



Domestic and foreign institutional investors' investment in IPOs



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ABSTRACT

The regulatory provisions in India ensure that IPO investors are able to observe the participation levels of other subscribers prior to their own subscription decisions. This should reduce the information asymmetry between the foreign institutional (FIIs) and domestic institutional investors (DIIs). We argue that because of this setting we should observe less difference in their investment patterns and performance. Our results, however, show that (a) FIIs subscribe to IPOs more aggressively than DIIs; (b) DIIs have better IPO selection ability than FIIs; and (c) in the post-listing period, FIIs reduce their IPO holdings more extensively than DIIs. FIIs reduce their post-listing holdings especially in firms that are smaller, younger, have higher stock volatility while increasing on stocks with higher returns, indicating that FIIs chase hot markets. Overall, in spite of transparency-enhancing regulations, the investment patterns of FIIs and DIIs differ significantly.

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1. Introduction

Recent years have witnessed growing foreign portfolio investments into emerging equity markets, potentially driven by reduced restrictions in capital mobility and improved information flow. Yet, only a few dimensions of foreign portfolio investments have been examined. One particular strand of literature investigates the investment preferences and performances of foreign institutional investors relative to domestic investors. For example, Ferreira and Matos (2008) show that while domestic institutional investors (DIIs henceforth) and foreign institutional investors (FIIs henceforth) share some common investment preferences, they also exhibit substantial differences. Some studies also document that FIIs exhibit superior performance relative to DIIs on account of their investment experience and expertise (see Grinblatt and Keloharju, 2000; Seasholes, 2000). On the other hand, Kang and Stulz (1997) and Choe et al. (2005) suggest that DIIs perform far better than FIIs, especially because of their informational advantage in the home markets. These findings are, however, based on the analysis of investments in secondary equity markets. No study, to our knowledge, has compared the investment patterns of DIIs and FIIs at the time of initial public offerings (IPOs). This distinction is important because investors are likely to have access to more information in secondary markets (particularly due to mandatory disclosure requirements, analysts' coverage, and the wider investor-base of listed firms) than in IPO markets. This paper aims to fill the void in the literature by comparing the investment patterns of FIIs and DIIs in IPO markets.

Given the paucity of publicly available information on IPO firms, DIIs are likely to be better informed investors than FIIs, since they have the advantage of local knowledge and familiarity with domestic firms. This suggests that FIIs face higher investment risks and therefore should participate in fewer IPOs. They are also exposed to a higher adverse selection risk, potentially leading to a lower average return as they have to depend on limited information to distinguish between 'good' and 'bad' IPOs. However,

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such differences between FII and DII should be significantly less in the context of the Indian IPO market. From the investors' perspective, the Indian IPO market is much more transparent than other markets, since the regulations require the stock exchanges to disclose subscription levels of other investors on a daily basis during the IPO subscription period.¹ FIIs should, therefore, be as informed as DIIs, through extracting information from the real-time participation activities of DIIs, and be able to participate as actively as DIIs in IPO subscriptions. Consequently, there should be no significant differences in the ability of FIIs and DIIs to distinguish between the 'good' and the 'bad' IPOs in the Indian IPO market.

There are several features of the Indian IPO market that are both unique and relevant for a comparative analysis of the participation of FIIs and DIIs. Indian IPO firms are required to allocate quota for three investor categories: institutional (50%), non-institutional (15%) and retail investors (35%).² The IPO process is very transparent, since the information on the subscription of various investor categories is publicly available at the time of the offering. Such information is published daily by stock exchanges until the closing date of subscription. This suggests that investors wishing to participate in the offer can find out the demand pattern of other investors before making their own decisions.³ The IPO pricing and allocation mechanism in India resembles a uniform auction price similar to the 'Open IPO' used by WR Hambrecht in the US.⁴ This process allows the underwriters to set the offer price within the advertised price range. Underwriters do not have any discretion in share allocation and subscribers receive their allocation on a pro rata basis. Further, underwriters neither undertake any market stabilization activities nor impose penalty bids both of which are fairly common in the US (see Aggarwal, 2003).

