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Mental Anguish on The Retail Investors Emanating from Mispricing of Initial Public Offering in Kenya

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Abstract

IPO pricing and information asymmetry is a thought provoking concept that begs for further prodding just to get an insight into how they affect the most vulnerable group in the capital market, the retail investors. These are the most uninformed investors who face greater risk in the Initial Public Offering (IPO). What appears to be great gains at the opening of the IPOs quickly changes into loss when the market corrects itself from the underpricing. Institutional investors are aware about the share price trends. Hence they offloaded their shares and made their profits. In the end, the retail investors are left with shares whose prices plummet below the purchase price. This paper has delved into the effect of IPO mispricing on the retail investors.

Key words: Institutional investors, retail investors, IPOs, information asymmetry, underpricing

Introduction

The process by which a private company sells shares of stock to the public for the first time is described as initial public offering (IPO) (Fidelity Viewpoints, 2022). An IPO's implication is that the ownership of a given firm is evolving from private nature to public, thus giving IPOs the moniker "going public". In order to successfully execute an IPO, private firms seek the services of investment banks (underwriters) to introduce their shares to the public, calling for all-encompassing due diligence, marketing, and compliance with the necessary regulations.

IPOs can either be: a fixed price whereby the offering price is set before the IPO opens for the subscription; and investors are required to apply for the IPO at the fixed price set with their allotment of shares being based on the subscription status of the issue; or a book building offering whereby the price is determined by an underwriter who calls for bids from various institutional investors such as fund managers.

Firms go through three stages in the IPO process: pre-IPO transformation phase where a firm set out the restructuring process in preparation for going public, IPO transaction phase involving maximization of credibility and investor confidence right before the shares are traded; and post-IPO transaction phase involving the actual execution of the firm commitments and strategies that had been put in place for the IPO.

IPOs are considered successful based on the demand of the investors for the firm's shares. When the demand is strong, the stock price will be higher. Two identical companies can have very different valuations for IPO only for the reason of the timing of the IPO and the effects of demand.

Firms have been known to exaggerate their corporate account through onboarding of industry experts and professionals to their workforce, in an attempt to give an illusion of growth in business and experienced management. The objective of an IPO is to offload a pre-determined number of shares at an ideal price and firms will mostly only conduct an IPO when they project a high demand for their shares.

Issuers can report unusually high earnings by adopting discretionary accounting accrual adjustments that raise reported earnings relative to actual cash flows. If buyers are guided by earnings but are unaware that earnings are inflated by the generous use of accruals, they could pay too high a price. As information about the firm is revealed over time by the media, analysts' reports and subsequent financial statements, investors may recognize that earnings are not maintaining momentum, and they may thus lose their optimism. Other things equal, the greater the earnings management at the time of the offering, the larger the ultimate price correction (Teoh, S, H., Welch, I., & Wong, T, J. 1998)

When a firm prepares to go public it engages an underwriter, on agency basis, to aid them in valuation and marketing of the IPO to potential investors. However, these underwriters also have long-term connections to their institutional investors, and are mostly also their agents. Many research studies have argued that a lot of these institutional investors are interested in the short-term gains linked with underpricing in IPO investments at the expense of the retail investors (Arthus, J, D. et al, 2008). The term underpricing denotes the difference between closing price of the first day trading and the offer price of an IPO stock. According to Platt, (2002), underpricing results in a reduction on the capital available for a firm's growth after its IPO and, looking at it from strictly an insider's point of view, reduction in the resources available for its expansion.

The current knowledge is that IPOs are shrouded mostly in mystery when it comes to their pricing of shares with instances where certain investors have been said to have had an advantage over others; but it is not known whether the imperfect markets with skewed information have allowed these underwriters leeway to breech trust in their pricing. This paper therefore, seeks to delve into the effects of information asymmetry and the underpricing associated with IPOs on retail investors, the most vulnerable parties.

