THE PERFORMANCE OF INITIAL PUBLIC OFFERING (IPO) IN MALAYSIA

Julia binti Joni

Corporate Master in Business Administration
2010
THE PERFORMANCE OF INITIAL PUBLIC OFFERING (IPO) IN MALAYSIA

JULIA BINTI JONI

A dissertation submitted in partial fulfillment of the requirements for the degree of Corporate Master in Business Administration

Faculty of Economics and Business
UNIVERSITI MALAYSIA SARAWAK
2010
## TABLE OF CONTENT

Approval page ........................................................................................................... ii
Declaration and Copyright Page ............................................................................... iii
Acknowledgements ................................................................................................... iv
List of Tables .............................................................................................................. v
List of Figures ........................................................................................................... vi
Abstract .................................................................................................................... vii

1. **INTRODUCTION**
   1.1 Background and Malaysia Stock Market ...................................................... 1
   1.2 Malaysia IPO Regulation ........................................................................... 3
   1.3 Problem Statement ..................................................................................... 7
   1.4 Objectives .................................................................................................... 7
   1.5 Significance of the study ............................................................................ 8
   1.6 Definition of key Terms ............................................................................. 8
   1.7 Organization of business research proposal ............................................. 10

2. **THEORETICAL FRAMEWORK**
   2.1 Theory and Empirical Study on IPO underpricing ..................................... 11
   2.2 Theory and Evidence on the Long-run performance of IPOs ..................... 13
   2.3 Malaysia Evidences on IPOs short run and long run performance ............. 18
   2.4 Hypothesis ................................................................................................ 19

3. **RESEARCH DESIGN**
   3.1 Sampling Design and Instruments ............................................................. 22
   3.2 Measurements ........................................................................................... 23
   3.3 Statistical Techniques .............................................................................. 24
   3.4 Empirical methodology on long run aftermarket performance ............... 25

4. **FINDING**
   4.1 Descriptive Statistic of Underpricing Model ............................................. 28
   4.2 Regression result of under-pricing Model ................................................. 29
   4.3 Regression results of Long run performance aftermarket model ............. 31

5. **CONCLUSION**
   5.1 Conclusion ................................................................................................ 34
APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion is conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Corporate Master in Business Administration.

Dr Mohammad Jais
Supervisor

This research paper was submitted to the Faculty of Economics and Business, UNIMAS and is accepted as partial fulfillment of the requirements for the degree of Corporate Master in Business Administration.

Prof Dr. Shazali Abu Mansor
Dean, Faculty of Economic and Business
UNIMAS
DECLARATION AND COPYRIGHT

Name : JULIA BINTI JONI
Matric Number : 08031527

I hereby declare that this research is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

Signature : .........................................................
Date : .................................................................

28 July 2010

© Copyright by Julia binti Joni and
Universiti Malaysia Sarawak
I would like to express my sincere gratitude to all those who have supported and rendered their assistance to me in my endeavour to finish this business proposal. Without supports, advices, helps and sacrifices from and made by those people, it would impossible to complete this research. First of all, I would like to offer my unreserved thanks to my supervisors, Dr Mohamad Jais for his invaluable comments, support and patience throughout the study.

Special thank also goes Universiti Malaysia Sarawak (UNIMAS) for giving me an opportunity to embark on this challenging journey. Finally, I would like to thank my family and friends for encouraging me to persevere and to learn at every opportunity.
<table>
<thead>
<tr>
<th>Table No.</th>
<th>Title of the Table</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table 1</td>
<td>IPO firms on the Main, Second Board and Mesdaq Market of Kuala Lumpur Stock Exchange (KLSE) during the year 2006 to 2009 according to their industry.</td>
<td>22</td>
</tr>
<tr>
<td>Table 2</td>
<td>Descriptive Statistic</td>
<td>28</td>
</tr>
<tr>
<td>Table 3</td>
<td>Multivariate regression analysis of cross-sectional variation for Underpricing Model</td>
<td>35</td>
</tr>
<tr>
<td>Table 4</td>
<td>Multivariate regression analysis of cross-sectional variation in Buy And Hold Abnormal Return (BHAR_{12})</td>
<td>35</td>
</tr>
<tr>
<td>Table 5</td>
<td>Multivariate regression analysis of cross-sectional variation in Buy And Hold Abnormal Return (BHAR_{24})</td>
<td>36</td>
</tr>
<tr>
<td>Table 6</td>
<td>Multivariate regression analysis of cross-sectional variation in Buy And Hold Abnormal Return (BHAR_{36})</td>
<td>36</td>
</tr>
<tr>
<td>Figure No.</td>
<td>Title of the Figure</td>
<td>Page</td>
</tr>
<tr>
<td>-----------</td>
<td>-------------------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>Figure 1</td>
<td>The regulatory structure of the Malaysian stock market.</td>
<td>4</td>
</tr>
</tbody>
</table>
PRESTASI TAWARAN AWAM PERMULAAN (IPO)

