ABSTRACT

In this study, we examine those factors generally considered to impact IPO performance to assess the extent to which investment bankers might utilize this information in determining the spread within which the offering price is likely to be set and in setting the offering price. Interestingly, we find no evidence that the variables investigated are related to either IPO offer price spread or the IPO offer price. The implications of these findings are notable, as they raise the issue of what information might account for investment bankers' valuation decisions, as captured in the offer price spread and offer price. This paper develops and tests two propositions. We demonstrate that there is a monotone relation between the (expected) underpricing of an initial public offering and the uncertainty of investors regarding its value. We also argue that the resulting under pricing equilibrium is enforced by investment bankers, who have reputation capital at stake. An investment banker who "cheats" on this under pricing equilibrium will lose either potential investors (if it doesn't under price enough) or issuers (if it under prices too much), and thus forfeit the value of its reputation capital. Empirical evidence supports our propositions.

In the IPO market, investors coordinate on acceptable IPO price based on the performance of past IPOs, and this generates an incentive for investment banks to produce information about IPO firms. In hot periods, the information produced by investment banks improves the quality of IPO firms, and this allows ex ante low quality firms to go public and increases the secondary market price, thus synchronizing high IPO volumes and high first day returns. When investment banks behave asymmetrically in information production, the “reputations” of investment banks are interpreted as a form of market segmentation to economize on the social cost of information production.
Keywords: Investment bankers; IPO pricing; Prospectus information; under pricing; equilibrium

1. INTRODUCTION

Since the Securities Act of 1934, it is legal practice in the U.S. that offering syndicates stabilize market prices of their recent public offerings. In their latest release the U.S. Securities and Exchange Commission (SEC) states: Although stabilization is a price influencing activity intended to induce others to purchase the offered security, when appropriately regulated it is an erective mechanism for fostering the orderly distribution of securities and promotes the interests of shareholders, underwriters, and issuers. With this paper we challenge the assertion that current regulation always serves the interests of all involved parties. We argue that issuing investment banks can combine two regulated stabilization tools to generate risk-free profits. Employing a model that captures the impact of this arbitrage opportunity on the offer price, we find that (a) either market transparency is lower or, on average, under pricing is exacerbated, and (b)the issuing investment bank's profits are boosted at the expense of issuer and investors. Current regulation allows investment banks to pursue the following three types of aftermarket activities. First, stabilizing bids can be posted at or below the offer price during the distribution period of the securities. Second, banks can establish a short position by selling securities in excess of the pre-announced amount.

2. OBJECTIVES OF THE PROJECT

- To understand the role of an Investment Banker in managing Initial Public Offers.
- To study and understand the concept of and procedure involved in Initial Public Offers (IPO).
- To study and understand the process of due diligence and its significance in Initial Public Offers.
- To analyze the performance of the Issuing company.

3. REVIEW OF LITERATURE

Investment Bankers play an important role in issue management process. Lead managers (category I investment Bankers) have to ensure correctness of the information
furnished in the offer document. They have to ensure compliance with SEBI rules and regulations as also Guidelines for Disclosures and Investor Protection. To this effect, they are required to submit to SEBI a due diligence certificate confirming that the disclosures made in the draft prospectus or letter of offer are true, fair and adequate to enable the prospective investors to make a well informed investment decision. The role of investment Bankers in performing their due diligence functions has become even more important with the strengthening of disclosure requirements SEBI's various operational guidelines issued from time to time to investment Bankers primarily addressed the need to enhance the standard of disclosures.

Registrar and Share Transfer Agents processes all applications received from the public and prepare the basis of allotment. Invalid applications have to be rejected, and the valid ones considered. At times, there may be an oversubscription. In such cases they must arrive at a valid basis of allotment of shares among the applicants. The dispatch of share certificates / refund orders is handled by them.

Bankers to the Issue are banks which accept application from the public on behalf of the company. These applications are then forwarded to Registrar & Share Transfer Agent for further processing.

