

# Ipo underpricing

Finance



P/E ratio is another term used for the “rice earning ratio”, and it is basically quotient of a company’s share price and the company’s earnings on each share. Finding the P/E ratios of a company high, investors foresee the possibility of overpricing of the company’s stock. Extremely lower earnings per share compared to the shares’ price lead to a high P/E ratio. Overpricing of a company’s shares builds an impression on the potential investors that the shares have low intrinsic value. This reduces the investors’ confidence in the company and becomes the cause of abandonment of the share purchase plan. Many companies have a tendency of having underpriced IPOs so that potential investors can be attracted into them.

Investors find it easier to influence the shares’ price with low offering price as their intention is to obtain the windfall gain in the period of issuing. Low-priced shares generally have a lot of capacity for share increase of price on the basis of market demand forces. As a result, low offering price signifies considerable share underpricing.

IPO underpricing has been explained with the offering size of a company for a long time, which is consistent with the ex ante uncertainty theory. This concept reflects in the works of Beatty and Ritter (1986) as well as in McGuinness (1992). Tu and TSE (2006), in their analysis of the Chinese A-share market, state the size of offering as a critical determinant of the IPO underpricing. A company’s offering size is calculated through multiplication of the offer price with the offered number of shares. The equation for this is,  $\text{size of offering} = \text{number of offered shares} \times \text{price of offering}$ . There is a perception that companies having bigger offerings’ size have superior management and control and are more mature as compared to the companies having smaller offering magnitudes. Bigger companies derive

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their tendency to underprice their shares from the fact that their information flow is relatively better than that of the smaller companies, that are more influenced by the asymmetry of information.

#### Data

Data used in this project was retrieved from the official website of Shanghai Stock Exchange (available at <http://www.sse.com.cn>) and also from the GTA Database. Like discussed before, there are five groups of shares in the Chinese stock market. However, it is just the A-share stocks that are completely quoted in Yuan. Many companies have a preference for being included in the Shanghai Stock Exchange instead of the Shenzhen Stock Exchange in spite of the existence of freedom of choice. This may be because mainly high-tech companies are listed in the Shenzhen Stock Exchange unlike the Shanghai Stock Exchange that mostly consists of ordinary companies as per guidance of the Chinese NASDAQ established in 2000 to transfer the board to Shanghai. The two stock markets have different units of measurement, though there is almost no big difference in the underpricing of both markets. More firms were listed in the Shanghai Stock Exchange while the sample was being collected. The research considered all IPOs listed from January 2011 to August 2014 in the Shanghai Stock Exchange, which consisted of 77 companies in total.