DI MALAYSIA


vii
THE PERFORMANCE OF
INITIAL PUBLIC OFFERING (IPO) IN MALAYSIA

The objective of this research paper is to evaluate the performance of Initial Public offering in Malaysia during year 2006 until 2009. It is investigate the determinants of the short and long run of IPOs performance. This study produces information about the degree of underpricing and long run return of IPOs up to 1-year, 2-years and 3-years and their determinants which are variable to investors in designing their security selection processes. The evidence indicates that, on average, the IPOs are underpriced. On the other hands, the IPOs show a pattern of underperformance (negative return) in the long run up to three years. However, the statistical evidence showed that in the long run the IPOs are neither under nor overpriced. Through statistical analysis of the dependency of several independent variables, it is found that only Offer to Open, Offer Size, Age of the firm and Lead Underwriter are significant influence the initial return for one year buy and hold abnormal return model.
INTRODUCTION

1.1 Background and Malaysia Stock Market

The Malaysia Stock Market was first established as the Malaysian Stock Exchange in 1960 and continued as the Stock Exchange of Malaysia and Singapore until the setting up of the Kuala Lumpur stock Exchange Berhad (KLSEB) and Singapore Stock Exchange (SES) in 1973. KLSEB was renamed and is currently known as Bursa Malaysia after the demutualization exercise in 2004. It was subsequently listed on the Main Board on 18 Mac 2005.

Malaysia has three main securities markets. The Kuala Lumpur Exchange (KLSE), which consists of the main board and seconds board and the more recently (1997) established Malaysian Exchange to securities Dealing Automated Quotation Berhad (MESDAQ). KLSE was established in 1973 to provide a central market place for buyers and sellers to transact in the shares, bonds and various other securities of Malaysian listed companies. A strong linked existed between the KLSE and Stock Exchange Singapore (SES) as Malaysian corporate companies were also listed and traded through SES and vice versa for Singapore incorporated companies. A significant milestone for the KLSE was achieved in 1990 with the delisting of Singapore incorporated companies and vice versa for Malaysian companies listed on the SES. This move heralded the growth of the KLSE as a stock exchange with a truly Malaysian identity.

One of the major significant changes in the Malaysian securities market was the establishment of the Securities Commission (SC) in 1993 to regulate, supervise and develop the capital market. Prior to 1993, the regulations and supervision of the capital market were fragmented amongst a number of regulations authorities such as
the Capital Issues Committee (CIC), the Registrar of Companies, Panel of Takeovers and Mergers, and Bank Negara (Central Bank of Malaysia). This fragmentation of responsibilities had contributed to administrative inefficiencies and complicated the overall planning and development of the market (SC, 1993).

Since its inception, the SC has taken the role of the CIC and the Panel of Takeovers and Mergers and is now responsible for the development of the securities industry, financial future and options market, unit trust and property trust schemes. During the 1997 Asian financial crisis, the SC played a major role in maintaining integrity of the Malaysian capital markets and imposed stringent regulations on the KLSE.

In Malaysia, companies are listed either on the Main Board or the Second Board of the KLSE, and are classified into range of diverse sectors reflecting their core businesses. Firms in Malaysia employ the fixed price method to go public whereby investors will specify the numbers of shares to which they wish to subscribe at the pre-announced subscription price. Following the close of applications for each issue, company board member and representative from the Malaysian Industrial Development Finance Consultancy and Corporate Services (MIDFCCS) and the SC meet to agree the basis for allotting the shares.