Underwriters are those intermediaries who underwrite the securities offered to the public. In case there is under subscription, underwriters subscribe to the unsubscribed amount so that the issue is successful. Before the opening of the issue, decision such as who will be the underwriter and what amount can be underwritten have to be taken. This information must be disclosed to not only the Regulatory Framework, but also to the investor.

Stock Brokers & Sub-Brokers are those intermediaries who through their contacts / sources invite the public for subscribing shares for which they get commission.

Depositories are the intermediaries who hold securities in dematerialized form on behalf of the shareholders. CDSL and NDSL are the two only depositories in India.

The Role of the Investment Banking

- Raising Capital
- Mergers and Acquisitions
- Sales and Trading
- General Advisory Services

List of Top 10 Investment Banks Worldwide

<table>
<thead>
<tr>
<th>Investment Bank</th>
<th>Revenue (in $B)</th>
<th>Net Earnings (in $B)</th>
<th>AUM (in $B)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goldman Sachs</td>
<td>45.2</td>
<td>13.4</td>
<td>871</td>
</tr>
<tr>
<td>JP Morgan Chase</td>
<td>100.4</td>
<td>11.8</td>
<td>1219</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>24.74</td>
<td>1.7</td>
<td>779</td>
</tr>
<tr>
<td>Citigroup</td>
<td>80.3</td>
<td>(1.6)</td>
<td>556</td>
</tr>
<tr>
<td>Bank of America</td>
<td>121</td>
<td>6.3</td>
<td>523</td>
</tr>
<tr>
<td>Barclays</td>
<td>31.8</td>
<td>10.3</td>
<td>1379</td>
</tr>
<tr>
<td>Lazard</td>
<td>1.53</td>
<td>(0.18)</td>
<td>98</td>
</tr>
<tr>
<td>Credit Suisse</td>
<td>31.05</td>
<td>7.9</td>
<td>384</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>25.3</td>
<td>4.96</td>
<td>181</td>
</tr>
<tr>
<td>UBS</td>
<td>24</td>
<td>(1.9)</td>
<td>159</td>
</tr>
</tbody>
</table>

Source: Balance Sheet of respective banks (2010) (AUM-Asset under Management)
What is IPO?

Initial public offering (IPO), also referred to simply as a "public offering" or "flotation", is when a company issues common stock or shares to the public for the first time. They are often issued by smaller, younger companies seeking capital to expand, but can also be done by large privately-owned companies looking to become publicly traded.
**Why may a Company need an IPO?**

Every company needs for its business for short term or for long term. To meet short-term requirements, the company may approach banks, lenders or may even accept fixed deposits from the public/shareholders. To meet its long-term requirements, funds can be raised either through loan from lenders, Banks, Institutions etc., (which carry financial burden) or through the issue of capital. Capital can be raised through public issue, private placement of shares, right issue, etc. Public Issue means raising funds from the public.

The IPO market has undergone a sea change. We as investors can only sit back and remember the days of under priced IPO’s in the Controller of Capital issue days-where getting allotment was akin to winning a lottery. Then came the era of free pricing-when many an overpriced issue hit the market , still there were some pearls to be found as suddenly some sectors got re rated by the market and the price of the issues seemed reasonable. Then in 1998 Securities and Exchange Board of India (SEBI) allowed every issuer of equity shares of Rs 250 million and above to have an option to make an issue through the Book Building Process.

The age of the big boys had arrived-the small investor’s role in the IPO market was to get marginalized.

Role of Intermediaries in public issues: Many intermediaries are involved in connection with the public issue. The following are the intermediaries who have to be registered with SEBI and must have a valid certificate from SEBI to act as intermediaries:-

- Investment Bankers
- Registrar and Share Transfer Agents
- Bankers to the issue
- Underwriters
- Stock Brokers and Sub Brokers and Depositories
- General Obligations and Responsibilities

The Investment Banker must meet the following general obligations and responsibilities:

- Every Investment Banker must abide by the code of conduct as specified by SEBI.
An Investment Banker should not carry on any business other than that in the securities market. An exception to this rule is a bank or a public financial institution that has been granted a certificate of registration under these regulations.

