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Do anchor investors create value for initial public offerings? An empirical investigation

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Abstract The concept of anchor investors was introduced by the market regulator, Securities Exchange Board of India (SEBI), to bring transparency in the book building mechanism. We examine anchor investors' investment in initial public offerings (IPOs) to determine how they create value for issuing firms and participating investors. Using a database of 135 IPOs issued in the Indian market through book building mechanism during 2009–2014, we find that anchor investors' investment in IPOs reduces underpricing. Larger subscription from retail investors for anchor-supported IPOs indicates that anchor investors' participation is viewed as a credible attestation of quality of the issue. We document that anchor-supported IPOs are more liquid and less volatile in the short run. We also find that by controlling for other factors such as offer size, subscription rate and age of the firm, a part of the underpricing is reduced by anchor investors.

Introduction

Book building[1] is the dominant price discovery and allocation mechanism for the initial public offerings (IPOs) issued in India. The idea central to the book building mechanism is to reduce underpricing i.e. to have the offer price close to list price, which in turn will be able to eliminate mispricing by unscrupulous promoters. Despite the increased use of book building, IPOs issued in India witnessed a high rate of underpricing relative to developed markets like the United States (U.S.), United Kingdom (U.K.) and other European countries. Studies including Marisettya and Subrahmanyam (2010) and Sahoo (2014)[2] document significant underpricing for IPOs issued in India. Marisettya and Subrahmanyam (2010) report that IPOs affiliated with reputed business groups failed to reduce information asymmetry, resulting in larger underpricing i.e. more than 100 percent during 1990–2006. In addition, studies suggest that many companies which went public during 1999–2000 subsequently vanished from the secondary market resulting in huge amount of wealth loss for retail

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[1] Book building is an established and well recognised process for initial public offerings (IPOs) issued in various leading markets across the globe i.e. USA, Japan, Germany, France, China, Brazil, and New Zealand. Indian book building is identical to "Dirty Dutch Auction" in the U.S. Post July 2009 the market witnessed anchor investors-backed book building, where anchor investors are allowed to participate in the IPO just one day before the book opens to the public.

[2] Sahoo (2014) reports an underpricing of 14.23 percentage for the IPOs issued in India during the period 2007–2012.

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investors. Larger underpricing indicates that a significant amount of information asymmetry still persists in the Indian IPO market.

The Indian book building mechanism distinguishes itself from other countries in three important aspects. First, unlike the book building mechanism in the U.S., the Indian mechanism allows investors to access aggregate demand on a real time basis at different price points within the price range. Second, investors can also observe the oversubscription rate for each investor category during the book building period. Third, regulation requires that a predetermined quota of shares must be kept in reserve for allocation to three different investor groups i.e. Qualified Institutional Buyers (QIBs), Non-Institutional Buyers (NIBs) and Retail Individual Buyers (RIBs).[3] Both QIBs and NIBs are required to submit only limit bids; however RIBs have the option to bid at cut-off i.e. at the upper limit of the price range. Additionally, institutional investors have to deposit a margin of 10 percent of the application amount at the time of bidding. Non-institutional retail investors have to pay the full amount to apply for IPO stocks. Thus the subscription rate for each category of investors reflects the genuine demand for IPOs. Fourth, the Securities Exchange Board of India (SEBI) introduced "anchor investors"[4] i.e. another group of institutional investors, and allowed them to invest one day before the issue opens to the public and the process was also to be completed on the same day. In principle, under anchor mechanism, the pricing was to be initially determined by the most informed institutional investors which is observable to the non-institutional retail investors. Anchors are compensated with assured allocation for their voluntary disclosure of information about the quality of the issue. The transparency in the book building mechanism, coupled with additional certification from anchor investors motivates us to investigate the IPO pricing in the Indian IPO market setting. Therefore, it is worthwhile to study how the anchor mechanism affects valuation including liquidity and volatility of IPO stocks in the short run.