The prospective applicants are sorted according to the amount of shares they are applying for and whether they are Bumiputras or not. Bumiputras are the local indigenous people and are given certain privileges as stated in the New Economic Policy. A significant privilege is the preference given to them in the allocation of shares where at least 30% or more of the securities are to be allocated to Bumiputra investors. The policy could also provide explanation for the high underpricing of
Malaysian IPOs, given the political need to be pleased the Bumiputra majority and to transfer wealth to them.

The main features of the balloting process is that it is carried out in two different phases, in the presence of representatives from the Anti-Corruption Agency, MIDFCCS, MITI, FIC, SC and members of the board of directors. Bumiputras investors are balloted in the first stage followed by a mini-balloting from the reserve list of the Bumiputra portion. In the second stage, all unsuccessful Bumiputra portions are added to the public portion for the second balloting which increases the probability of success for the Bumiputra investors. The pricing mechanism of IPO is regulated by the SC rather than being market driven. Once a firm has agreed to the pricing of the issue with its lead underwriter, an application has to be lodged for approval with the Ministry of International Trade and Industry (MITI), the Foreign Investment Committee (FIC), and the Securities Commission (SC).

1.2 Malaysian IPO Regulation

The regulatory body of the securities and future industry is the Securities Commission (SC) while Bursa Malaysia is a self-regulatory organization with its own Memorandum and Articles of Association. Securities Commission was established on 1 March 1993 under the Security Commission Act 1993. It provides regulations and governance for the capital market and at the same time act as advisor to the Ministry of Finance on matters related to the capital market. Bursa Malaysia on the other hand has its own set of rules that govern the conduct of its members in securities dealings. It also serves as an enforcer of its Listing Requirements. In addition to the Securities Commission, the conducts of all the share market listed participants are also governed
by the Commissioner of Companies which was formerly known as Registrar of
Companies.

_Regulatory Structure_

![Regulatory Structure Diagram]

Figure 1 portrays the regulatory structure of the Malaysian stock market.

Bursa Malaysia Central Depository Sdn Bhd was incorporated on 26 October,
1987 and is a subsidiary of Bursa Malaysia. It operates Bursa Malaysia Depository
Sdn Bhd (formerly known as Central Depository System (CDS)), which is the Bursa
Malaysia’s scripless electric settlement system. Bursa Malaysia Securities Clearing
Sdn Bhd, formerly known as SCANS was set up in 1984 as the centralized clearing
house for Bursa Malaysia. On the other hand,

Bursa Malaysia Derivatives Berhad was known as Malaysian Derivative
Exchange (MDEX) previously and is the official exchange for derivatives. Clearing
and settlement activities for derivatives are managed by the Bursa Malaysia
Derivatives Clearing Berhad. The approach to regulate the stock markets in Malaysia
was based on the merit-based regime inherited by the Securities Commission upon its
establishment in 1993. Under the merit-based securities regulation, new issues or
offers are subjected to review by regulators on their investment merit, only ‘fair, just and equitable’ securities will be approved.

Later, on 1 January, 1996, the disclosure-based regulation was introduced to replace the merit-based regime on a gradual basis. Under this new regime, regulators would not assess or pass the applications of new issues nor do they determine the fairness of the new securities. Here, the issuers are expected to provide all the relevant information accurately with due diligence following the parameters established by the securities law and regulations in setting their own offer prices. The issuers are expected to closely follow a Securities Commission publication known as ‘Due Diligence Practices’ which was introduced in August 1996. The investors would have to judge on the fairness of the investments in new securities based on the information provided usually in the prospectus. This move is carried out to enhance the efficiency of the capital market, improve transparency and facilitate a market-driven discipline. This disclosure-based regime are enforced in full fledge after its final phase from 2003 onwards.

IPO applicant firms are required to furnish a detailed prospectus to the Securities Commission and the Bursa Malaysia. The prospectus must include, among other things, a profit estimate or a forecast, the accounting policies and calculations for profit or cash flow estimates, and forecasts or projections (as applicable). These are all to be reviewed and reported upon by the Reporting Accountants. Sufficient details on the basis and assumptions of the estimate, forecast or projection must also be disclosed to enable the investor to assess the reliability of these and the effect of any changes in the assumptions used. Although Malaysian regulated IPO firms are required to make forecast for a three-year period beginning from the year of the IPO,
they are only required to publish an earnings forecast for the first of these period of at least three months.

