offering and listing dates of newly issued stocks. Furthermore, global empirical evidence indicates that IPOs conducted through the book-building process generally exhibit lower degrees of underpricing when contrasted with their fixed-price counterparts. Within the Indian IPOs market, the book-building mechanism has gained significant traction, especially for larger IPOs, since its introduction in 1999. In the traditional Indian IPOs landscape, offerings were characterized by fixed prices, where stock valuations were predetermined before soliciting investor bids. While book building has seen a surge in popularity, especially for substantial offerings, smaller IPOs from relatively smaller firms continue to adhere to the fixed-price approach. As a result, the Indian IPOs environment provides a unique opportunity to investigate whether there exist any systematic differences in the levels of underpricing of IPOs following the fixed-price method as opposed to the book-building method.

The Book building method is often favored over the fixed price method, and it has been noticed that IPOs which were unsuccessful in the market tended to opt for the Book building method. However, there is no concrete evidence to suggest a direct correlation between the failure of IPOs and the choice of pricing methods, as stated by K. Rajendra Prasad (2018) [1]. Additionally, Bedanta Bora *et al*., (2012) [3] stated that the Fixed Price method shows greater promise for long-term performance as compared to the Book-Building process. Furthermore, majority of larger companies with substantial issue sizes have chosen the book building mechanism, which has resulted in less under-pricing as compared to Fixed Price offers. Moreover, Rohit Bansal and Dr. Ashu Khanna (2012) [2] identified a substantial disparity in the degree of underpricing between

IPOs that employed the book-building approach and those that opted for the fixed price method as against to A. K. Mishra (2010) [4] reports that there is a significant average positive underpricing. However, it's worth highlighting that a substantial sixty percent of IPOs initially suffer from overvaluation, and there is no observed difference in underpricing between fixed-price and book-built offers.

Objective of the Study

To examine the price performance of selected IPOs in Indian Capital Market using Book Building and Fixed Pricing Strategies

Hypothesis Development

H_1: There is no significant difference between the number of IPO issues and underpricing of IPOs pricing mechanism methods.

H_2: There is no significant difference between the number of IPO issues and market adjusted excess returns (MAERs) of IPOs pricing mechanism methods.

Methods

This empirical study relies on secondary data, collected from NSE and CMIE Prowess IQ to examine the price performance of selected 365 IPOs newly listed on the NSE in India between April 1, 2011, and March 31, 2023. The study provides fresh insights into the first-day IPO price performance, particularly concerning the shift from the traditional fixed price approach to book building as the institutional pricing method. The study aims to understand how this shift impacts underpricing levels and market-adjusted excess returns (MAER). To achieve this, combination of both descriptive and inferential statistical tools are used for analysis.

Results

Table 1: Performance of Price Mechanism of IPOs in Indian Capital Market

Year	No of IPO Issues	Pricing Mechanism: Book Building: Underpriced	Book Building: Overpriced	Book Building: MAER (%)	Fixed Price: Underpriced	Fixed Price: Overpriced	Fixed Price: MAER (%)
2011	38	20 (52.63%)	18	217.20	0	0	0.00
2012	10	6 (60%)	4	129.54	0	0	0.00
2013	4	2 (50%)	2	129.10	0	0	0.00
2014	5	4 (80%)	1	658.12	0	0	0.00
2015	21	12 (57.14%)	9	176.09	0	0	0.00
2016	28	18(64.29%)	10	-876.03	0	0	0.00
2017	36	24 (66.67%)	11	374.43	0	1	-1229.78
2018	24	12(50%)	12	234.72	0	0	0.00
2019	16	9 (56.25%)	7	488.96	0	0	0.00
2020	16	12 (75%)	4	2306.80	0	0	0.00
2021	56	32 (57.14%)	15	257.99	5 (8.93%)	4	338.00
2022	93	34 (36.56%)	15	777.36	38 (40.86%)	6	751.22
2023	18	6 (33.33%)	0	385.74	10 (55.55%)	2	741.51
Total	365 (100%)	191 (52.33%)	108 (29.59%)	5260.01	53 (14.52%)	13 (3.54%)	600.94
T-stat		1.831		-1.959	3.269		-0.137
P-value		0.080		0.062	0.003		0.892
Average	28.077	14.692	8.308	404.616	4.077	1.000	46.226
S D	24.247	10.323	5.836	692.774	10.618	1.915	475.480
C V	0.864	0.703	0.703	1.712	2.604	1.915	10.286
Skew	1.795	0.766	0.103	1.417	3.173	2.020	-1.253
Kurt	3.720	-0.421	-1.197	5.544	10.481	3.416	4.540

