UNIVERSITI PUTRA MALAYSIA

AN EMPIRICAL STUDY ON MALAYSIAN IPOS AND THEIR PROFIT FORECASTS.

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Specially Dedicated to

My dearest Jye Im, for her love, understanding and support.

My family members Mom, DAD, brother and sister

for their support

My friends for their full encouragement

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ABSTRACT

This paper is divided into two parts. The first part examines the trend of IPO's premiums and accuracy of profits forecasting in short run and long run. The second part examines the reputation of underwriters and size of auditors as possible determination of IPO's premium and accuracy of profits forecasting. Two hundred and forty-five new issues were analysed for the period 1993-1996. There are significant excess returns on the first day of trading with an average premium of 88 per cent.

The first day IPO's premiums have a significant effect of two difference economy period. The average first day premium is about 104 per cent in the economy boom period (93-94) compared to 66 per cent in the post boom period. The results on profit forecast error showed reasonable accuracy of forecasts with an error of -2.72 per cent.

Looking at the reputation of underwriters, size of auditors and the first day IPO's premium. The size of auditors and reputation of underwriters are not the determinates of the first day IPO's premium. From a sample of 137 companies after screening for outliers, 62 companies under-estimated and 75 over-estimated their profit forecasting. There is no statistically significant relationship between reputation of underwriter and size of auditor with the accuracy of profit forecasts.

ABSTRAK

Kajian ini dibahagikan kepada dua bahagian. Bahagian pertama menganalisa tentang arah aliran pulangan saham baru dan ketepatan ramalan keuntungan dalam prospectus bagi jangkamasa pendek and jangkamasa penjang. Bahagian kedua menganalisa tentang kesan kemusyhuran penaja jamin dan saiz juruaudit terhadap pulangan saham baru dan ketepatan ramalan keuntungan mereka. Dalam kajian ini, dua ratus empat puluh lima saham baru telah dipilih dan melingkungi tempoh masa dari tahun 1993 hingga 1996. Keputusan kajian ini menunjukkan bahawa terdapat pulangan positif yang singfikan sebanyak 88 peratus.

Pulangan saham baru pada hari yang pertama, mempunyai signifikan terhadap perbeza keadaan ekonomi. Dalam masa ekonomi berkembang (93-94) pulangan saham pada hari yang pertama secara purata mencatat rekod 104 peratus, manakala dalam masa selepas ekonomi berkembang (95-96) purata pulangan saham hanya mencatat 66 peratus. Selain daripada ini, keputusan kajian tentang ralat ramalan keuntungan adalah dalam lingkungan ralat ramalan yang memuaskan iaitu -2.72 peratus.

Kajian tentang kesan kemusyhuran penaja jamin dan saiz juruaudit terhadap pulangan saham baru pada hari pertama tidak dapat dibuktikan. Selepas tolak saham baru yang kesilapan terlalu besar hanya tinggal 137 syarikat. 62 syarikat kurang ramal keuntungan mereka manakala 75 syarikat lebih ramal keuntungan mereka. Tidak ada signifikan hubungan diantara kemusyhuran penaja jamin dan saiz juruaudit terhadap ketetapan ramalan keuntungan.

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CHAPTER ONE

INTRODUCTION

The Malaysian Stock Market is relatively new. In recent years a lot of companies are raising funds from the public through new issues of shares. When firms need to raise capitals they may choose to sell or float securities. These new issues of shares are usually offered to the public by investment bankers in the primary market. Whereas, purchase and sale of already issued securities among investors occur in the secondary market. A company "going public" must provide a prospectus that includes a description of its present and future operations and audited financial statements. Since firms face limited disclosure requirements, the market usually has less public available information. This difference in regulatory environment provides a potentially fruitful setting in which to consider the effective role of the public accountant in ascertaining valid information for potential investors.

Initial Public Offerings (IPOs), is shares issued by privately owned company that is going public, that is, selling shares to the public for the first time. Sometimes, this is referred to as unseasoned offerings. Malaysian laws recognise sale of expended authorised shares of a firm as new issues. Offer of existing share holdings are defined as simply sales of shares. Private placements of shares refer to an issue that is usually sold to one or few institutional investors, are permitted only in limited cases. They account for about 5-10 percent of the funds raised in stock exchange. Seasoned new issues are offered by companies, which already floated its equity in the capital market.