And from 1 January 1996, additional regulation also was applied to IPOs in specific industries through the Securities Commission’s Prospectus Guidelines (SC, 1995a). The guideline required the substantial shareholders and promoters of any main board applicant firm involved in constructions, trading/services or specialized industries and all second board applicant firms either to opt or to provide a profit guarantee of 90% of the forecast profit as stated in the prospectus (SC, 1995b).

The guarantee secured either by providing a bank guarantee in favour of the IPO firm or by depositing securities beneficially owned by guarantors with an independent stakeholder who was responsible for carrying out daily reviews of the price movement of the shares based on the daily closing transacted market price of the shares. In the event that the actual profit before taxation was less than 90% of the guaranteed profit for the relevant financial year, the guarantors are required to compensate the group for the shortfall, the contribution was reported in the income statement for the relevant years as ‘profit contribution’ or ‘proceed from profit guarantee’, credited to the inappropriate profit for the group and of the company. In practice, the penalty was weakened by the exercise of another provision in the regulation whereby, subject to the approval of the shareholders and the Securities Commission, the guarantors could obtain a variation in the terms of agreement (Ismail and Weetman, 2007). From 1 July 1997, all second board firms were required to provide a profit guarantee (SC, 1997) instead of a moratorium.

The moratorium required the major shareholders who promoted the IPO to retain shareholdings for one year from the date of admission to the board. Thereafter these major shareholders were allowed to sell or transfer up to a maximum of 20 per
cent per annum for main board or 15 per cent per annum for second board shareholders. Under modifications of the regulations, taking effect from 30 April 1999, the guarantee condition was replaced by a share moratorium on all promoters of regulated IPOs but with no condition on forecast accuracy (SV, 1999). The major shareholders of the regulated firms were required to retain 45 per cent of their shareholdings until one year after listing. In every subsequent year they were permitted to dispose of 15 per cent of the shares subject to the moratorium. Hence, expectations are ambiguous as to whether profit guarantee firms manage earnings to a greater or lesser extent than moratorium firms.

1.3 Problem Statement

Empirical evidence shows that are two main patterns associated with IPOs: the short run-underpricing of IPOs and their poor stock price performance in the long run. The study of Loughran et al. (1994) found that the IPO underpricing phenomenon existed in 25 countries, with higher IPO underpricing in developing market than that in develop markets.

1.4 Objectives

The empirical literature on IPOs has shown some irregularities two of which are short-run underpricing and long-run aftermarket underperformance. The first, known as short-run anomaly, is that IPOs are, on average, substantially underpriced in the first day of trading. Second, what appears to be underpricing in the short-run turns to be overpricing in the long-run. The specific objectives of the study are the following:
a) To examine both the short run and the long run IPOs performance.
b) To examine the level of initial returns gained by investors.
c) To examine the long-run IPOs performance up to three years.
d) To examine the determinants of the one, two and three-year long run performance.
e) To examine factors that associated with the long run stock return performance.

1.5 Significance of the study

There have been some studies about IPOs underpricing in Malaysia but studies focusing on the long-run performance of IPOs are scare. Dawson (1987) using 21 Malaysia IPOs for period of 1977-1983 find an initial underpricing of 167% and an 18.2% twelve month holding period return. Sufar (1993) reports an average initial return of 140.5% for 43 Malaysian IPOs, however a loss of 10.9% over 12 months in the aftermarket. Similarly, Wu (1993) reports positive monthly returns in the first 11 months and negative returns thereafter. Mohammad, Nassir, and Ariff (1995) report lucrative average excess returns on the first trading day of 135%. However, for investor holding new issues over three year gains only 21% per annum. Mohamed et al. (1994) examine the initial and the long run performance of 65 IPOs over the 1975-1990 periods and finds that in the three year after offering date, Malaysian IPOs neither outperform nor underperform the market.