***Sources*:** Authors Compilation

There are total 365 number of IPO issues over the period suggesting a vibrant IPO market; it implies that a robust IPOs market indicating a healthy economy with companies seeking capital for growth and expansion. On an average 28% of IPO issues annually indicates a consistent flow of new companies entering the market, it can be said that a steady stream of IPOs provide investment opportunities and diversification for investors. 191 IPOs (52.33%) of total IPOs are underpriced as against overpricing of 108 IPOs (29.59%) using the book building method. It means that pricing strategy can impact investor interest and success in raising capital. While in fixed price method, underpricing of 53 IPOs (14.52%) and overpricing 13 IPOs (3.56%), suggest a less common pricing approach for which companies may prefer book building for its flexibility. There are more average annual underpriced IPO issues in book building method than that of fixed price method. It is indicating issuers' willingness to offer favorable terms to investors and underpricing can lead to oversubscribed offerings and a positive debut in the market. Since the p-value is greater than the significance level (0.05), we fail to reject the null hypothesis. This means that there is no statistically significant difference between the number of IPO issues and underpricing using the book building price as against underpricing of IPOs using fixed price method. The choice of pricing mechanism method does not appear to have a significant difference between the number of IPO issues and market-adjusted excess returns (MAERs). This implies that, both methods may lead to similar MAERs. However, further research and analysis may be needed to explore other potential factors that affect IPOs performance.