Literature review

The choice to exercise discretion is imperative mostly as discretion of the insiders will have an influence on the planned allocations, both retail and institutional, but insiders take measured action aimed at influencing the thoughts of the investor through explicit price discounts assertions in the prospectus. Owing to the fact that valuation and distribution are instantaneous decisions that are predictable, it is presumed that discounts will be incorporated into initial allocations to investor groups. Discretion plays a key role in underpricing, and it has been used mainly to entice institutions to participate in IPOs through bigger concessions as opposed to retailers who invest more in stocks and riskier assets in attempting to get better returns. (Tutuncu, L. (2021). They call for more awareness by the retail faction of the investors of the probable impediments brought about by reallocations and pay keen attention to the price discounts likely to be part of the allocations.

Durukan, M, B. (2002) posits that the anomalous initial returns come about because of the ambiguity characteristic of the IPO process and assumes that in order to lessen this uncertainty, IPO shares are purposely underpriced. Therefore, the market ought to right this intentional deed of underpricing, under efficient market conditions, to end up with an equilibrium price. He noted that: The underpricing of IPOs could result from information asymmetry between the investors, making those that are informed to be rewarded through this deliberate underpricing; The abnormal initial returns to the IPOs could result from the overvaluation of IPOs in the early aftermarket by the investors. The market therefore, rectifies this inadequacy resulting to an inverse relationship between initial returns and abnormal returns; and that the causative factors to the abolition of ambiguity should be important in the determination of the performance of prices of IPOs.

It is a foregone conclusion that the issuer or their agents possess more information equated to the issue subscribers leading to the typical 'winners' curse' where ignorant investors wind up subscribing to overvalued stocks (Peter, S. 2007). Signaling hypothesis posits that the issuer would purposely underprice their stock with an intention to build credibility among the investors. In so doing, their future issues would have better chances of acceptance in the market allowing them to have window to charge a higher price. The phenomenon of issuer underpricing is widespread even in small developing economies with likely attribution to the pronouncement of asymmetry of information here.

Varshney, S, B., & Hedge, S, P. (2003) contended that subscribers who are uninformed to an initial public offering of common stocks are more susceptible to ex ante risk of trading compared to their informed counterparts in the secondary marketplace owing to the fact that introduction of public trading conveys what was previously private information thus alleviating adverse selection. The firm that is going public underprices their new issue as restitution for the uninformed subscribers because of the added adverse selection risk in the secondary market. This in a nutshell, implies that the uninformed subscribers to the IPO are faced with a bigger ex ante risk of trading against their informed counterparts, as compared to those who trade the new issue after the firm goes public. They further argue that the choice of ownership structure by the entrepreneurs may expose investors in IPOs to greater risk of trading against informed traders in the secondary market.

According to Chemmanur, T, J., Gang, H., & Huang, J. (2010) institutional investors do have at their disposal private information about IPOs and that underpricing is a tool for their compensation in order for them to reveal this private information. Institutions hold IPO allocations that have weaker post-issue demand for an extended period, and they are rewarded for this by the underwriters with more IPO allocations. Institutional trading also has extrapolative power for long-run IPO performance. This is especially true in IPOs in which they received allocations; however, this power to predict declines over time. Overall, they posit that institutional investors have at their disposal important private information about IPOs, play a significant supportive role in the IPO aftermarket, and receive substantial reward for their involvement in IPOs.

Andreff, W. (2019), encourages a fixed price IPO technique to be adopted citing France where a privatization commission, after reviewing a public enterprise earmarked for privatization, came up with a minimum stock price. They mostly always settled for a price that was higher than the minimum recommended but way lower than any projected market price of the stock. With such clarity and systematic way of asset underpricing French privatization became a success story due to the triggering off effect of this action to an excess demand for stocks of privatized companies. Privatization became popular to investors and, likewise, the core shareholders made their wealth.

