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DISCLOSURE OF INTENDED USE OF IPO PROCEEDS AND UNDERPRICING: INDIAN EVIDENCE

Gagandeep Singh*

Abstract *It is interesting to observe the role of various certification mechanisms that a company opts before going public to signal elitism over others. There is vast literature examining the various certification mechanisms adopted by a company going public; however, there exists scant literature examining the role of disclosure of intended use of IPO proceeds and risk factors in lowering information asymmetry and underpricing in Indian economy. An endeavor is made through current study to analyze the impact of disclosure of intended use of IPO proceeds and risk factors on underpricing of 100 companies hitting the capital market for the first time from 1 April 2010 to 31 March 2012. A multivariate regression analysis reveals no relation between disclosure of intended use of IPO proceeds and underpricing in Indian market. But the disclosure of risk factors is found to relate negatively to underpricing. It implies that stakeholders rely more on other mechanisms to interpret quality of IPO and, more specifically, Indian investors rely on recommendations of middlemen in making investment decisions.*

Keywords: *Underpricing, Disclosure, IPO Proceeds, Risk Factors, Indian Market*

INTRODUCTION

Whenever a company opts to go public by making an offer through IPO (Soriya & Meena, 2020), it has some purpose to which the funds so raised would be put. The purpose is predecided by the issuer company before going public but its disclosure in prospectus depends upon the will of the manager of issue. Disclosure is a signal of favorable information (Grossman, 1981; Verrechia, 1983) or superior management quality (Trueman, 1986). Disclosure is a tool to attract investors. Disclosure acts as a 'Silent Salesman' in the sense that higher disclosure signals superior quality of IPOs. Issuer company makes every effort to attract investors by disclosing more information through IPO prospectus, which serves as a 'treasure box' out of which investors are able to get clues in order to chunk out good quality IPOs and take rationale decision. Kim and Ritter (1999) found that IPO prospectus revealing future forecasts is more valuable and useful than a prospectus showing historical data. The investors are anxious to know the expected future earnings as per managements' assessment of the firm's future prospects. The correct pricing of an IPO is primarily based on disclosure of firm's future earnings, which is given prime significance by all potential investors.

More uncertainty an investor has about the return from his investment, more is the issue underpriced. The issuer company can endeavor to minimize this ex-ante uncertainty, which is the major reason for underpricing of the issue, by appointing good quality auditors (Beatty, 1989), adhering to good governance mechanisms (Bhalla et al., 2012), appointing reputed underwriters (Beatty & Ritter, 1986), disclosing intended use of IPO proceeds (Leone et al., 2007; Hanley & Hoberg, 2008), disclosing risk factors linked with the offering (Hanley & Hoberg, 2008), disclosing managerial earning forecasts (Jog & McConomy, 2003) or any other material information which can help the investors make an informed judgment about the present IPO. Further, the stock market returns are affected by macroeconomic variables (Ul Islam & Habib, 2016) and the level of risks involved (Sanghvi & Bansal, 2014). Disclosure, of any kind, is a signal of some good news and is expected to lower uncertainty among investors.

If disclosure results in lower underpricing of IPOs, the issuing company still favors a less-than-complete disclosure because of the probable reasons discussed here under (Leone et al., 2007; Spindler, 2010). Healy and Palepu (2001) conclude that firms have an incentive not to disclose information that will weaken their competitive position, even if it makes it more costly to raise additional equity. Second, issuer companies backed by good quality venture capitalist, underwriters or auditors disclose less, as auditor's quality speaks of the value of the issuer company and acts as a substitute for providing complete information (Shi et al., 2013). Third, more disclosure does not always mean better disclosure. Hence, complete disclosure is argued to overburden the unsophisticated investors rather than helping them.

* Assistant Professor, PG Department of Economics, DAV College, Amritsar, Punjab, India.
Email: singhgagan24365@yahoo.com

Managers decide the level of disclosure which may vary from detailed disclosures to no disclosures at all. (Leone et al., 2007). Although it is desirable for the companies to disclose the use to which funds raised are put, but in practice, the companies escape this obligation by giving a vague disclosure in the prospectus so that their flexibility is not restricted. This vague disclosure is a major reason for information asymmetry which ultimately causes uncertainty in the minds of investors which leads to underpricing in IPOs.

