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Transparent bookbuilding, certification and initial public offerings☆

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ABSTRACT

India has the unique distinction of being the only country that releases information on the IPO bookbuilding process live to investors. Against this backdrop, we investigate the role this mechanism plays in generating investor interest during the bookbuilding process and the subsequent performance of IPOs in the immediate aftermarket. We show that, to retail investors, institutional bids in the early days of the bookbuilding process offer a coherent signal about the quality of the IPO. IPOs with high levels of institutional demand in the early days of the book also see high levels of bids from retail investors in the later days of the book. Large subscriptions have a strong positive effect on initial returns. Known certification mechanisms, such as the reputation of the sponsor, VC affiliation and IPO grading, are of limited importance in the Indian IPO market.

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1. Introduction

Though bookbuilding has emerged as one of the dominant methods of pricing and selling initial public offerings (IPOs) around the world, there is still considerable debate about the strengths, weaknesses, and future of this process. Jagannathan and Sherman (2005) highlight the problem of exclusivity and the lack of transparency in the current bookbuilding practice.[1] Wilhelm (2005) forecasts that advances in communication technology and auction theory will reshape the future of the bookbuilding process. In this paper, we contribute to this current debate by documenting the case of an emerging market, India, where the IPO bookbuilding process has indeed been reshaped. We study the benefits of this modified bookbuilding process for investors, especially retail investors, and its consequent impact on the underpricing of IPOs.

IPOs are characterized by high levels of information asymmetry. Firms that plan to go public often use various certification mechanisms, such as high-quality underwriters and venture capital (VC) affiliations, to reduce information asymmetry and signal their quality to potential investors. Past research has studied the impact of these certification mechanisms on the pricing of IPOs, mostly in developed markets.[2] It is only recently that the focus has shifted to developing markets such as India. In a recent paper, Deb and Marisetty (2010) document an interesting certification mechanism in Indian IPOs, namely IPO grading. They report that its introduction has resulted in a reduction in underpricing and that higher IPO grades lead to increased demand from retail investors.[3] However, Jacob and Agarwalla (2012) find no evidence of an improvement in IPO pricing as a result of the introduction of grading, and suggest that IPO grading has failed as a certification mechanism for Indian IPOs. This conclusion has been reiterated by the Indian stock market regulator SEBI, which has recently acknowledged that IPO grading has "not served the purpose that it was supposed to."[4] The results of our study may provide an explanation for this failure. We show that the announcement of an IPO grade is followed by a transparent bookbuilding process. IPO certification (or the lack of it) emanating from strong (or weak) institutional investor demand in the early days of the bookbuilding process renders IPO grades irrelevant for retail investors.

The IPO process in India has evolved over the last two decades and, as compared to the U.S. situation, it differs in at least three ways [for a detailed analysis of the institutional setting and regulatory framework, see Bubna and Prabhala (2011)]. First, since May 2007, the Indian regulations have required all IPOs to be graded by at least one credit rating agency. IPO grading was mandated primarily to protect retail investors from unscrupulous issuers. Second, 35% of the shares sold in Indian IPOs are reserved for retail investors.[5] This makes retail investors an important investor class for the issuing firms. Third, since 2006, the Indian IPO bookbuilding process has been extraordinarily transparent, in that the timing and subscription pattern for the different investor groups is observable on the stock exchange's website, with 'live' updates every thirty

[1] Jagannathan and Sherman (2005) advocate applying certain transparency features of standard auctions (such as the timing of bids) to the bookbuilding process. They refer to this as a hybrid solution or modified bookbuilding. Jagannathan and Sherman also recommend that retail investors should be encouraged to participate in the bookbuilding process without the discouragement of institutional investors.

[2] For example, for U.S. IPOs, Beatty and Ritter (1986) and Carter, Dark, and Singh (1998), among others, show that IPOs with highly reputable underwriters show lower initial returns. Barry, Muscarella, Peavy, and Vetsuypens (1990) and Megginson and Weiss (1991) show that venture capitalist (VC)-backed IPOs exhibit lower initial returns.

[3] There have been some other recent studies on Indian IPOs. Bubna and Prabhala (2011) examine bidding, allocation, and underpricing in Indian IPOs in two situations: when underwriters had allocation powers and when such discretion was removed. Their results support bookbuilding theories in which discretionary allocation powers for underwriters assist with pre-market price discovery. Neupane and Poshakwale (2012) focus on the returns retail investors make in Indian IPOs. They find that retail investors can earn high first-day returns in IPOs with above-average demand from institutional investors. Brooks, Mathew, and Yang (in press) show that when-issued trading plays an important role in price discovery in the Indian IPO market.

[4] 'IPO grading has not served the purpose', The Indian Express (May 29, 2013). Available at www.indianexpress.com/news/ipo-grading-has-not-served-the-purpose-sebi/1122038.

[5] A few other countries, such as Italy and Germany, have a similar arrangement (Vismara, Paleari, and Ritter, 2012; Gounopoulos and Hoebelt, 2013).