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Corporate Governance, IPO (Initial Public Offering) Long Term Return in Malaysia

Edris Heidari Darani +

Multimedia University

Abstract. This research examines the relationship between corporate governance of companies listed on the bursa Malaysia and long term return of initial public offerings during the years 2007 to 2010. We set some hypothesis dealing with the relationship between IPOs long term return and independent variable which corporate governance variables.

Keywords: corporate governance, IPO long term return

1. Introduction

In the developing economy firms and enterprises go public by selling their common stock to expand business. An initial public offering (IPO) occurs when the equity demand of firms can no longer be satisfied by single or individual investor. During the stage of going public, determining the appropriate price for an IPO is a difficult task. IPO phenomenon has caught many researchers' attention. Although many researchers identify variables to explain the extent of under pricing but few studies speak about the function of corporate governance. It is a known point that good corporate governance systems are associated with better corporate performance (Davies, 1999). Good corporate governance is not only able to protect shareholder's investment, but can also motivate entrepreneurs to maximize the wealth of investors (Tam, 1999). Investors' interest is guaranteed in the future by good corporate governance. This study tries to explain the IPO long-term performance from corporate governance perspective in Malaysia using data from Malaysian listed firms.

2. Definition of initial public offering (IPO)

The concept of IPO is very clear. The IPOs occur when private firm switch to the public firm. Most firms started by raising capital from a few investors, with no existing liquid market. If the firm needs additional equity capital to go public, the best choice for them is to sell stock to a large number of diversified investors. Increasing liquidity allows the firms to raise liquidity capital. Existing shareholder should sell their share in the second market. Furthermore, buying and selling shares need cost. This cost consists of direct and indirect. The direct cost include legal, auditing and under pricing fees. Indirect cost like as management cost. Indirect cost and direct cost are affected the cost of capital for firms going public. It is difficult to determine an appropriate price for new stock or issues for firm and its underwriter because IPO has no trading history for the firm in the stock market,. Normally, the offer price in IPO is lower than the closing market price in first day. It means the investors can enjoy high return from an IPO. Some previous studies indicate an average IPO is under priced (Aggarwal, 1993; Loughran and Ritter, 2000).In the short term, there is profitable to purchase the stock at the offer price. The result of long-term performance is very different. Some empirical evidence from U.S and some developed countries suggest the performance of IPOs in long-term is based on the overall market performance. (Levies, 1993; Aggarwal et al, 1993).

+ Corresponding author. Tel.: + 00989138080387 fax: 00983116503195.
E-mail address: edris.heidary@gmail.com

3. Corporate governance

Finance committee on corporate governance in Malaysia (2002) stated that "corporate governance is the process and structure used to direct and manage the business and affairs of the firm towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking into account the interests of other stake holders." Williamson (1984) defines corporate governance is the institution that arrange to join the interests of management and shareholders. Zingales (1998) said corporate governance is the place for manager and shareholders to speak about distribution and valuation of the shares are to be allocated. Shelifer and Vishny (1997) define that corporate governance is the way for suppliers of finance to assure themselves of getting a return on their investment.

