AN ANALYSIS OF A SUCCESSFUL INITIAL PUBLIC OFFERING (IPO) AMONG NAIROBI SECURITY EXCHANGE LISTED COMPANIES

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ABSTRACT

The Nairobi Security Exchange is an ideal place for this research on analysis of a successful initial public offering. The Nairobi Security Exchange is an ideal avenue for this research because it provides a platform where investment banks and licensed stock brokers acting on behalf of their clients buy and sell shares. The study was carried out to analyze factors affecting a successful initial public offer at the NSE and find out whether to agree with previous findings that a successful IPO is significantly influenced by the cost of going public, pricing of the IPO, Governance issues and the timing of an IPO. The study was built upon major theoretical streams: Window of Opportunity theory, Impresario or Fads hypothesis, Divergence of opinion theory and Entrenchment theory and contextualize them to successful IPO perspective. The research design method used was a descriptive survey. The target population were companies listed at the NSE. The target population for this study were all the 56 listed firms. The target population for this study were all the 56 listed firms. Since this research was census, no sampling technique was used to select the sample. The study found out that the pricing factors that affected the firms going public were offer price, efficient capital market and subsequent market performance. Further, governance issues also affected the success of IPO in Kenya and also for the success of IPOs, timing was very important. From the study, it is concluded that listing costs factors such as auditors' costs and transfer of cost to the investors were the main factors that influenced the IPO success. The study recommends that for the firms to succeed in IPOs, they should take into consideration the timing, governance issues, price and the cost to be incurred before the firm goes for IPO. The study also recommends that the firms should also consider other factors such as the economic situation, previous IPOs performance, advertisement, profits of the firm and also their reputation for the IPO to be successful.

Key Words: *initial public offering (IPO), Nairobi Security Exchange NSE, listed companies*

Introduction

An initial public offering, or IPO, is the first sale of stock by a company to the public. A company can raise money by issuing either debt or equity. If the company has never issued equity to the public, it's known as an IPO. Initial Public Offerings (IPO) is when a company issues common stock or shares to the public for the first time (Gregoriou, 2006).They are often issued by small, younger companies seeking capital to expand but also can be done by large privately owned companies looking to become publicly traded. Initial Public Offerings (IPO) involve problems regarding price discovery due to uncertainties regarding aggregate demand and the quality of the issuer. Bensveniste and Spindt (1989) posit that issuers can feign themselves to investors as high eminence than they are. Derrien (2005) agrees that pricing of IPOs is a daunting task due to obscurity of discovering an appropriate comparable firm.

Empirical studies document two different dimensions of post-IPO share price performances. First, that the IPOs are getting listed with significant premium to issue price (large scale under price). As a result, investors are able to earn abnormal high rate of return in comparison with benchmark index on the listing day (Ibbotson, 1975; Ritter, 1984; Kuklinski, 2003; Purnanandam and Swaminathan, 2004). Second, the underperformance of the IPOs persists in the long run. Hoechle and Schmid (2007) find a significant underperformance of IPO firms over the first year after going public, while there is virtually no underperformance thereafter. Ritter (1991) and Jaskiewicz *et al* (2005) find that the underperformance persists usually up to three to five years after listing.

The pricing and performance of public offerings is one of those empirical issues that incessantly attract attention of many researchers in finance. Even though there is extensive Empirical evidence on the Abnormal returns provided by them, and in the “hot issue markets” both the number of issues and the number of initial returns reaching unprecedented peaks and long term underperformance of these shares, the search for the reasons of these anomalies is still unresolved (Durukan, 2002).

Madhusoodanan and Thiripalraju (1997) analyze both short-run and long-run after-market pricing performance of the Indian IPOs issued prior to 1997. They indicate that in the short run, the Indian IPOs generate more market-adjusted initial return than the international IPOs. In the long run too (after one year of listing), Indian IPOs generate higher returns compared to the negative returns reported from other countries. Hensler, Rutherford and Springer (1997); Jain and Kini (1994), Bhabra and Pettway (2003); and Jaskiewicz et al (2005) have also examined the determinants of a successful IPO.

