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Extreme IPO underpricing and the legal environment in wealthy emerging economies

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This paper investigates IPO performance in the wealthy economies of the Gulf countries using restricted access data from regularity bodies. Contrary to asymmetric information theories, we find that IPO performance relies crucially on the unique institutional framework adopted by regulators. We also find that governance regulation in economies with weak regulation tends to provide better protection for investors in IPO markets. Finally, we find that underpricing is more severe when foreign investors are banned from sharing IPOs.

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1. Introduction

The correlation between the short- and long-run stock returns of initial public offerings (IPOs) has been a subject of research for decades. The cumulative evidence shows that investors who purchase IPOs at the offer price and sell them on the listing day receive positive returns (Ritter and Welch, 2002). However, it is hazardous to buy IPOs at the listing day's closing price and hold them over a long period (Loughran and Ritter, 1995).

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In this paper we examine the short- and long-run performance of 139 initial public offerings (IPOs) between 2003 and 2010 in the Gulf Cooperation Council (GCC) region consisting of Saudi Arabia, Kuwait, Bahrain, Qatar, the United Arab Emirates (U.A.E.) and Oman. The region has recently experienced a hot issue market, with the number of IPOs in some markets exceeding the number of the originally listed firms, and with the IPOs raising a combined total of more than US$55 billion. This huge amount of capital is greater than that raised by 2476 U.S. IPOs (Ritter, 1991), 445 Canadian IPOs (Kooli and Suret, 2004) and many others. This implies that IPOs in the GCC have been priced extremely highly without any intention of leaving money on the table.

IPOs issued in the GCC were significantly underpriced by an average of 227.36%. This is consistent with global evidence, but is much larger in magnitude (Loughran et al., 1994). This raises the important question of whether underpricing is a deliberate discount by the issuer. We investigate reasons behind this high degree of underpricing and such a great deal of money being left on the table. Evidence suggests that there is no such thing as "money left on the table", as it is actually capital brought to the market by speculators on the listing day. The widespread underpricing observed in the GCC can be explained by the behavior of investors (flippers and speculators). One might argue that this analysis is only valid in the GCC region, given its unique degree of underpricing compared to other countries. In this regard, it is imperative to realize that similarly large degrees of underpricing have been observed in other countries. For example, underpricing in the U.S.A. was 65% during the internet bubble period (Loughran and Ritter, 2004) and in China it is usually over 200% (Ritter, 2011).

We conclude that underpricing in the GCC is caused by the unique institutional framework adopted by the GCC capital market authorities. The GCC institutional arrangement promotes strong demand during the subscription period and shapes investor behavior on the listing day. As opposed to all other markets, IPOs prices in the GCC are only allowed to freely fluctuate on the listing day, and from the second day onward the price is restricted to a 10% increase or decrease, similar to other listed companies. While GCC authorities justify this policy based on the need to establish a market price for the IPO on the listing day, the policy attracts aggressive speculators. Those speculators participate heavily on the listing day in hopes of an unlimited potential profit if the price increases. If the price moves adversely, however, there is a loss limit of 10% that acts as protection from the second day onward. Therefore, underpricing in the GCC is a governmental choice managed by the capital market authorities. Consistent with Ekkayokkaya and Pengniti (2012), we conclude that governance regulation in an economy with weak regulations tends to provide better protection for investors in the IPO markets.

In GCC, IPOs are used as a strategy for distributing wealth among citizens. In all GCC countries foreign investors are prohibited from sharing IPOs. This restriction leads to shallow market and severe underpricing. Also, the authority regulations prohibit foreign underwriter to lead the IPO in favor to local underwriter.[1] Consistent with Hopp and Dreher (2013) we conclude that the underpricing is more severe when foreign investors are banned from sharing IPOs.

In most GCC countries, mainly Saudi Arabia, the capital market authority requires firm's evaluations by a star analyst. Consistent with Liu and Ritter (2011) we document severe underpricing in countries when the lead underwriter provides all-star analyst coverage.

As opposed to IPO asymmetric and symmetric literature, we explain underpricing as a function of four major factors: firm characteristics, subscription period outcome, investors' behavior on listing day, and market conditions. Secondly, we provide evidence of the long-run performance of these IPOs. We measure IPO performance relative to the offering price as well as by the traditional listing day closing price (Ritter, 1991; Aggarwal et al., 1993; Levis, 1993; Lee et al., 1996). These measures the underpricing of IPOs beyond the listing day, including the second day, first week, first month, first six months and first year post-listing. The relevance of the long-run performance is highlighted by Ritter and Welch (2002) who state "Still, we hope to see further work to tell us which subsamples are particularly prone to poor post-IPO performance, both in the United States and in other countries" (p. 1822).

[1] Fung et al. (2014) investment bank has an incentive to set the IPO high to gain experience and keep customers.

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