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Article

Do analyst's pre-issue recommendation create value? Empirical evidence from Indian IPO market

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ABSTRACT

This study investigates impact of pre-issue analysts coverage on IPO performance i.e. subscription rate, underpricing, volatility and liquidity. Using pre-issue analyst's recommendation for a sample of 157 IPOs issued in India during the period 2007–2012, we find that analysts' recommendation reduce underpricing. Precisely, more analysts participated in issuing recommendation (including favorable recommendation) reduce underpricing. The result also shows that favorable recommendation issued by more number of participating analyst's boosts confidence of potential investors and hence probability of getting success for IPOs in terms of oversubscription is more. Further, affiliated analysts are associated with lesser oversubscription rate. Additionally, independent analyst's recommendation is inversely associated with underpricing. In support of IPO grading, which is a unique practice in India, we find that superior grading reduce underpricing and attract more response from investors. Further, evidence suggests that pre-issue analyst coverage increase oversubscription rate, while reduce listing day volatility and liquidity for IPO stocks.

1. Introduction

Analysts' coverage including research coverage has become an essential element of the security issuance process in recent years. Existing studies (Dunbar, 2000; Clarke et al., 2003) find that underwriters utilize analyst firm's to increase their market share in the IPO market. By moving one step ahead, Clarke et al. (2003) document that underwriters prefer to include all-star analysts to gain greater IPO market share. Analyst coverage might be valuable for IPO market participants on account of several reasons. First, analyst coverage can generate publicity for issuing company, thereby potentially increase firm value by generating more customers. Better analyst coverage might lead to greater investor recognition of the IPO firm. Greater investor recognition can lead to higher value for company Merton's (1987). Second, post-IPO analyst coverage boost share price, which can be especially important for insiders wishing to sell their shares in the open market (Chen and Ritter, 2000; Aggarwal et al., 2002). Third, studies suggest that lead investment banks prefer to recruit more co-managers (having own research wing) as part of underwriting syndicate to garner more analyst coverage following the IPO (Loughran and Ritter, 2002). Bradley et al. (2008) also find evidence that larger syndicate helps in generating more information via after market analyst coverage. Fourth, coming to issuing firm view point, most of the analysts demonstrate biasness while issuing coverage. Analyst firm's coverage is in line with the management policy of the issuing firm (McNichols and O'Brien, 1997). He also finds that analyst's coverage for initial and seasoned public offerings are systematically more optimistic. Finally, analysts are often good at picking mispriced stocks as they have expertise in market study.

Analysts play an important role in capital markets in general and IPO market in particular. For example, by doing in-depth research for their large institutional clients and employers, analysts help in guiding a substantial sum of capital to more productive uses in our economy. Research analysts study fundamentals of firms and project the likely performance on the basis of industry, economic, and business trend information to help their clients make better investment decisions. In an IPO context, if analyst's coverage is available before issue open can helps in reducing information asymmetry between issuing firm and the prospective investors. Even analyst approval from a reputed investment bank (or brokerage firm) may also act as a certification of quality for the issue. Retail investors might believe that most analysts work for them as part of their primary obligation to the investing public. However, full story

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is much more complicated. Some analysts are unaffiliated and they sell their independent research to financial or investment institutions, banks, insurance companies, or private investors on a project or subscription basis. But a large number of analysts are employed by institutions whose financial stake in their coverage may go well beyond their accuracy. Taken together, it is always challenging to investigate whether analyst's issuing coverage (or recommendation) helps in creating value for new issue market participants (i.e. issuing firm, investors, and underwriting firms).

Analyst coverage and its impact on stock price performance of existing listed firms are expansively documented in capital market literature (Moshirian et al., 2009; Jegadeesh and Kim, 2006; Chen and Ritter, 2000; Womack, 1996). However, little evidence is recognized on value implication of pre-issue coverage provided by analysts. In this paper, we hypothesize that whether analysts are doing any value addition in the IPO market, while providing pre-issue recommendation. Value insinuation of analyst coverage for an IPO firm is evaluated at four different points i.e. subscription rate, initial day return (underpricing), after market volatility and liquidity. Taken together, this study is motivated to uncover the usefulness of analysts' recommendation and coverage for making IPO a successful event. In this paper we address five key issues relating to IPO market i.e. (a) Whether analyst recommendation is useful in attracting more subscription from the investors or not?, (b) Can analyst endorsement (pre-issue) for IPOs helps to reduce underpricing?, (c) How do analyst's pre-issue recommendation affect volatility of IPO stocks, both on listing and in aftermarket, and (d) Does analysts' approval of the IPO trigger more liquidity in the market?

