LIQUIDITY AND RETURNS OF UNDERPRICED IPO STOCKS IN THE SECONDARY MARKET

Ruslan Prijadi
Universitas Indonesia

Offering stocks below their market value (underpricing) is a common phenomenon of the Initial Public Offering (IPO). Issuers expect that underpricing keep their stocks attractive to investors (thus, more liquid and more disbursed stocks ownership). Investors, the party involved in stocks trading, may have different expectation; they want to gain profit from the purchase of the low price IPO stocks. This paper will examine if the underpriced IPO stocks improve both the liquidity and returns. The data include underpriced IPO stocks offered during 1998–2005 at the Indonesia Stock Exchange (BEI). Stocks performance will be recorded subsequently 3 (three) years after the IPO, divided into 4 (four) periods. Then, the regressions are applied on: (a) various measures of liquidity as a function of underpricing and other factors, and (b) returns (cumulative adjusted returns) as a function of underpricing, liquidity and other factors. The results show that underpricing improves stocks performance for very short time, i.e., until Period 2 (61-180 days after the IPO) on the liquidity, and until Period 1 (60 days after the IPO) on the returns. The less liquid stocks—held by investors with longer term horizon—may not compensate the investors accordingly.

Keywords: Initial Public Offerings; Underpricing; Liquidity; Stock Returns.

INTRODUCTION

The firms' long-term goal by issuing their shares to public is not only to accumulate fund to support the firms' growth, but also to sustain the trade of their stocks after the IPO. They will consider every single strategy to make their issued stocks always attractive to the market. One of the strategies most commonly used by the issuing firms is to lowering the initial stock price, known as an underpricing strategy.

Many issuing firms believe that underpricing could affect stocks market liquidity through a dispersed ownership structure. Booth and Chua (1996) on ownership dispersion hypothesis say that issuing firms may intentionally under price their shares to generate excess demand that will enable them to attract a large number of small investors. The disperse ownership structure will increase the liquidity of the stocks in the market. They find that underpricing is negatively related to the stocks owed by block holders and positively related to non block institutional shareholders. These results are followed by Brennan and Franks (1997) who find similar results on the relationship between underpricing and ownership structure. The effect of dispersed ownership is due to increasing number of firms who own the stocks which potentially improve market liquidity.

Underpricing tends to be a strategy used of the issuing firms to attract potential investors' attention to buy the issued shares. Reese (1998) implies that investor interest is the driver that may affect the IPO's initial returns (level of underpricing), initial trading