The application of new issues in Malaysia must be opened to the public and allocation in event of over subscription is done by lottery. Furthermore, at least 30 percent of the issued shares must be set aside strictly for designated investment funds, individuals, companies, co-operatives, societies, institutions and members of certain segments of the population, who are considered to have less equitable capital ownership in Malaysia's stock of private capital. This scenario is a unique microstructure imposed by the government since 1976 to achieve public policy's objective approved by the country's legislature for that purpose.

If the company wants to be listed on KLSE, it must submit its application to Securities Commission (SC). The Securities Industry Act also requires submission of Memorandum and Articles of Association for KLSE's approval. The process takes about half a year. However the process in developed market only need 6-8 weeks. The IPOs in an emerging market are more risky. Hence, there will be higher risk of price changes during the long period of process. The situation makes the study of IPOs in KLSE more interesting.

Upon approval from the SC and KLSE, the company registers its prospectus with the Registrar of Companies (ROC). It then advertises and issues its prospectus to the public and the offer period opens. The company then announces the basis for allotment and issues shares pursuant to the allotment. Shares are then admitted to the official listing. The practices of building-books or red-herring (preliminary prospectus), which are intended to reduce uncertainty of off-takes of a new issue before the approval are not allowed in KLSE. Thus, there is high risk of price changes during the period waiting for the approval.

In Malaysia, self-listing is not permitted. Firm going for listing will appoint investment bankers to make application and market their securities. The investment bankers will advise the firm regarding the terms on which it should attempt to sell the securities because they are more informed about the market's conditions. The investment bankers sometime also become underwriters of the firm. The condition of underwriting is between the firm and investment bankers. In return, the underwriters will receive underwriting commission from the issuer. Beside that the underwriters also become marketing people for their firms.

Every time there is new issue in Malaysia, there seems to be overwhelming support from the public. Firms normally issue new shares as the first step to be listed on the stock exchanges as well as souring their capital need. From the investor's prospective of view, they buy new issues because they believe that the new issues are under-priced (Rock, 1986). This means that the public perceives the purchase to be short-term investment which guarantees big profits with minimum risk (Tinic,1988). With this kind of belief, it is not surprising that every time there is a new issue, the shares are over subscribed.

1.1 Statement of Problems

Many findings have shown that there is excessive under-pricing of IPO’s in KLSE. This mean that investors who are fortunate to get IPO offer will get high premium on the first day of trading. However, in today's economic scenario performance of IPO’s on the KLSE not necessarily generates positive premium but might even be negative premium. The prospectuses become a very important source to help investor understand the activity of the company and minimise the risk of investment.

Disclosure of corporate profit forecasts information in the prospectuses for new issues is a mandatory requirement of the Company's law. Prospectus is the only public source of information for Fund Managers, corporate investors and individual investors.

The degree of the accuracy of forecasts profits disclosed in the prospectus is a vital piece of information. According to SC unwritten ruling since July 1987, forecast profits must not deviate more that 10% from actual profits.

1.2 Statement of Objectives

The uncertainty of investors regarding IPO value is the basis of the study. Below are the issues that will be addressed in this study:

1. To examine the trend of IPO premium in the short term and long term.
2. To investigate the reliability of net profit forecasts in prospectuses.
3. The relationship between reputation of auditor, underwriter and the first day Initial Public Offering premium.
4. The relationship between forecasting error and reputation of auditor and underwriter.

1.3 Usefulness of this Study

This research will help to substantiate further the trend of IPO premium, reliability of net profit forecasts in prospectuses, relationship between the IPO, profit forecasting errors, underwriter and auditor of emerging market. Apart from being useful for academic purposes, it enhances the investors' understanding of Malaysian Stock Market behaviour especially with regard to Initial Public Offerings. The investor's can use the funding to create opportunities and to detect threats in their bid to make profit from Initial Public Offering. These findings will also help corporate investors to know better the behaviour of Initial Public Offering in KLSE.