1.6 Definition of Key Terms

The following is the definition of each key term used in the thesis:

a) Initial public offering (IPO) — The first time a company sells stock to the public. An IPO is a type of a primary offering, which occurs whenever a company sells new stock, and differs from a secondary offering, which is the
public sale of previously issued securities, usually held by insiders. Some people say IPO stands for "Immediate Profit Opportunities." More cynics say it's probably overpriced.

b) **Underpricing** — refers to a situation when the price of a stock at the first day of trading is higher than the offer price. There are two ways of computing the underpricing: unadjusted and adjusted by market returns in case the time between the date of prospectus and official listing date is quite awhile (various sources).

c) **Overpriced** — refer to the short sale constraints including various costs and risks of shorting, as well as legal and institutional restrictions can allow stocks to be overpriced. If these impediments prevent investors from shorting certain stocks, then these stocks can be overpriced and thus have low future returns until the overpricing is corrected. By identifying stocks with particularly high short sale constraints, one identifies stocks with particularly low future returns.

d) **Lead underwriter**—The investment bank in charge of setting the offering price of an IPO and allocating shares to other members of the syndicate. Also called *lead manager*.

e) **Offering price** — The price that investors must pay for allocated shares in an IPO. Not the same as the opening price, which is the first trade price of a new stock.

f) **Opening price** — The price at which a new stock starts trading. Also called the first trade price. Underwriters hope that the opening price is above the offering price, giving investors in the IPO a premium.
g) **Oversubscribed** — Defines a deal in which investors apply for more shares than are available. Usually a sign that an IPO is a hot deal and will open at a substantial premium.

1.7 **Organization of business research proposal**

This proposal is organized into 5 chapters. Introductory chapter is the chapter on institutional background of the Malaysian stock market including the Malaysian IPO regulation. Chapter Two discusses the literature review which includes the theoretical explanations and variables affecting new listing phenomenon. Chapter Three will focus on research design which is also including the sampling design and instrument, measurement and statistical techniques. Chapter Four will discusses the finding and conclusions and recommendations are presented in Chapter Five.
2 THEORETICAL FRAMEWORK

2.1 Theory and Empirical Study on IPO Underpricing

Initial Public Offerings (IPOs) of common stock have been widely examined in the finance literature for the past two decades, and academic interest in IPOs continues today. The academic community understands IPOs as synonymous with high initial returns and long-run loss. Considerable work has been on short run underpricing (for a review, see Jenkinson and Ljungqvist (1996), and lately, long run underperformance has been the subject of focused research (Ritter, 1991).

The international evidence on IPOs reveals strong underpricing in the short-run and inconclusive results in the long run. Some studies showed overpricing (negative returns) while revealed underpricing (positive returns). A large number of evidences of IPO underpricing in the short run come from studies of U.S. capital market (Ibbotson and Jaffe, 1975; Ritter, 1991; Ibbotson, Sindelar, and Ritter, 1994) as well as other developed countries such as European countries (Husson & Jacquillat, 1990; Levis, 1993; Kunz & Aggarwal, 1994). In Canada, Kooli and Suret (2001) report that IPOs underperform significantly in comparison to seasoned firms with the same market capitalization. By comparison, IPOs in developing countries show even greater initial excess returns e.g. Malaysia 166.67% and Singapore 39.4% (Dawson, 1987). In Chile, average initial return is 16.3% (Aggarwal et. al., 1993). In short, most evidences show that in the short-run IPOs are underpriced either in developed or emerging economies.

Baron (1982) suggested that the issuer wants to maximize net sale proceeds, and offers a delegation contract to the underwriter, who sets the price and distributes the shares. Both issuer and underwriter are risk neutral. The issuer is less informed than the underwriter, in that it does not observe some demand parameter prior to
contracting, and it cannot monitor the underwriter’s distribution effort. In this setting, Baron shows that the optimal offer price is a decreasing function of the issuer’s uncertainty about the capital market conditions.

Rock (1986) assumes that there are two groups of investors, and one group is better informed than the other group and the issuer about the actual value of the company. The better informed investors subscribe to the not overpriced issues where as the uninformed investors subscribe to the whole issues. This is called winner’s curse. To overcome this winner’s curse, the offers have to be underpriced on average otherwise; the uninformed investors will not participate in IPOs. More asymmetry of information about the value of the issue will require more underpricing.

