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Group affiliation and the performance of IPOs in the Indian stock market

Vijaya B. Marisetty[a], Marti G. Subrahmanyam[b,*]

[a]*Department of Accounting and Finance, Building H, Caulfield Campus, Monash University, Caulfield, Vic 3145, Australia*

[b]*Leonard N. Stern School of Business, New York University, Kaufman Management Center, 44 West 4th Street, New York, NY 10012, USA*

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Abstract

We document the effects of group affiliation on the initial performance of 2,713 initial public offerings (IPOs) in India under three regulatory regimes during the period 1990–2004. We distinguish between two competing hypotheses regarding group affiliation: the ''certification'' and the ''tunneling'' hypotheses. We lend support to the latter by showing that the underpricing of business group companies is *higher* than that of stand-alone companies. Furthermore, we find that the long-run performance of IPOs, in general, is negative. We also find that Indian investors over-react to IPOs and their over-reaction (proxied by the oversubscription rate) explains the extent of underpricing.

JEL classifications: G14; G32

Keywords: Initial public offering (IPO); Underpricing; Business groups; Certification; Tunneling

The decision to go public through an initial public offering (IPO) is one of the most critical decisions in the lifecycle of a firm. Due to its presumed importance, it has become one of the most widely researched topics in the finance literature. One aspect of this literature is the use of some form of certification to reduce the costs associated with an IPO. To alleviate the costs associated with the IPO decision, firms often build their

*Corresponding author. Tel.: +1 212 998 0348; fax: +1 212 995 4233.

E-mail addresses: vijay.marisetty@buseco.monash.edu.au (V.B. Marisetty), msubrahm@stern.nyu.edu (M.G. Subrahmanyam).

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reputation by obtaining different types of quality certifications to signal their true value to the market. Some popular certification strategies include employing a reputable auditor (Beatty, 1989), associating with a venture capitalist with an established track record (Barry et al., 1990), hiring a well-known underwriter (Carter et al., 1998), attracting strong institutional affiliation (Hamao et al., 2000), and recruiting a good quality management team (Chemmanur and Paeglis, 2005).[1]

One form of certification, popular in many countries where family-controlled businesses play a dominant role in the economy, is affiliation to a business group. For group companies, certification can also come in the form of being associated with a large multinational company (MNC), or a continuing link with the government after the privatization of a state-owned company. In this paper, we aim to address three main issues related to group affiliation and the initial and long-term stock market performance of firms in the Indian context:

1. Does affiliation with a group, domestic, government, or foreign, act as a form of certification at the time of the IPO, as reflected in its initial underpricing?
2. Does the long-run survival/success probability of such group-affiliated companies differ from that of stand-alone companies?
3. How do IPOs of firms that are affiliated to groups, domestic, foreign, or government, perform in the long run, in terms of returns to investors?

These questions arise in the context of the Indian economy, which provides a natural setting to examine various types of group affiliations. The Indian economy is dominated by family-controlled business groups. Khanna and Palepu (2000) argue that, in this context, business group affiliation provides certification benefits in the absence of developed institutions in the product, labor, and capital markets.

Using a sample of 2,713 IPOs in India under three regulatory regimes during the period 1990–2004 we examine the performance of IPOs that are affiliated to business groups, foreign business groups, government-affiliated firms, and stand-alone firms. We examine both the short-run and long-run performance of IPOs. Unlike other papers in this area, we also examine the longer term *survival* of firms making the IPOs. Longer-term survival could be the decisive factor that separates group-affiliated firms from their stand-alone counterparts in an environment where institutional structures are somewhat weak.

We find that group-affiliated companies experienced greater underpricing than their stand-alone counterparts in their IPOs. Although this indicates that valuations of group firms exhibit the effects of higher information asymmetry, we find that even foreign group-affiliated firms that belong to better governed multi-national companies (MNCs) experience higher underpricing. These groups do not generally have complex cross holdings, and furthermore, are presumed to abide by more stringent disclosure norms.[2] We, therefore, extend our analysis to explore other alternative hypotheses for differential underpricing.

[1]There is a vast literature on the role of certification in IPOs. We do not attempt to survey this literature in any detail here, but rather provide a few examples to set our research in context.

[2]However, as discussed later, private foreign groups may have a conflict of interest between the Indian affiliate and the overseas parent, due to royalties and other transfer payments paid to the parent, which may partly explain our results.