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Malaysian institute framework and initial public offering (IPO) in short term return

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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 2006 to 2009. This study is to investigate the significance of corporate governance in explaining IPOs long term performance. Therefore, we set some hypothesis dealing with the relationship between IPOs short term return and three independent variables which are: corporate governance variables, issue variables and control variables.

Keywords: institute framework, IPO, short 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. 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. 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).

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).

3. Long term after market performance

After market return to IPOs is reflected in the IPOs volume. The IPO volume is high when market- to-book ratios are high. Underperformance is concentrated in firms with heavy- volume years and younger firm.

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The earnings per share of private firms increased when they go public, but actually decline in the few years after IPO.

4. Malaysian institutional framework

The Kuala Lumpur stock exchange (KLSE) is a self-control organization. KLSE carries out the listing requirements which explain very clearly the listing standards to public listed firms. KLSE was established in 1973 to provide central market for transaction of the shares, bond and other section of Malaysian listed firms. Malaysian firms are listed in two boards, main board and second board and they are classified in different sectors reflecting their core business. Firms in Malaysia are using the fix-price method to go public. The firm board members and proxy from the Malaysian Industrial Development Finance Consultancy and Corporate Services (MIDFCCS) and the Security Commission (SC) meet to agree the basic allotment of shares after applications close for each public issue. The applications are stored according to the magnitude of share that they applied and which kind of applier Bumiputra or non Bumiputra. Bumiputras are the local people with certain privileges in the New Economy Policy; Bumiputra investors are allocated at least 30% or more of security. The security could explain high under-pricing of Malaysian IPOs and transfer wealth to Bumiputra majority. In Malaysia, the IPO pricing mechanism is regulated by security commission (SC).when firm agree to pricing issues with underwriter, an application requests for approval from the Ministry of International Trade and Industry (MITI), the Foreign Investment Committee (FIC) and security commission (SC).This study is interested in Malaysian market because IPOs in Malaysia are smaller than those launched in more developed markets. 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. Short term performance of IPO

In theory, when the cost of equity capital is low, there would be low return for investors. The firms are able to identify times in which the market is overvalued or demonstrate the time that investors will pay for a specific IPO relative to other firms. However, variety of factors is correlated to the short-run performance of IPOs. Investors are sometimes overoptimistic about prospects of firms entering the market. Prospect theory applied and suggested the underperformance of IPO. IPOs in short-run are closer to have extremely high returns. Also, average returns in short-run show the decrease in magnitude of return but investor will still invest because the return is sometimes compensated by very high positive returns. It is also possible that IPOs in primary market are reasonably priced but on the first day of trading are over price in secondary market. It means IPOs offer price are overpriced in the secondary market and are correctly valued in the short-term. There are several factors to explain the short-run performance of IPOs. The first one is initial return on the day of listing. The second one is size of IPO. The third one is holding retained by government. The fourth one is the probability of success in the allocation. The fifth one is firms' underlying operating performance after IPO.

6. Problem statement

After 1997/8 Asian financial crisis and following that and a series of firm's collapses around the world, it has become accepted that Malaysian institutional framework system can help top management identify the problem and prevent significant losses (Elson, 1999). Previous study papers have emphasized the impact of Malaysian institutional framework on firm's performance. The purpose of this study is to find the answer on what is the pattern of Malaysian institutional framework mechanisms affecting the IPO aftermarket performance in Malaysia. This paper utilizes data for Malaysian listed firms over the period 2006 to 2009.

The primary study question is:

- Do Malaysian institutional framework variable explain short term returns of Malaysian IPOs?
- Is there any relation between Malaysian institutional framework variables and IPO short term return in Malaysia?

7. Study objective

The overall objective of this study is to explain the relationship and effects of Malaysian institutional framework on the IPO performance in short term return in Malaysia. Specifically, the objectives are as follow:

- To explain the impact of the Malaysian institutional framework on after market performance of initial public offerings (IPOs).