4. Corporate governance in Malaysia

The discussion on corporate governance in Malaysia like other Asian countries should be initiated from second half of 1997. Corporate governance is important during the period for the public and private sector in those countries. The financial crisis was set off in Thailand when foreign investor started to withdraw capital. This problem is transmitted to other neighboring countries. In Malaysia, attempts to decrease devaluation caused higher level of interest rate and credit contraction. The Kuala Lumpur composite index is declined by 72% during the period from end-June 1997 to end-August 1998.Paul (1998) argued that crisis was due to structural weaknesses in the domestic financial institutions supported by unsound macroeconomic policy and moral hazard. According to international monetary fund (IMF) (1999) the crisis was infected by the domestic policy weaknesses. The World Bank (1998) regarded the vulnerability in the banking sector was attributed to poor risk management and excessive lending. Poor risk management is reflected by weak corporate governance. The crisis indicates how good governance affects the collection of funds in an effective way. Corporate finance is concerned about the effectiveness of corporate governance as an assurance in protecting the invested funds and to generate returns. Scheifer et al. (1997) stated corporate governance mechanism in Malaysia assures investor in organizations that they will receive adequate returns in their investments. Corporate governance mechanisms are viewed from two perspectives, internal and external. The internal perspective sees the equity ownership and board of director's as primary internal mechanism while take over and market for corporate controls are the primary external mechanism. Bia et al. (2003) highlighted the corporate governance mechanisms according to two models. First market-base governance model has characteristics of independent board, dispersed ownership, transparent disclosure, and active take over market and well-developed legal infrastructure. The second model is control model which emphasizes the values of insider board, limited disclosure, reliance on family finance and the banking system and concentrate ownership structure. The external governance mechanisms can be implemented as a result of the failure of internal governance mechanism. The practices of governance mechanisms in the Malaysian corporate sector can be analyzed from the direction in the master plans similar to orders from the regulatory bodies. The main sources of corporate governance reform agenda in Malaysia are form the Malaysian Code on Corporate governance by finance committee on corporate governance, Capital Market Master plan by securities commission and Financial Sector Master Plan (FSMP) by bank Negara Malaysia. It provides guidelines on the principals and best practices in corporate governance and the direction for implementation as well as charts the future prospects of corporate governance in Malaysia. Corporate governance in Malaysia has succeeded in attracting a good deal of public interest because of its importance for economic health of corporate and society in general. The concept of corporate governance should be defined to the needs of the nation because it potentially covers a large number of economic phenomenons. Corporate governance is not a one size that fits all. Malaysian corporation achieved satisfactory level of corporate governance practices and compliance. This is evident from a joint study by emerging market investment bank CLSA and Asian corporate governance 2003.

5. Long term performance of IPO

Fama(1998) argued that it is hard to measure the long-term returns and long term returns are sensitive to methodology. Loughran et al (2008) explains why some authors choose three or five years to show the behavior of IPOs in long term. One assumption can be the ability of firms to identify times in which the market is overvalued or times when investors will pay for an IPO relative to other firms. The empirical evidence in the US and other countries suggest that IPO underperformance in the long –term is relative in the overall market. Generally, IPO firms have seen positive performance in the first year, negative performance recorded in next three years and positive performance is experienced in year five (Ibbotson, 1975). In three years after going public IPO firms matched by size and industry have declined in average of return around -29.13 percent with the sample of 1526 IPOs between 1975 and 1984in US (Ritter, 1991). He said the strategy of investing in IPOs at the end of the first day's trading and holding this Capital for three years would produce a wealth of 83%. The result of IPOs Swiss stock market in 42 firms going public indicate if the purchase is made at the first day's closing price, then three years return are negative (Kuns and short,1994). Loughran and Ritter (1995) comprised 4753 IPOs firm between 1970 and 1990. As a result, their sample provides poor long-term returns for investors. After five years investors received average return of 5 percent per year for public firms. The IPO positive initial return and long-term underperformance is not a unique phenomenon but is applicable to countries such as Great Britain, Chile or Mexico (Ritter, 1975). The outcome of achieving high returns are valued more than in the standard expected utility setting, so the average returns in long term are lower. Therefore the investor still invests in IPOs because of very high positive return (Ma and Shen, 2003). In UK IPOs firm during 1984 to 1988 level of under pricing in long term is related to equity retained in the firm, raised of money on flotation and presence of earning forecast (Keasey and Short, 1992). Long –term underperformance tend to be significant. Even more important, underperformance tends to disappear (Drobetz and Kammermann, 2005). They explained this result as indicating that underperformance is not an IPO effect.

6. Problem statement

After 1997/8 Asian financial crisis and following that and a series of firms collapses around the world, it has become accepted that corporate governance system can help top management identify the problem and prevent significant losses (Elson, 1999). Previous study papers have emphasized the impact of corporate governance on firm's performance. The purpose of this study is to find the answer on what is the pattern of corporate governance mechanisms affecting the IPO aftermarket performance in Malaysia. This paper utilizes data for Malaysian listed firms over the period 2003 to 2005.