Wherein full disclosure is not made in the prospectus by the issuer company, the investor perceives it as some bad news withheld by the company because of which the issue is underpriced. The firms which fear litigation risk tend to disclose less and consequently face greater discount on their shares (Spindler, 2010). But when the issuer company gives a detailed disclosure, it provides certainty in the minds of investors; hence, the issue is fairly priced. Many studies confirm that not only the disclosure of intended use of IPO proceeds is valuable but disclosure on risk factors also increases investor's knowledge about the quality of IPO, reducing underpricing. Information on a number of risk factors provides investors with an idea of the level of risk involved with their investment. This reduces the informational difference because it reduces uncertainty in the minds of prospective investor, thereby lowering IPO underpricing. More information makes investors better informed, who are able to comprehend without errors. Since investors avoid taking risk, they reward disclosing firm by paying a premium for more information revealed. There is a dearth of literature examining the impact of disclosure of intended use of IPO proceeds and disclosures of number of risk factors on underpricing in India; hence, the current study is a modest attempt to fill this gap.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Despite the growing relevance of disclosure in decreasing cost of capital, the empirical work on this issue seems to be limited (Healy & Palepu, 2001). Healy and Palepu (2001) supported the previous research on the role of voluntary disclosure in reducing the cost of capital. Core (2001) held the view that information asymmetry can be reduced by a voluntary disclosure, which lowers the equity cost of capital. Bushee and Leuz (2005) noticed changes in underpricing on the introduction of more stringent disclosure norms by the SEC. They found that 76 percent of the sample companies started revealing more information which resulted into lower information asymmetry. Schrand and Verrecchia (2005) pointed towards the significance of regular disclosure of material information during pre IPO period. They found that the IPOs which disclosed more frequently during pre-IPO regime faced lower underpricing as uncertainty in the minds of investors is removed with each disclosure. They concluded a negative relation between the frequency of informative disclosure and underpricing. Spindler (2010) and Shi et al. (2013) evidenced existence of negative relation between disclosure and IPO underpricing.

Bozzolon and Ipino (2007) studied a sample of 85 IPOs hitting Italian stock market during the period 1999 to 2005 and concluded that the firms which disclose forward-looking information (FLI) in terms of future activities, i.e. R&D, plan about expansion and diversification in new products, face a lower degree of underpricing as compared to those firms which avoid disclosure or give vague disclosures. Jog and Riding (1987) examined the performance of 100 IPOs listed on a Canadian Stock Exchange during 1971-1983 and indicated that underpricing was significantly related to three variables – namely trading volume, business sector of the firm and the use to which funds raised from the IPO were put. They revealed that issues raising funds for pure investment purposes (acquisition, capital expenditure, exploration and development, working capital) had higher average underpricing than the issues raising funds for other purposes (like financing or general purposes). Wyatt (2002) collected information on 241 Australian IPOs hitting the market during June 1994-December 2000 and revealed that more disclosure of "Use of Proceeds" lowers IPO underpricing.

Leone et al. (2007) analyzed 787 IPOs and found that disclosure of specific use of proceeds is inversely related to underpricing, as more specific disclosure reduces uncertainty, information asymmetry and informational differences, which subsequently result in lower underpricing. Hanley and Hoberg (2008) studied the use of proceeds section of 2043 U.S. filings made during January 1996-31 October 2005 and concluded a negative relation with underpricing. On the contrary, Stigler (1964), Benston (1973), Helwege and Liang (1996), Strom (2006) and Mahoney (2006) found no significant role of disclosures in reducing uncertainty in the minds of investors or lowering information asymmetry thereby failing to produce any impact on underpricing. Chamber and Dimson (2009) revealed a startling increase in underpricing of U.K. IPOs listed on London Stock Exchange (LSE) during 1917-1986 from 3.80 percent to 9.15 percent despite improvements in regulations and information disclosure. Contrary to the above findings, Beatty and Ritter (1986) documented a positive relation between the number of use of proceeds and underpricing.

Some authors made an attempt to study the impact of risk factor disclosure on underpricing. Beatty and Welch (1996) and Arnold et al. (2007) concluded a positive relation between the number of risk factors disclosed and the subsequent underpricing. Incongruent to the above view,

Huang et al. (2011) confirmed the existence of negative relation between risk factor disclosure and underpricing in Chinese market. They suggested managers of an IPO must not only disclose risk factors, but also enhance the quality of risk factor disclosure as well as focus on detailed risk factor disclosure as it not only improves the quality of information disclosure but also helps in efficient pricing of IPOs. Hanley and Hoberg (2008) studied 'Risk Factors' and 'Use of proceeds' section of 2043 US IPO filings made from 1 January 1996 to 31 October 2005 and extended the earlier findings. They concluded that increase in the number of risk factors increases investor's knowledge about the quality of IPO that ultimately lowers underpricing.

A brief review of literature scrutinizing the impact of disclosure on underpricing exhibits a lopsided review in developed nations and a small number of examinations in developing nations. Extensive research probing the impact of intended use of IPO proceeds as well as the number of risk factor disclosure on underpricing fails to provide any conclusive evidence. Moreover, hardly any study has comprehensively analyzed the relation between risk factor disclosures and disclosure of intended use of IPO proceeds and underpricing in Indian market; hence, the need for the current study arises. Based on review of literature, disclosures are expected to reduce underpricing; thereby following hypothesis is framed:

H_1: There is a negative impact of disclosure of intended use of IPO proceeds on underpricing in Indian market.

