CHAPTER 3

OBJECTIVES, SCOPE AND HYPOTHESES

3.1 RESEARCH ISSUES

The research issues examined in this study are as follows:

(i) What are the determinants factors that may influence the decision of Indian companies to do IPO?
(ii) What is the impact of IPO on financial performance of Indian companies?
(iii) What is the impact of change in promoter’s ownership around IPO on post IPO financial performance of Indian companies?
(iv) What is the impact of underpricing on post IPO financial performance of Indian companies?
(v) What is the impact of market timing on post IPO financial performance of Indian companies?

3.2 OBJECTIVES

Keeping the above research issues in mind following objectives have been pursued in this study:

(i) To explore the determinant factors that may influence the decision of Indian companies to do IPO.
(ii) To analyze the impact of IPO on financial performance of Indian companies.
(iii) To analyze the impact of change in promoter’s ownership around IPO on post IPO financial performance of Indian companies.

(iv) To investigate the impact of underpricing on post IPO financial performance of Indian companies.

(v) To examine the impact of market timing on post IPO financial performance of Indian companies.

3.3 SCOPE OF THE STUDY

The present study focuses on Indian IPOs. The study period is between 1997 and 2007. The analysis of the present study is based on secondary sources of information mainly CMIE Prowess and Prime Database. The scope of study is confined in terms of the operational definitions and uses of variables as a proxy for various qualitative and quantitative factors.

3.4 HYPOTHESIS

**Raising capital for growth & expansion**

This hypothesis posits that firms do IPO to finance their future investment and growth. Future investment and growth is captured by sales growth, financial leverage and capital expenditure.

*H1: Firms which go public experience higher sales growth than firms which remain private.*

*H2: Firms which go public has higher financial leverage than firms which remain private.*
**H3: Firms tend to do higher capital expenditure and investments after becoming public**

**Risk diversification**

This hypothesis posits that riskier firms are more likely to go public and owners take their firm public to diversify their future risk by reducing their stake at the company. The stake of owners is calculated by promoters’ ownership.

**H4: Firms which go public face more risk than firms which decide to remain private.**

**H5: The level of promoter's ownership in firms should significantly come down after they become public**

**Capital structure rebalancing**

This hypothesis contends that firms do IPO to rebalance their capital structure by reducing their financial leverage. Financial leverage is calculated as debt equity ratio.

**H6: Firms which go public tend to have higher financial leverage than the firms which decide to remain private.**

**H7: Debt Equity ratio should significantly come down after firms become public.**

**Lowering of cost of capital**

This hypothesis posits that firms do IPO to lower their cost of capital. Cost of capital is captured by beta and cost of credit.

**H8: Firms having higher cost of capital are more likely to go public.**

**H9: Firms face lower cost of capital after becoming public.**
Liquidity

This hypothesis states that firms which go public are likely to be larger than firms which decide to remain private as the former firms are better positioned to reap the benefit of improved liquidity after becoming public.

*H10: Firms which go public are likely to be larger than firms which decide to remain private.*

Monitoring

Companies intentionally try to limit the stake of large shareholders and raise the expansionary capital by dispersing the stake across small and dispersed shareholders to avoid excessive monitoring by large shareholders. As per this hypothesis firms tend to do higher capital expenditure and investments after becoming public as the very reason for going public is the subsequent planned large scale expansion.

*H11: Firms tend to do higher capital expenditure and investments after becoming public.*

Windows of opportunity

As per this hypothesis firms belonging to an overvalued industry are more likely to go public. Industry aggregate market to book ratio of the industry to which a firm belongs is used to access whether the firm’s industry was overvalued or not.

*H12: Firms are likely to do their IPOs when their industry peers are overvalued.*
Information Asymmetry and Adverse Selection Costs

This hypothesis states that in IPO situations, investors are generally less informed than the issuers about the true value and quality of the company doing an IPO. Thus prevailing information asymmetries about the quality of issuers in IPO market results in adverse selection cost and should be a factor influencing the firms’ going public decision. As per this hypothesis, the firm deciding to go public should be visible, whether in terms of size, age or profitability, to overcome adverse selection costs.

\textit{H13: Firms which go public tend to be bigger, established and visible than firms which decide to remain private.}

Loss of confidentiality and higher taxes

Public companies are in close scrutiny from tax authorities that reduces their scope for tax elusion and evasion. This hypothesis states that firms paying more taxes would like to stay private.

\textit{H14: Firms which go public tend to pay higher taxes as compared to firms which decide to remain private.}

Initial and subsequent expenses

The initial and subsequent expenses associated with IPO can discourage companies from going public. This hypothesis contends that bigger size firms are less affected by such costs and hence hypothesize that bigger size firms are more likely to go public.

\textit{H15: Firms which go public tend to be bigger in size than firms which decide to remain private.}
Post IPO performance

The purpose of this hypothesis is to examine the impact of IPO on the financial performance of firms. This hypothesis posits that firms’ financial performance deteriorates in post IPO period.

*H16: IPO significantly affect the financial performance of firms, which means financial performance in pre IPO period will be significantly different from that of post IPO period i.e. (Financial Performance) pre IPO ≠ (Financial Performance) post IPO*

Ownership and post IPO performance

There seems to be no consensus as far as the true nature of relationship between ownership and performance is concerned. Where, alignment of interest argument advocates for positive relationship, entrenchment argument advocates for a negative relationship between the two.

The hypothesis posits that there should be a curvilinear relationship (rather than a simple linear relationship) between the level of owner-managers’ ownership and firm performance. The hypothesis further states that the ‘entrenchment effect’ (negative relationship) dominates the ‘alignment of interest effect’ (positive relationship) for medium levels of owner-managers’ ownership. In view of the competing theories and empirical results reported in prior studies, the following hypothesis is proposed:

*H17: The relationship between ownership and firm performance is nonlinear and curvilinear in nature.*
**H17 (a):** When net ownership is low, there is a positive relationship between ownership and performance.

**H17 (b):** When net ownership is intermediate, there is a negative relationship between ownership and performance.

**H17 (c):** When net ownership is high, there is a positive relationship between ownership and performance.

**Underpricing and Post IPO Performance**

As per this hypothesis undepricing is a mechanism through which a high value firm signals its worth to the general public. A high value firm, having confident in its future prospects, compensate the loss of underpricing by bringing a secondary issue with a fairly valued issue. Whereas a low value firm cannot afford to underprice its issue because of chances of revelation of actual value of firm in the future. Therefore a low value firm would like to maximize its proceed at the time of IPO only. Hence this hypothesis posits that a low value firms should perform more badly in post IPO period.

**H18:** Underpricing affects the deterioration of financial performance of firms in post IPO period, which means changes in financial performance of low underpricing firms around IPO will be significantly different from that of high underpricing firms i.e. (post IPO Financial Performance) \( \text{low underpricing} \neq \text{(post IPO Financial Performance) high underpricing} \)
Market Timing and Post IPO Performance

As per market timing hypothesis, issuers of a low value firm wait for the right opportunity in the market. The right opportunity is usually termed as ‘hot market period’. Hot market period refers to the bullish market situation or an overvalued market situation. Past evidences show that most of the IPOs during HOT period do well in terms of public response and subscriptions. This hypothesis states that a low value firm should bring its IPO in HOT market period and hence should perform badly in post IPO period.

**H19 (a): There is a significant decline in earning potentials of the firms in post IPO period.**

**H19 (b): Total IPO proceeds in HOT issue market significantly differs from total IPO proceeds in COLD market i.e.** (Total Proceeds) \text{Hot market} \neq (Total Proceeds) \text{Cold market}