Research in International Business and Finance 25 (2011) 255–265

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Explaining underpricing of IPOs in frontier markets: Evidence from the Nigeria Stock Exchange☆

Charles K.D. Adjasi*, Kofi A. Osei, Eme U. Fiawoyife

University of Ghana, Finance-Business School, University Avenue, Legon, Accra, Ghana

ARTICLE INFO

Article history:
Received 27 February 2009
Received in revised form 19 January 2011
Accepted 21 January 2011
Available online 1 February 2011

JEL classification:
G12
G14
G15
G24

Keywords:
Underpricing
IPO
Abnormal returns
Stock market
Uncertainty
Africa

ABSTRACT

The paper provides empirical analyses of IPO underpricing on the Nigerian Stock Exchange, from the period 1990 to 2006. The results indicate an average abnormal initial day returns of 43.1%. There is evidence of long-run underperformance of 0.6%. Results from our regression model explaining initial abnormal returns for the IPOs of Nigeria show that size of firm and audit quality are important variables affecting underpricing. The results also show the presence of a non-linear relationship between the offer price and underpricing.

1. Introduction

Initial public offerings (IPOs) are a means of going public for firms. IPOs offer opportunities for firms to diversify ownership, use stock markets as an exit strategy for mature businesses and raise funds

☆ This paper is part of a larger study – Underpricing of Initial Public Offerings on African Markets – funded by the African Economic Research Consortium. The paper has been presented in various stages at the African Economic Research Consortium Research Workshop and Conferences held in Nairobi, Dar er Salaam and Entebbe and has undergone substantial revisions. We are particularly grateful to Lemma Senbet, Chris Adam, Victor Murinde, and also Machiko Nissanke, Leonce Ndikumana, Ernest Aryeetey and all members of African Economic Research Consortium Thematic Group C for helpful comments and suggestions.

* Corresponding author. Tel.: +233 24 46130.
E-mail address: adjasikd@ug.edu.gh (C.K.D. Adjasi).

0275-5319/$ – see front matter © 2011 Elsevier B.V. All rights reserved.
doi:10.1016/j.ribaf.2011.01.005

for investment. In the case of younger firms, IPOs also serve as an early-stage financing option, Riding (1998). One of the interesting anomalies in finance is the fact that IPOs provide significant abnormal returns on the initial day of trading – Khurshed and Mudambi (2002). The abnormal returns from IPOs are as a result of underpricing of IPOs, which occurs when the offer price of an IPO is significantly lower than the end of first day trading price as well as trading prices for subsequent days. It is also argued that even though initial returns are high and positive, in the long run IPOs yield significantly negative abnormal returns (Ritter, 1991; Levis, 1993).

There is considerable amount of literature on the subject of underpricing of IPOs, Loughran et al. (1994) and Ritter (1998) as well as many others note that studies on the anomaly have been documented in over 30 countries. One of the most common and the most observed reason for underpricing is that of adverse selection which is due to information asymmetry problems. Information asymmetry exists among different investors as well as between the issuer and investors, and this raises uncertainty surrounding a firm's value and consequently its IPO offer. In an attempt to solve the information asymmetry problems, IPOs are underpriced by investment banks to encourage investors to provide more information (Allen and Faulhaber, 1989; Chemmanur, 1993). Underpricing therefore is an additional cost for issuers and a transfer of wealth to investors who buy the shares. IPO underpricing continues to be a recurring phenomenon and African stock markets have not escaped this phenomenon. Indeed in Africa, inefficiencies and information gaps on the markets could accentuate information asymmetry problems attributed to underpricing of IPOs.

Unfortunately, there is little research on IPOs on African stock markets. Existing studies include that of Page and Reyneke (1997) and Alli et al. (2010) on IPOs on the Johannesburg Exchange in South Africa and that of Chahine and Tohme (2009) on relationships between IPOs underpricing, CEO duality, and strategic ownership in 12 Arab countries of the Middle East and North Africa (MENA) region. More so there is no study on IPOs on the relatively small and frontier stock markets in Sub Saharan Africa.

This study therefore attempts to examine the underlying factors behind IPOs on African stock markets. This study therefore attempts to examine the underlying factors behind IPOs on African stock markets. The Nigeria Stock Exchange (NSE) in Nigeria is one of such budding African frontier markets. There have been about 125 IPOs issued on the NSE since 1990. Evidence shows that there are considerable price movements during the initial days of trading on this markets as observed in other markets. But how large are the price changes? To what extent does underpricing as an additional direct cost reduce the benefit of public listing? What factors cause underpricing of IPOs on this typical African frontier market if it exists? Finding answers to the above questions will add considerably to our current knowledge on African stock markets.

The rest of the paper is structured as follows: the next section examines listing procedures on the Nigerian Stock Exchange, Section 3 provides an overview of literature, Section 4 discusses the methodology as well as empirical results and conclusions are drawn in Section 5.

2. Listing on the Nigerian Stock Exchange

The Nigerian Stock Exchange with over 300 listed companies was established in 1960 as the Lagos Stock Exchange and later renamed as the Nigerian Stock Exchange in 1977. The procedure for enlisting on the Nigerian Stock Exchange is outlined in the Securities and Exchange Act (SEC) No. 45 of 1999 and the Companies and Allied Matters Act of 1990. The enlisting company appoints an issuing house in terms of designing the instrument and raising of funds through the sale of shares at a given price. Additionally, the issuing firm appoints reporting accountants, underwriters, trustees and solicitors. The prospectus is prepared by all parties involved while three to five meetings are held to review the work done. The Securities and Exchange Commission then receives the offer document from the issuing house for review and if satisfied, issues a letter confirming the registration of the securities. Again, a final meeting of the board is convened for all the parties to witness the signing of the documents and onward submission of the signed documents.

The SEC gives approval to open the issue with application forms distributed by all banks. For public offer, 21 working days is given as closing day while 28 days are allocated for right issue. The basis of allotment of the issue is prepared by the registrars, the issuing company and the issuing house. The proposal is submitted within six weeks of closure of offer by the issuing house. Moreover, the issuer