These core shareholders seized assets at a greater initial stock price offered to them than to regular investors, even though still at a discount price, and then purchased more stocks at devalued prices after the 1987 crash. Discount-price asset grabbing was even more widespread when the process of privatization progressed with over-the-counter non-market sales of assets. This way, the price of an asset stemmed from a bargaining exercise between the government and private saviors, with the outcome being underpricing. International consultants who frequently offered advice to the saviors became tools used to widely proliferate the notion that the economic value of firms on the rim of privatization was nearly zero due to purportedly out-of-date physical assets.

IPO, for instance, of Facebook in 2012 and Alibaba Group in 2014 dominated the airwaves around the world predominantly because of the ambiguity that backdrops the IPO atmosphere (Ljungqvist, 2007). It is for this reason that governments all over, including Kenya, have put directives that firms that wish to go public must prepare a prospectus containing pertinent information of its background, financial performance and risk factors to enable prospective investors to get better insight of the firm before deciding to invest in it (Beatty, 1989).

The prospectus, is therefore perceived by these investors as a vital source of reference to alleviate doubt and risk exposure. The information therein guides them to make essential investment decisions (Bhabra and Pettway, 2003; Abdou and Dicle, 2007), thereby leading to superior IPO pricing thus abating pricing error. The Securities Commission Malaysia, for instance, has specified guidelines for minimum information required in a prospectus. Information pertaining to the IPO offering, the risk factors involved, the firm and the group, the shareholding, fundamental management, conflict of interest, financial information and reports from accountants are items that must be included in the prospectus.

Methodology

This is a desk study attempting to amplify the effects of IPO mispricing on retail investors.

Results

The insufficiency of risk disclosures procedures may cause a variation in levels of disclosures among firms and, in some instances, these disclosures may be inadequate, ineffectual and of very little significance to investors. Previous studies have indicated that allocation discretion is mostly implemented to gratify institutions, by offering them bigger discounts to take part in IPOs. The equity markets are experiencing a resurgence of retail investor interest who prefer to invest more in stocks and riskier assets in their pursuit of enhanced returns as interest rates drop and currencies in the emerging markets depreciate. These emerging markets therefore, are faced with a flight of foreign investors to assets that are considered safer. The involvement of foreign institutional investors is key for the robust operation of equity markets not only for their much needed buying power but also that they bring superior signals along with their capital and take part in the offerings in a more informed manner than domestic institutional investors.

In the case where equity markets do not become stable in the short run, underwriters may choose transfer more shares to retail investors to pay for their absence. Retail investors must be cognizant of the probable impediments that come along with these transfers and ought to keenly observe price discounts as these are possible to be integrated into allocation. Research has shown that IPOs are underpriced at a much greater level in low-income developing countries equated to their developed counterparts. Research to appreciate the causal elements that stem such rare returns in these markets could offer valuable discernments on the pricing apparatuses of IPOs in such emerging markets.

The findings from the studies point to the informational effects of the selection of ownership structure in the context of IPOs. They posit that, contrary to the absence of agency and/or incentive effects recognized in earlier empirical studies, the adverse selection arising from choice of ownership structure has noteworthy effects on both the primary market pricing and the secondary market liquidity of new issues.

Conclusion

The pricing of IPOs has remained an active issue in the finance literature. Various hypotheses have been formulated by researchers owing to the enduring discussion on the explanations of anomalous initial returns from IPOs and long-term underperformance of IPOs. In this article, the analysis has been on the effects that information asymmetry and underpricing have on the retail investors. The theoretical literature on IPOs has extensively contended that institutional investors possess private information about IPOs and that underpricing is a tool that has been used to compensate them for this information. This has been at the expense of the retail investors who are uniformed and vulnerable to greater risks. This class of investors ought to be protected through oversight and legislation that requires firms going public to prepare prospectus with pertinent information about themselves, but even with all this, information asymmetry in the imperfect markets of developing countries like Kenya still renders them exposed.

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