The primary study question is:

- Do corporate governance variable explain long term returns of Malaysian IPOs?
- Is there any relation between corporate governance variables and IPO return in Malaysia?

7. Study objective

The overall objective of this study is to explain the relationship and effects of corporate governance on the IPO performance in long term return in Malaysia.

Specifically, the objectives are as follow:

- To explain the impact of the corporate governance on after market performance of initial public offerings (IPOs).

The researcher attempts to explain the IPO long term return from corporate governance perspective in Malaysia using data from Malaysian listed firm.

8. Methodology of measuring the long-run return

Use of cumulative abnormal return or buy- and-hold returns (BHR): Barber and lyon(1997), lyon et al.(1999), Kothari and Warner(1997) and Fama(1998) analyze the alternatives used for the measure of abnormal returns but they couldn't tell which one is the preferred method. Fama(1998)state cumulative abnormal returns(CARs) would produce fewer artificial rejection than the use of buy-and-hold returns and there is greater knowledge of distribution and statistical tests for CARs. Brav et al. (2000) used buy –and-hold return tend to over- estimate the long-run underperformance of IPOs. Barber and Lyon (1997) reveal the advantage of BHRs for measuring the investor's experience. They used monthly returns or their cumulative returns. In this method it doesn't need to measure the returns obtained by an investor who holds a stock for a long period of time. According to these authors, the returns obtained by investor in long run are better measured by compounding the simple returns in short run. They believe cumulative abnormal returns (CAR) are a predictor of BHRs.

9. Variables

Each researcher's effort to establish relationships variables can be divided into two parts, Dependent variables and independent variables. Independent variables are manipulated by the researcher and dependent variables are manipulation of the independent variable. In this study, dependent variable is IPO long term return and dependent variables are corporate governance variables, issue variables and control variables.

10.Effects of Corporate Governance on the IPO Performance

To examine the relationship between corporate governance and IPO, the multiple regression analysis was used. The relationship was analyzed not only using Enter method but also using Stepwise method. Overall, according to statistical analysis, fraction of equity has positive significant relationship with IPO performance. Hence, it can be clearly seen that corporate governance has positive effect on the IPO performance in long term return in Malaysia. The amount of coefficient for fraction of equity shows weak effect on IPO among Malaysian firms. Thus, establishing effective corporate governance is a priority for Malaysian firms in order to maximize their IPO returns. Similarly, Gap Day and Offer size have also weak significant effect on IPO returns. Hence, Malaysian companies should pay serious attention on these two factors. In Contrast, Earning per Share with coefficient of 0.577 has strongest impact on IPO returns. It means, Malaysian companies have paid attention on this variable in order to maximize their IPO returns. Amongst all variables, only Offer Price has negative relationship with IPO performance.

11.Conclusion

This study empirically investigated the relationship between corporate governance and long run after market performance of Malaysian IPOs. The data used covered the period from 2007 to 2010 with the sample included 157 Malaysian companies. An examination of the Malaysian listed companies it can be seen that corporate governance has positive and poor impact on IPO returns. This emphasized poor corporate governance characteristics of Malaysian companies. According to examination of listed companies' financial indicators on IPO returns, it becomes apparent that Earnings per Share have positive significant impact on Initial Public Offering on returns. In contrast, offering price had negative and significant impact IPO's returns. Other variables included Gap Day, Fraction of Equity, and Offer Size which had significant positive relationship with Initial Public Offering returns. Hence, it can be concluded that Gap Day, Fraction of Equity, and Offer Size had positive impact on IPO returns among Malaysian listed companies. It is hoped that this study shed some light on the IPO aftermarket pricing from corporate governance perspective. It is also hoped that the results and findings of this dissertation provided significant contributions for Malaysian companies and executives in order to get a clear picture of the relationship between corporate governance and IPO returns.

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