This study tries to show the Malaysian institutional framework mechanisms at work and make a suggestion to potential IPO investors. The researcher attempts to explain the IPO aftermarket from Malaysian institutional framework perspective using data from Malaysian listed firm**.**

8. Why Go Public

Basically, the serious question for some firms is why private firms should switch to public firm. There are several reasons can explain why some firms want to sell shares and get shareholders. The main reason is to refinance the firm (Baron, 1982; Ritter, 1984). After several years the founder or shareholders might want to convert their share into cash or buy new shares. The second reason is to obtain new funds or pay up their borrowing (Levis, 1993). By going public equity funds are raised because of expanding operations, increasing working capital or reducing borrowing (Li, 2005). Furthermore, by going public firms can obtain some benefits such as enhance corporate image, advertise trademarks and products, attract and retain key person (Rajan, 1994). Emery and Finnerty (1997) claimed that going public allows a firm to use new capital resources and obtain a higher price than in private placements. The significant point in IPO is initial shareholder are allowed to diversify their portfolio. A successful IPO can create broader shareholder base to rising capital and satisfy its financial market and establish market for firm's securities (Loughran, 1994). There are some disadvantages with going public like weakening of control, additional responsibility for directors of public firm, heavy cost for firm. Firms that switch to the public firm has to meet initial cost of conversion to a public listed firm, underwriting fees, brokerage, accounting and legal fees, listing fees, share registry costs and cost of producing annual reports (Ross, 1999). Nonetheless, the motivation of going public is stronger than other ways (Ritter and Welch, 2002).

9. Short term return

Some studies revealed the high initial returns on IPO at international level. During the period 1960 through 1969 the initial IPO returns on average 11.4 percent and there is smaller opportunity of loss (Ibbotson, 1975), so IPO is still attractive to common investors. Finn and Higham (1988) found the initial IPO return is on average 29.2 percent on first trading day by using a sample of 93 new issues from 1966 to 1978 in Australia. Ibbotson (1988) found an average 16.4 percent as initial IPO return for 4534 IPOs from 1977 to 1987 in US. The IPO under pricing is a universal phenomenon and they found that on average developing countries have higher IPO under pricing than the undeveloped countries (Loughran et al, 1994).

10. Short-term initial return

Initial return is difference between the prices of new shares offered for sale and closing price at first trading day after listing. Ritter (1998) pointed out the average long term return in 33 countries in two categories, that is, developing market and developed market. The average of initial return in developing market is 13.6% to 38.8% and 4.2% to 54.4% in developed market. Ibbotson's (1975) used 120 new listing firms as a sample on the New York Stock exchange. He found the average of initial return from listing date to the end of listing month is 11.4%. Garfinkle et al (2002) discover similar study on the NASDAQ from 1997 to 1999. They recorded 44% as initial long-term return. Ritter and Welch (2002) used a larger sample at longer term. They used 6,249 samples from 1980 to 2001. The initial return for this period is near to 18.8%. In Malaysia, Dawson (1987) after studying twenty-one samples from 1987 to 1983 reported an initial return of 166.7%. Yong (1991) recorded 167.4% as initial long term return from 1983 to 1988. Isa and Phmad (1996) on 126 new listing firms from 1980 to 1991 found 76.8% as an initial return. Leong et al (2000), state that the initial return was at 107% from 1992 to 1998.

11.Methodology of measuring the short-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 short-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 short run are better measured by compounding the simple returns in short run. They believe cumulative abnormal returns (CAR) are a predictor of BHRs.

12.Effects of Malaysian institute framework 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. The outputs of multiple regression using enter method is depicted as below.

13.Measuring IPO

Barber and lyon(1997), lyon et al.(1999), Kothari and Warner(1997) and Fama(1998) used cumulative abnormal return or buy- and-hold returns (BHR) to measure IPO returns. Fama(1998) stated that 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. In contrast, Brav et al. (2000) preferred buy–and-hold return to cover bias estimation of the short-run underperformance of IPOs. This method was confirmed by Barber and Lyon (1997). They used monthly returns or their cumulative returns. In this study, regression modeling was used to measure and estimate IPO returns.

14.Conclusion

This study empirically investigated the relationship between Malaysian institutional framework and short run after market performance of Malaysian IPOs. The data used covered the period from 2006 to 2009 with the sample included 150 Malaysian companies. An examination of the Malaysian listed companies it can be seen that Malaysian institutional framework has positive and poor impact on IPO returns. This emphasized poor Malaysian institutional framework 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 short run 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 Malaysian institutional framework 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 Malaysian institutional framework and IPO short run returns.

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