CHAPTER TWO

LITERATURE REVIEW

2.1 Evidence on IPO Performance

A lot of international evidence on IPOs found that those experience strong under-pricing in the short-run but for the long run the findings are inconclusive. Aggarwal and Rivoli (1990), Ibbotson (1975), Ibbotson Sindelar and Ritter (1988), Downes and Heinkel (1982), Rock (1986),Tinic (1988), Ritter (1991) and Welch (1989). Some research on the issue of securities of newly listing companies is also documented in Dev and Webb (1972), Real Estate Investment Trust (REIT) IPOs by David and Michael Ryngaert (1997), and on take overs (Dave 1972), Westwick (1972). David and Michael Ryngaerts (1997) test on Real Estate Investment Trust (REIT) IPOs in 1970, 1980 and 1990 found in 1970 and 1980's IPOs were overpriced but subsequently underperfonned. However 1990, findings show an average of 3.6% under-pricing and have moderately outperformed seasoned equity REITs after issuance.

Jay R. Ritter (1991), suggested that under-pricing of initial public offering appears to be a short run phenomenon, and there is substantial variation in the under performance year to year and across industries, with companies that went public in high-volume years faring the worst. The patterns are consistent with an IPO market in which (1) investors are periodically over optimistic about the earnings potential of young growth companies, and (2) firms take advantage of these "windows of opportunity". This study will analyse the IPO performance in the pre and post economic boom periods.

Malaysia, Annuar, Shamsher and Ariff (1993) documented short run and long run under-pricing of IPO's on the KLSE .

Companies that were listed as new issues on KLSE raided a total of about RM10 billion; which is equal to 20% of the Malaysian Gross National Saving in 1992. In Malaysia, all new issues achieve positive rates of return and never yield negative return to the offer price over any period. This is evidenced by a record of 56 new issues in 1993. Investors and speculators then believed that new issues generate lucrative and assured returns and investing / speculating in new issues then become a prudent investment behaviour. This perception also reinforced by report finding that Malaysia's new issues are under price by 7.5 times the average normal returns in the stock market. Therefore studies had been done to the perception of excessive under-pricing.

In Shamsher, Annuar and Ariff (1996) study, analysis of under-pricing of 65 new issues over 10 years to 1993 was carried out to study the gains to short term speculators and long term investors. The results suggested that the average excess return on the first trading day is no doubt lucrative at 153% which is the largest reported for any country. The rate of return for investors holding new issues over 3 years was only 21% per annum which means that in long run Malaysian IPO does generate excessive return. This short term large under-pricing gain is driven mostly by short-run price pressure. Lastly, this study suggested that increased allocation ratio to a higher rate of application lots could improve the profitability for long term investors. Ritter (1987), Benveniste and Spindt (1989) and Rock (1986) suggested that this under-pricing was because of price being discounted to reflect the fundamental risk of the firm or characteristics of the pre-offering process.

2.2 Reputation of Auditor and Pricing of Initial Public Offerings

Beatty, (1986) repeats that an inverse relation exists between the reputation of the auditor of an initial public offering and the initial return earned by an investor. More reputable CPA firm exhibit less under-pricing of an initial public offering of equity securities than clients that choose to hire CPA firm with less reputation capital at stake. This study will also address the issue as in Malaysia, we have the reputation auditor such as big six and non-big six-auditor firms that vet through the listing firm's prospectors.

2.3 Investment Banking, Reputation and the Under-pricing of Initial Public Offerings

Ibbotson (1975) and Ritter (1984), developed and tested these two propositions. They demonstrate that there is a monotone relation between the (expected) under-pricing of an initial public offering and the uncertainty of investors regarding its value. They also argue that the under-pricing 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 does not under-price enough or issuers if it underprices too much). The evidence supports their propositions. Ruud (1993) argues that premium of IPO is due to underwriter price support. This is because the Securities and Exchange Commission allows investment bankers to do price stabilization to avoid negative returns. Richard, Frederick and Ajai (1997), found that the (under performance of IPO stock relative to the market over a three-year holding period) more reputable underwriters the less short-run under-pricing.