H_2: There is a negative relation between the number of risk factors disclosed in IPO prospectus and underpricing in Indian market.

RESEARCH METHODOLOGY AND DATA COLLECTION

The technique of multiple regression is applied on information collected from 100 companies hitting the capital market for the first time from 1 April 2010 to 31 March 2012. Some companies are deleted due to unavailability of data. Variables under study are categorized into three sub-headings:

Dependent Variable: Since the study intends to capture the impact of disclosure on underpricing, underpricing is taken as a dependent variable, which is calculated as the first day closing price minus the offer price divided by the offer price (Certo et al., 2001). Data on offer price and first-day closing price is collected from the website of capital market.

Independent Variables: Disclosure of risk factors is measured by counting the number of internal and external risk factors disclosed in the 'Risk Factor Section' of the prospectus, which was downloaded individually for each company. Disclosure of intended use of IPO proceeds is measured by percentage of IPO proceeds earmarked for some specific purpose as symbolized by 'Specificity' variable in the regression model.

Control Variables: Some control variables have been introduced in the regression model so that the impact of independent variables is clearly noticed. Singh and Gupta (2018) suggest that issue size and level of subscription affect underpricing. Past studies suggest taking assets (as measured by total pre IPO assets in rupees lakhs), IPO size (as measured by the amount in rupees lakhs raised by the issuer by making offer to the public) and age (as measured by difference in date of incorporation to the issue offer date) which are expected to have a negative relation with underpricing (Carter, Dark and Singh, 1998). Oversubscription (taken from www.capitalmarket.com) and listing delay calculated as the time gap between date of listing and issue close date are expected to correlate positively with underpricing.

EMPIRICAL FINDINGS

The characteristics of the variables are studied through descriptive statistics, which are shown in Table 1 (calculated using SPSS). The minimum number of risk factors disclosed by Indian companies while going public is 23 while the maximum is 94. The mean number of risk factors disclosed by Indian companies is 56. Normally, it takes 12 to 140 days for Indian companies to get their securities listed on stock exchange. On an average, it takes 17.53 days. The Indian IPO issuers normally possess pre IPO assets worth 204,240 lakhs rupees. Indian companies do not feel the need to tap the capital market before 593 days and after 37427 days from their incorporation. The average life of the issuer is 5675 days when it raised funds through an IPO.

Table 1: Descriptive Statistics

	Minimum	Maximum	Mean	Standard Deviation
Risk factors	23.00	94.00	55.98	14.28
Listing delay (in days)	12.00	140.00	17.53	13.09
Oversub-scription (in times)	0.92	92.91	10.46	16.54
Assets (in Rs. Lakhs)	1382.89	6150078.00	204240.11	848067.09
Age (in days)	593.00	37427.00	5675.58	5684.47
Specificity (in percent)	49.89	100.00	84.51	10.68
IPO Size (in Rs. Lakhs)	725.00	270000.00	27538.74	44089.92

Source: Author's own compilation

Normally, the Indian companies raise huge amount of money i.e. around 27,538 lakhs rupees. The average over-subscription rate of Indian IPOs is 10 times. Oversubscription rate ranges from 0.92 to 92.91. Despite there being no mandatory provision for disclosure of intended use of IPO proceeds in Indian context, the issuer companies however seem to specify 84 percent of the amount (raised through IPO) earmarked for some specific purpose. It appears that Indian companies favor disclosing the intended use for which the money so raised through IPO would be put. The variables which depicted very high standard deviation are normalized by calculating their natural logarithm.

Table 2 shows the impact of disclosures on dependent variable i.e. underpricing. A strong negative relation exists between risk factor disclosure and underpricing, which is found to be statistically significant at 5 percent level of significance (p-value is 0.02 < 0.05). Thus, the results on relation between risk disclosures and underpricing are consistent with the earlier work of Huang et al. (2011), Hanley and Hoberg (2008) and Dobler (2005), who concluded that increase in the risk factor disclosure informs investors about the future risks involved in investing in IPOs, which is expected to lower underpricing as it lowers the level of uncertainty associated with the issue.