The key foundation of this paper rests on the fact that, owing to the transparent IPO process, both FIIs and DIIs should be able to observe the demand of various investor categories before submitting their own subscriptions. Both types of investors should be able to extract information from other investors' activities. Given the transparent nature of the process, we should not expect any significant difference in the investment patterns (e.g. participation in IPOs, rate of returns, and post-IPO holdings) of FIIs and DIIs. To test this prediction, we address three empirical issues, using a sample of IPOs listed on the Bombay Stock Exchange (BSE) and/or National Stock Exchange (NSE). First, the determinants of DIIs' and FIIs' subscriptions at the time of the IPO are examined by drawing economic reasoning from literature on both IPOs and institutional holdings. Second, we examine the impact of the quality of IPOs, measured by the initial as well as the immediate post-listing returns, on the participation of DIIs and FIIs. Finally, we examine the flipping patterns of DIIs and FIIs, by analyzing their holdings in the immediate post-listing period. This analysis shows us how DIIs and FIIs adjust their holdings in the post-IPO period.

Our analysis reveals three key findings. First, at the time of the offering, FIIs subscribe more heavily than DIIs. FIIs' subscription is, on average, almost 30% higher than that of DIIs' (3.12 times vs. 2.40 times the number of shares offered). FIIs also seem to subscribe to the IPOs that are avoided altogether by DIIs. Analysis of the determinants of IPO subscription shows that both DIIs and FIIs prefer firms that are larger, less closely held by insiders, have large cash holdings and appear to be positively influenced by recent market returns. On the other hand, market volatility at the time of the offer appears to dissuade only DIIs, and not FIIs, from investing in Indian IPOs.

Second, both DIIs' and FIIs' subscriptions have a positive relation to the quality of IPOs, measured by initial and immediate post-listing returns. However, when both DIIs' and FIIs' subscriptions are included in the same equation, the influence of the former's subscriptions subsumes that of the latter. DIIs' subscription appears to be far more measured and informed than that of FIIs. This implies that in spite of the transparency of the IPO process, DIIs seem to have superior information to FIIs, possibly reflecting the value of local knowledge.

Finally, we find that institutional investors in general reduce their holdings in IPOs in the immediate post-listing period.⁵ This reduction is more prominent in cold (negative initial return) than in hot (positive initial return) IPOs. FIIs reduce their holdings significantly more than DIIs. Further, DIIs reduce their holdings considerably more in hot IPOs, while FIIs appear to do the same in cold IPOs. In the post-listing period, FIIs adjust their position by gravitating towards mature and better cashed up as well as those with better stock returns and lower volatility. Since FIIs reduce their holdings in cold IPOs and increase their holdings in stocks with better stock returns, the evidence is consistent of them being momentum and return chasing investors, as noted in Grinblatt and Keloharju (2000).

This study makes three major contributions to the literature. First, to the best of our knowledge this is the first study to investigate the investment patterns of DIIs and FIIs in the context of IPOs. As such, this work extends the literature on investment behavior of DIIs and FIIs (Ferreira and Matos, 2008 and Grinblatt and Keloharju, 2000) and reveals that although they have several common preferences, their IPO investment strategies differ. Second, this study also adds to the investment behavior literature of DIIs and FIIs in an informationally transparent context where the concern of information asymmetry is lower than in other IPO markets (Kang and Stulz, 1997 and Choe et al.,

¹ The Indian IPO market has become even more transparent in recent years, as the firms which are going public are required to acquire and disclose their quality ratings. Similarly, trading activities in grey markets provide an opportunity to gather the market value of the IPOs before the closing date for subscription. See Neupane and Poshakwale (2012) for further discussion on the transparency of Indian IPO markets.

² Large investors such as commercial banks, mutual funds, venture capital funds, and insurance companies who are registered with the SEBI are considered to be institutional investors. Retail investors are those who can bid up to a value of INR 100,000 in the offering. All other investors are considered to be non-institutional investors.

³ Appendix B.1 (which we also use to demonstrate how we calculate the institutional subscription variable) shows this information for one of the sample companies.

⁴ Prior to 2006, the Securities and Exchange Board of India (SEBI) allowed the use of a modified form of book building mechanism in which allocation in the institutional investor category was discretionary. Thus, some of our sample firms were issued under this regime. Moreover, firms wishing to go public are also allowed to use fixed pricing if they do not meet the requirements for the book building/auction mechanism. However, since we are unable to track the participation of institutional investors in these IPOs, we exclude them from our analysis.

⁵ Since Indian firms are required to submit their shareholding structure on a quarterly basis, we examine domestic and foreign institutional holdings at the end of the first four quarters after the date of listing. Since institutional holdings remain steady beyond the first quarter, we focus primarily on holdings at the end of the first quarter after listing. Section 3.2 discusses quarterly holdings data.

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