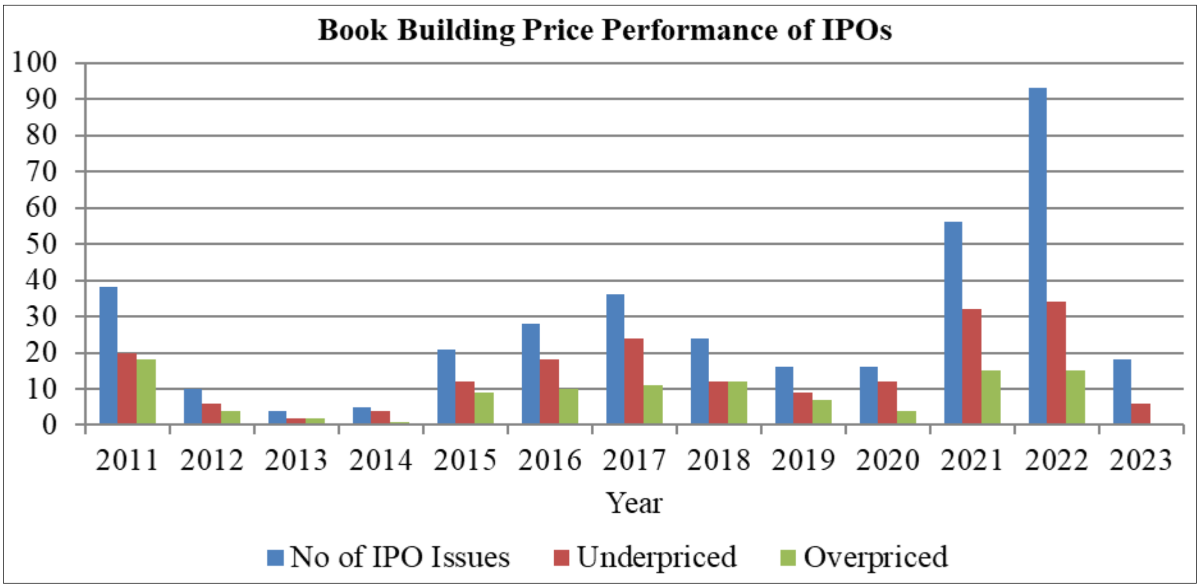

Fig 1: Graphical Representation of Book Building Price Performance of IPOs

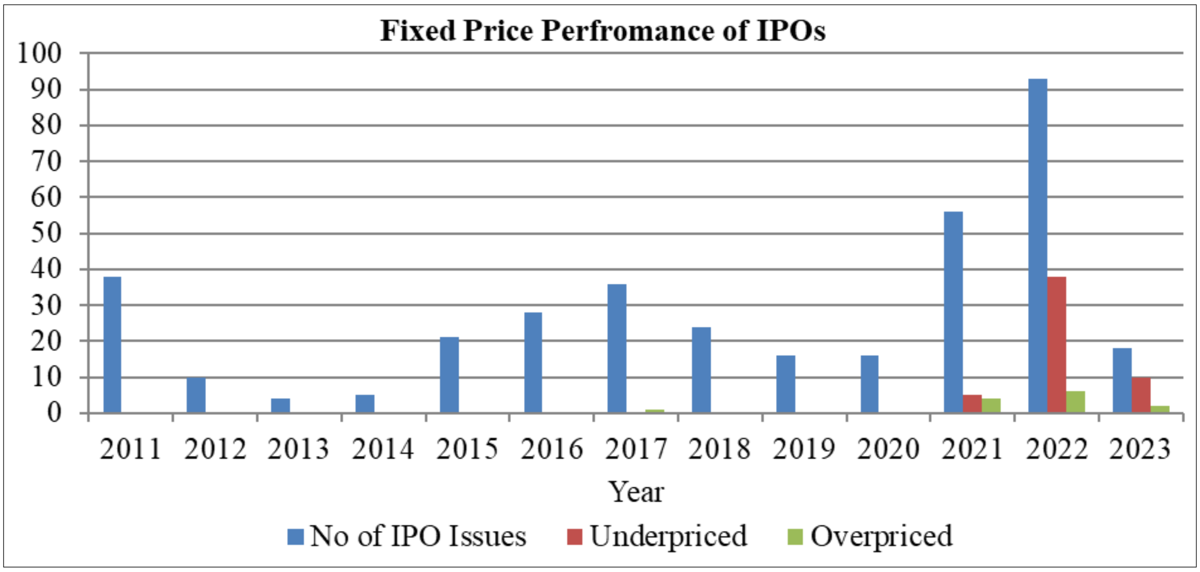

Fig 2: Graphical Representation of Fixed Price Performance of IPOs

Comparative Analysis of Pricing Mechanism

Performance Analysis: The Book Building mechanism exhibits varying performance over the study period, with significant fluctuations and positive movement in the average annual Market-Adjusted Excess Returns (MAER) ranging from -876.03% to 2306.80%. This mechanism experienced both outstandingly high returns in 2020 and 2022, and periods of underperformance, such as in 2016. Under fixed Price IPOs demonstrates relatively stable performance over the study period, with the annual average MAER consistently 46%. This suggests that returns are closely aligned with the issue price, providing investors with more predictable outcomes. This mechanism also experienced both exceptionally high returns in 2022, and 2023 and periods of underperformance, such as in 2017.

Pricing Accuracy: The presence of both underpriced and overpriced Book Building IPOs in different years suggests challenges in accurately pricing offerings. While underpriced IPOs attracted investors, overpriced ones led to substantial losses. The absence of significant underpriced or overpriced of Fixed Pricing demonstrated greater consistency in pricing accuracy, suggesting a more reliable mechanism for investors seeking transparency and fair pricing and only recent years are emerging trend.

Market Activity: The number of Book Building IPO issues diverse considerably, reflecting market dynamics and investor sentiment. The mechanism appeared to be more sensitive to changes in market conditions as compared to Fixed Pricing. The number of Fixed Price IPO issues also varied, but the mechanism exhibited more stability, with no years showing an extremely high number of offerings. Fixed Pricing seemed less sensitive to market fluctuations as compared to Book Building.

Risk and Return: Book Building IPOs presented higher potential returns but also higher variability and risk. Investors seeking higher returns may be attracted to Book Building, but they must be prepared for the associated volatility. Fixed Price IPOs offered more stable, despite being modest returns with lower risk. This mechanism may be favored by risk-averse investors seeking stability in their investments.

Suggestions

The study advice to investors, should consider a diversified portfolio that includes both Book Building and Fixed Price IPOs managing balance risk and return. Thorough due diligence, market timing considerations, professional advice, and the efficient pricing mechanism are crucial for making informed IPO investments in the Indian capital market. Book Building may be attractive during periods of market volatility, while Fixed Pricing can provide stability in less certain market conditions. Risk management strategies should be employed for Book Building IPOs to limit potential losses. Alignment of IPO investments with long-term financial goals is essential to mitigate short-term fluctuations.

Conclusion

The analysis of IPOs pricing mechanisms in the Indian capital market from 2011 to 2023 reveals a trade-off between risk and return. In nutshell, the study concludes that the Book Building Method of IPOs exhibited varying performance, with periods of exceptional returns and periods of underperformance. Pricing accuracy is mixed, with instances of both underpricing and overpricing, highlighting the need for careful evaluation. Market activity in Book Building IPOs fluctuated significantly, reflecting market dynamics and investor sentiment. Furthermore, this mechanism offered potentially higher returns but with greater volatility and risk. While, IPOs issued based on Fixed Pricing Method are demonstrated relatively stable performance, with returns closely aligning with the issue price. Market activity in Fixed Price IPOs is relatively stable in recent years, with fewer fluctuations as compared to Book Building. Moreover, this mechanism provides more stable but modest returns with lower risk.

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