The Indian IPO market offers an important setting to extend our understanding of pre-issue analyst coverage (or recommendation) on subscription rate, initial day return, after market volatility and liquidity. Following are the few aspects by which Indian IPO market distinguishes itself from other developed markets: first, unlike US Indian book building mechanism is highly transparent, which allows investors to access subscription related information during book building period. However in US and UK investors are only allowed to access bidding information once book building period is over. Second, Indian regulation does not impose any restrictions on issuing pre-issue coverage. On the surface it is found that brokerage houses including market analysts publish analysts' reports on upcoming IPOs providing investment advice i.e. subscribe, or not to subscribe. Third, another important aspects of IPO process is that with effect from May 1, 2007 it was made mandatory for all IPOs issued in India to be rated by a professional rating agency, and the rating score (assigned on a five-point scale) needs to be revealed in the prospectus. IPO rating is one-time assessment of fundamentals of IPO firm at the time of issue and is intended to aid the prospective investors in their decision making. IPO grading sets an international precedent in primary market regulation (Jain and Sharma, 2008). Fourth, Indian regulation allows the issuers to cap the price band at 20% of the floor price, which is relatively wider than the practice followed in US IPO market.[1] Within the framework of wider price band, Indian IPOs are found priced within the price range, a practice identical to European IPO market. Fifth, unlike USA and other European countries, all valid bids are legally binding in India and all successful bidders are obligated to take allocation of shares. Sixth, Indian IPOs are required to get it listed within twelve days from book closure date, which is significantly higher than the practice being followed in USA. In USA there is no time gap in between offer closing date and listing. Finally, Indian IPO market is passing through a transition phase, where a substantial number of IPOs are getting oversubscribed at a higher rate in comparison to the developed economies.

This paper examines relationship between pre-issue recommendation (and coverage) issued by analysts and IPO pricing performance. Using a sample of 157 IPOs issued in India during 2007–2012, this paper motivates to interlink between analyst's pre-issue recommendation and IPO performance i.e. underpricing, rate of subscription, aftermarket liquidity, and volatility. Taking cue from the signalling theory, this study postulates that endorsement from analysts is proved to be a useful signal of quality for the issue. Predictive relationship between pre-issue coverage and underpricing is unlikely to be subject to endogeneity issues, because underpricing occurs only on initial day of trading (when listing day close price is compared with offer price) and is unlikely to affect analyst's coverage. Further, analyst's pre-issue coverage is not subject to confounding events, because analyst's coverage for an IPO impounds all information (including fundamentals) available before an issue open for subscription. We evaluate analyst recommendation from five different perspectives i.e. (a) number of analysts participated in issuing coverage (or coverage), (b) analysts affiliation to lead investment bank including any underwriting syndicate member participating in an IPO, (c) strength of coverage, measured as ratio of number of analysts issue favorable coverage to total number of coverage issued by participating analysts, (d) analysts score issued by independent analyst's i.e. capital market database[2] and (e) IPO grading issued by rating agencies, which is unique to the Indian IPO market. Rating agencies contended that IPO rating is an independent and unbiased opinion of a rating agency. Besides analyst coverage characteristics, other control variables i.e. age of the firm, offer size, and venture capital (VC) participation are used in the econometric model to control maturity, size and VC effect.

We find that analyst's recommendation reduce underpricing. More favorable recommendation including larger pre-issue coverage significantly reduces underpricing for IPOs. We predict that superior graded IPOs are lesser underpriced than poorly graded IPOs. Investigating impact of venture capital participation, we shows that IPOs affiliated to venture capital firms are comparatively lesser underpriced than non-affiliated IPOs. Further, it is documented that some independent analysts prefer to recommend underpriced IPOs. We find a strong positive relationship between analyst recommendation and subscription rate. Increasing consensus among analysts providing pre-issue positive recommendation helps in attracting more response from potential investors. Even recommendation from affiliated analysts including IPO grading trigger positive response among investors. In other words, analyst's coverage is proved as an attestation of quality for IPO firm. These findings provide novel evidence on the role of analyst's coverage on IPO performance. Further, we find that pre-issue analyst coverage reduce aftermarket volatility and increase liquidity for IPO stocks both at listing date and post listing period up to one month from listing.

This study is of particular interest for three reasons; first, we investigate impact of pre-issue analyst's coverage on IPO performance, while most studies link underpricing and post-issue analysts following IPO. This represents a departure from earlier studies by proposing the causality moves from analyst coverage available before the issue open to IPO performance i.e. underpricing, subscription rate, and aftermarket volatility. Theory suggests

[1] In the USA IPO market a typical price range of $2 or 10% of the floor price is followed.

[2] Not affiliated to any syndicate members, issuing firm and capital market database. In other words, these independent analyst firms are neither a subsidiary nor a joint venture of any of the participants including issuing firm, book running lead managers, participating syndicate members and capital market database.