Table 2: Multiple Regression Analysis Taking Underpricing as Dependent Variable

	Model 1		Model 2	
	Coefficients	t-Value	Coefficients	t-Value
Constant	0.288	2.63 (0.01)	0.224	1.848 (0.06)
oversubscription	0.005	10.67* (0.00)	0.005	10.75* (0.00)
Listing delay	-0.004	-5.66* (0.00)	-0.004	-5.69* (0.00)
Log IPO size	-0.008	-0.82 (0.41)	-0.008	-0.812 (0.41)
Risk factors	-0.002	-2.35** (0.02)	-0.002	-2.22** (0.02)
Log age	-0.003	-0.297 (0.76)	-0.004	-0.400 (0.69)
Log assets	-0.002	-0.223 (0.82)	-0.003	-0.411 (0.68)
Specificity			0.001	1.257 (0.21)
Adj R^2	0.608		0.610	

Note: One*; two ** and three asterisks*** indicate statistical significance at the level of 1 percent; 5 percent and 10 percent respectively; p-values are provided in the parenthesis.
Source: Author's own compilation

The control variables depict similar relation with underpricing as has been discovered in previous research. Oversubscription shows a significant positive relation with underpricing (p-value 0.00 < 0.01) supporting the findings of Shah (1995) that higher demand for securities results in higher underpricing. Similar to the results of Lee, Taylor and Walter (1996), the model shows a negative relation between listing delay and underpricing at 1 percent level of significance (p-value 0.00 < 0.01). A large issue size signifies a larger company to investors, who believe more safety of their funds in such companies. As such, issue size is expected to generate a negative impact on underpricing (Shah, 1995). Results also confirm this notion, but the relation is not found to be statistically significant. Age of the company and assets fail to generate any significant impact on IPO underpricing. Model 1 captures 60 percent variation in underpricing.

The impact of disclosure of intended use of IPO proceeds on underpricing is discerned by introducing specificity variable in Model 2. Specificity variable capturing disclosure fails to establish any significant relation with underpricing consistent with the findings of Helwege and Liang (1996), Stigler (1964), Benston (1973) and Mahoney (2006). However, disclosure related to risk factors reduces the level of uncertainty in the minds of investors thereby lowering IPO underpricing. The results depict a significant negative impact of number of risk factors on underpricing in Indian context (p-value 0.02 < 0.05). The other control variables depict similar relation as in model 1.

Log age variable exhibits inverse relation with underpricing. However, the result is found to be statistically insignificant. The finding is in line with the results of Bubna and Prabhala (2010), who concluded a negative although insignificant relation between age of the issuer company and underpricing in Indian context. The variables log assets and log IPO size also reveal negative relation with first-day underpricing which is consistent with the previous work that larger firms are more viable and are able to stand the future challenges; hence, investors depict more confidence in investing in such firms, thereby reducing underpricing. The findings of the study depict that the impact of these variables is not statistically significant. Oversubscription and underpricing are positively related (Shah, 1995) whereas more delay in listing decreases underpricing as proposed by Lee et al. (1996). Model 2 captures 61 percent variation in underpricing.

CONCLUSION

The purpose of the study is to explore the benefits of disclosing at the time of IPO launch, specifically in terms of reduction in first-day trading returns. The results do not support the hypothesis (H_1) and indicate no impact

of disclosure of intended use of IPO proceeds on IPO underpricing, thereby implying that Indian capital market is dominated by retail investors who neither have the analytical skills to comprehend and interpret the disclosures made in prospectus nor have the time to go through such a lengthy document. Also, the disclosure of intended use of IPO proceeds fails to lower underpricing as majority of the investors make an investment decision following "herds approach". The results are supported by various previous studies conducted in developed nations (Helwege & Liang, 1996; Stigler, 1964; Benston, 1973; Mahoney, 2006; Strom, 2006). Indian corporate houses send many clues when going public, hence it may be inferred from the above findings that Indian investors' value other signals more.

However, the disclosure information on risk factors is found to relate negatively with underpricing, which implies that higher is the number of risk factor disclosure in IPO prospectus, lesser is the underpricing. Since the potential investors become aware of probable level of risks through the "Risk Factor Section" and their apprehensions get removed, thus reducing uncertainty which lowers underpricing. The results support hypothesis (H_2) and are consistent with the findings of Huang et al. (2011) who established similar proposition for an Asian country (from where the sample comes).

The study however is not without limitations. First, the study examines the impact of disclosures on a small sample size of 100 companies. However, the results of the study might improve taking large sample size. Second, a detailed examination of intended use of IPO proceeds in terms of funds being used for R&D, expansion, modernization might depict better results. Third, the current study does not delineate risk factors into internal risk factors and external risk factors. Fourth, the study did not control other signaling mechanisms like gender diversity, auditor quality, IPO grading and underwriter quality. Future research can examine the impact of disclosures on underpricing on a longer time frame as the present study is limited to a smaller time window. Thus, a longitudinal study might give comprehensive results. The study intends to explore the impact of quantity of risk disclosure on underpricing; however, the quality of risk disclosures might be examined in future.

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