Every Investment Banker must maintain his own books of accounts, records and documents. This includes the balance sheets, Profit and Loss Accounts, Copy of Auditor’s Report, Statements of Financial Position, etc. This must also be easily accessible to SEBI. This must be done so that SEBI can monitor the capital adequacy of the Investment Banker.

All issues should be managed by at least one Investment banker functioning as the lead Investment banker.

Every lead Investment banker must enter into an agreement with his client company and other Investment Bankers setting out their mutual rights, liabilities and obligations relating to such issue and in particular to disclosures, allotment and refund, before taking up the assignment relating to an issue.

4. CURRENT TREND IN INVESTMENT BANKING IN IPO’S:

From an investment banking perspective, the IPO process consists of these three major phases: hiring the managers, due diligence, and marketing. Hiring the Managers. The first step for a company wishing to go public is to hire managers for its offering. This choosing of an investment bank is often referred to as a "beauty contest." Typically, this process involves meeting with and interviewing investment bankers from different firms, discussing the firm's reasons for going public, and ultimately nailing down a valuation. In making a valuation, I-bankers, through a mix of art and science, pitch to the company wishing to go public what they believe the firm is worth, and therefore how much stock it can realistically sell. Perhaps understandably, companies often choose the bank that provides the highest valuation during this beauty contest phase instead of the best-qualified manager. Almost all IPO candidates select two or more investment banks to manage the IPO process. Due Diligence and Drafting. Once managers are selected, the second phase of the process begins. For investment bankers on the deal, this phase involves understanding the company's business as well as possible scenarios (called due diligence), and then filing the legal documents as required by the SEC. The SEC legal form used by a company issuing new public securities is called the S-1 (or prospectus) and requires quite a bit of effort to draft. Lawyers, accountants, I-bankers, and of course company management must all toil for
countless hours to complete the S-1 in a timely manner. Marketing: The third phase of an IPO is the marketing phase. Once the SEC has approved the prospectus, the company embarks on road show to sell the deal. A road show involves flying the company’s management coast to coast (and often to Europe) to visit institutional investors potentially interested in buying shares in the offering. Typical road shows last from two to three weeks, and involve meeting literally hundreds of investors, who listen to the company's canned presentation, and then ask scrutinizing questions. Often, money managers decide whether or not to invest thousands of dollars in a company within just a few minutes of a presentation. The marketing phase ends abruptly with the placement of the stock, which results in a new security trading in the market. Successful IPOs trade up on their first day (increase in share price), and tend to succeed over the course of the next few quarters. Young public companies that miss their numbers are dealt with harshly by institutional investors, who not only sell the stock, causing it to drop precipitously, but also blame management and lose faith in the management team.

5. CONCLUSION

Investment banks legally pursue supposedly price stabilizing activities in the post-offer market. In this paper we analyze how these aftermarket activities influence the setting of the offer price in the first place. We take a different perspective from existing theoretical work as we build the model around the stylized fact that investment banks can realize risk-free profits through aftermarket short covering. The current model cannot assess why some investment banks expose themselves to risk and establish ‘naked shorts’, or why they do not exercise the overallotment option in full even when prices rise above the offer price. This paper only explains the strategic impact of the possibility of risk-free profits. The investment bank's behavior must not be perceived as rogue or fraud, but as a rational response to a change in the environment. Investors anticipate the bank's behavior and react rationally to it. We propose a stylized model of an offering procedure that is in accordance with empirical findings and perceived industry practice. We assume that both the investment bank and investors hold private information about the intrinsic value of the offered security. Prices are set so that rational-expectation investors only order the security if they expect to make a profit, taking into account the behavior of the investment bank. The market price after the offering will adjust according to investors' signals. As these are conditionally the price almost surely reflects the fundamental value of the security. The bank cannot stabilize ‘against’ this fully efficient price, but, of course, if the price is efficient, it need not and must not be
`stabilized'. So in the best of worlds, one with full transparency, the bank can make an extra profit through short covering. In the real world the IPO process is opaque; neither investors nor regulators nor researchers know precisely the banks' strategies.

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- Working The Street: What You Need To Know About Life on Wall Street, by Erik Banks