Beatty and Ritter (1986) analyzed the effects of investment bank reputation and share value uncertainty on IPO underpricing. The share value uncertainty is referred to “ex-ante uncertainty”. They argue that the greater the degree of ex-ante uncertainty, the higher the degree of underpricing. Beatty and Ritter (1986) suggested that underwriters play an important role in enforcing an equilibrium whereby the relatively riskier companies are underpriced more. Underwriter selects to offer prices which are neither too high nor too low in order to maintain their market share in underwriting IPOs. Using (log [1+number of uses]) and inverse of gross proceed as proxies for ex-uncertainty; the results reveal that underpricing was positively related to ex-ante uncertainty.

Allen and Faulhaber (1987), Grinblatt and Hwang (1989), and Welch (1989) model the underpricing in IPOs as a signal of the firm’s value. In these models, the issuer knows the true value of the offer, while investors are uninformed. The high value firm optimally signals its type through underpricing in the initial sale, because
this will allow charging higher prices in subsequent offers. Here, underpricing occurs in partial sales.

Leland and Pyle's (1977) model is one of the first signaling models which described the issuer's function in the IPO process. Their model is a simple static equilibrium model where the ownership retention rate signals to investors the quality of the issuer. They argue that the level of retention of shares by original shareholders can be a convincing signal of the firm value to outsiders. This idea is very much tied to the principal-agent conflict which should be less of a problem when owners of the company retain a large amount of shares after the IPO, thus these companies are regarded as high quality ones. Investors are expected to make their IPO purchasing decisions based upon this crucial information. This model lacks empirical support, but it is the basis for which Titman and Trueman (1986), Grainblatt and Hwang (1989) and Allen and Faulhaber (1989) build their conceptual framework.

Allen and Faulhaber (1989) used the bivariate signaling model which is an extension of Leland and Pyle's (1977). In addition to ownership retention rate being a signal of a company's quality, the issuer deliberately undervalues his IPO as a second signal to convey the high quality of the company to investors. By doing this, the issuer conveying the message that it is financially sound and will be able to recoup losses incurred by undervaluing the issue.

2.2 Theory and Evidence on the Long-run Performance of IPOs

The conclusion from past research is that IPO firm subsequently experience stock price under-performance relative to non IPO control firms in the long run. This period is typically defined to be in the region of three years. Some of the previous studies on the long run performance of UK IPOs by Levis (1993) and Espenlaub et al.
(1998) have documented the existence of long-run overpricing but have only provided limited explanations for the existence of this phenomenon.

Ritter (1991) and Loughran and Ritter (1995) propose the window of opportunity hypothesis, which suggests that when firms are substantially overvalued, managers are more likely to issue equity, taking advantage of the opportune time to lower the cost of capital. In other words, if the window of opportunity holds, firms going public in high issue volume periods are more likely to be overvalued compared with other IPOs, thus high issue volume periods should be associated with relatively low long run returns. As a matter of fact, although the fads hypothesis and the window of opportunity hypothesis are labeled with different titles, both of them are built on the same overvaluation phenomenon stated by De Bondt and Thaler (1985, 1987). The fads hypothesis is from the investors' point of view, while the window of opportunity hypothesis is from the managers' point of view.

A seminal article by Ibbotson (1975) reported a negative relation between initial returns at the IPO and long-run share price performance for a sample of US IPOs issued during the period 1960-69. He reported that there was a general positive performance in the first year, negative performance in the next three years and a general positive performance in the fifth year. Ritter (1991) analyzed the performance of US IPOs issued between 1975-84 and reported that they underperformed the benchmark (NASDAQ and AMEX-NYSE) by about 29% in the three year period after their launch. Rajan and Servaes (2003) showed that over a five-year period following their IPO, companies underperform the market benchmark (NYSE/AMEX) by 17% to 47.1%. More recently Carter et al. (1998) showed that over a three-year period after the IPO, the US firms underperformed the market (NYSE/AMEX/NASDAQ) by 19.92%. Work in other countries of Korea (Kim et al.