The anchor mechanism which is unique to the Indian IPO market is relevant for a number of reasons. First, anchor investors are institutional investors[5] (carved out from QIBs), are sophisticated and they have private information which is not available to common investors. They are informed investors, who have extensive understanding about the market as well as valuation of the firms going public. Second, although anchors are qualified institutional investors, they have to invest in the IPO one day before the book opens to the public. Hence larger participation from anchors in terms of subscription provides an early signal to the market apropos issue quality. Additionally, the price at which they bid for IPO stocks could be used as a reference for price band and final offer price. Third, usually anchors are impartial, as they are not connected with the issuing firm. Moreover, they have their own reputation to protect as institutional investors, hence reputed institutions invest in quality issues to maintain their credibility in the market. Fourth, anchor investors are supposed to apply for IPO stocks just like other investors at the price they consider as best price. They are required to deposit a margin of 25 percent of their application and the balance has to be deposited within two days from the close of the issue. Additionally, these investors are not allowed to sell their allotted stocks within one month from date of listing. Thus, anchor investors' contracts are genuine and based on a well calculated investment strategy. Fifth, unlike underwriters and syndicates, anchor investors' participation in an IPO does not add any cost to the company, because anchors are investing on their own. Finally, details of the anchor investors' investment in an issue is publicly available, hence information asymmetry between institutional and non-institutional investors can be minimised.

The current paper sheds new light on the impact of anchor investors' participation within the context of the Indian book building mechanism. Allocation to the anchors before the issue opens to others is a unique practise followed in India to assure more information production and transparency in pricing. The research questions addressed in the current paper are the following: First, does anchor investment reduce underpricing? The presence of anchor investors raises one important issue i.e. whether such arrangements benefit the company going public by reducing underpricing. Second, does anchor investor participation stimulate other investors to bid for IPOs? Further, anchors as institutional investors have private information regarding quality of the issue, and their investment seems to be an attestation of quality. Taking the cue from this, retail investors overwhelmingly subscribe to the IPOs backed by anchor investors. The ensuing inclusion of anchors could be beneficial to the issuing firm to get more subscription. Third, a related question is whether anchor-backed IPOs are more liquid than the non-anchor backed issues. Liquidity of the newly listed issues is a major concern in the Indian market. Though the Indian stock market has more than 8000 listed companies only 10% of them are highly liquid. Illiquidity of IPO stocks is an additional burden for the investors in general and retail investors in particular. Fourth, do anchor investors' investments reduce the aftermarket risk for IPO stocks? Fifth, we further perform robustness checks to investigate how characteristics of anchor-backed IPOs are different from non-anchor backed IPOs. Using a sample of 135 Indian IPOs, issued during 2009–2014, we find that: (a) anchor investors' investment in an IPO reduces underpricing. Additionally, the larger the number of anchors bidding for an issue the less would be the underpricing. This result suggests that anchor investors being institutional investors help the new issue market to reduce information asymmetry among issuing firm, investment bankers and investors; (b) all investors respond to the anchor-participated IPO in a positive manner i.e. both retail and institutional investors subscribe more to anchor-backed IPOs than non-anchor backed IPOs; (c)

[3] Qualified Institutional Buyers (QIBs) are defined in SEBI DIP Guidelines, 2000, Chapter 1, XXIVa. The QIBs category consists of institutional investors including commercial banks, mutual funds, multilateral developmental financial institutions, venture capital funds, pension funds, and provident fund. Non-Institutional Buyers (NIBs) are all bidders that are not either QIBs or Retail Individual bidders and who have bid for an amount more than INR. 200,000. Retail Individual investor means an investor who applies or bids for securities for a value of not more than INR. 200,000, SEBI DIP Guidelines, 2000, Chapter 1, XXIVc.

[4] Anchor investors are the first investors in an IPO and are qualified institutional buyers. We discuss the anchor investment regulation in the Indian IPO market in detail in the third section.

[5] Studies including Cohen et al. (2002), Nagel (2005), Michaely and Shaw (1994), argue that institutional investors are sophisticated and hence firms with larger institutional holdings perform better than firms with less institutional holdings.