Bhabra and Pettway (2003) find that prospectus information, i.e., pre-IPO profitability, R&D spending, relative offer size, firm size, and number of risk factors listed in the offer document help in predicting long-run performance of IPOs. They also document that the underperformance is more severe for smaller and younger firms than that of the large-sized mature firms. Offer size, level of under pricing, insider's retention, industry affiliation, and the IPO activity period are statistically significant (and positive) in explaining long-term survival (Hensler, Rurtherford and Springer, 1997). Houge, et al (2001) find poor long run performance for the IPOs bundled with more uncertainties.

Besides exploring the period up to which IPO under price persists, many of the studies also examine factors affecting post-issue price performance. Aggarwal, Liu and Rhee (2008) study after-market pricing behavior of IPOs issued in the Hong Kong market during 1993 to 1997. The study OF the after-market performance of the IPOs in relation to the subscription rate (the times at which an IPO is subscribed by the investors) and Found out those IPOs with high investor demand realize a high initial excess return, but a negative long run return, while the reverse is true for the low demand IPOs.

Statement of the problem

According to Nairobi Security Exchange (NSE) Annual report June 2008 Safaricom shares were floated at KSh 5 per share (NSE 2008). The report also revealed that the first day closing price of the Safaricom share was ksh 7.35. This is an indication that the offer price of Safaricom share was underpriced by 47%. According to Nairobi Security Exchange (NSE) Annual report June 2006 Kengen shares were floated at KSh 11.90per share (NSE 2006). The annual report also revealed that the first day closing price of Kengen share was ksh 40. This is an indication that the offer price of Kengen share was underpriced by 236%. According to Nairobi Security Exchange (NSE) Annual report June 2009 (NSE 2009) Cooperative bank of Kenya share was floated at 9.50 per share (NSE 2009). The annual report revealed that the first day closing price of the Cooperative Bank of Kenya share was ksh 10.45. This is an indication that the share price of the Cooperative bank of Kenya was underpriced by 10%.

Previous studies done include Lee *et al*. 1996; Chen and Ritter 2000; Loughran, and Ritter, 2004; Goergen et al 2006); who did studies on IPOs dealing with the costs to go public (agency costs and ownership structure (Mikkelson, Partch, and Shah 1997; Goergen 1998; optimal pricing strategies (Seguin and Smoller 1997; Kim and Ritter 1999); and the timing of the IPO as it pertains to the life cycle of the firm (Maug 2000).

Given that no study of this nature has been done in Kenya, the present study sought to fill the knowledge gap by establishing the factors influencing the success of initial public offers in emerging markets with reference to NSE.

General objective

The study generally sought to analyze the determinants of a successful IPO in Kenya.

Specific objectives

The specific objectives are:

1. To establish the effect of costs of going public on the success of IPO;
2. To determine the effect of pricing on the success of IPO;
3. To determine the relationship between governance issues and the success of IPOs in Kenya and
4. To establish the effect of timing on the success of an IPO in Kenya. This is on the period in which the IPO is floated in the market.

Theoretical Review

Window of Opportunity Theory

Ritter (1991) and Loughran and Ritter (1995) argue that the firms that successfully time out their issues during the high valuation period, yield low returns for the investors in the long run. They predict that taking the advantage of queue in the high IPO activity period, the firms manage to overprice their issues. Even some young firms without having substantial growth prospects are able to raise capital from the market at exorbitant prices. However, in the subsequent periods, these issues failed to justify the valuation, as the market quickly adjusted with real valuation.

Impresario theory or Fads Theory

Under pricing also helps in creating an assured return for the initial day investors. By doing this, they succeed in creating an impression that the brokers and underwriters are giving good investment advice (Shiller, 1990). This theory establishes that the initial return and subsequent underperformance moves in the same direction. More the magnitude of under price more is the frequency at which the sub-sequent correction takes place, resulting in lower returns for IPOs. Other empirical evidence supporting impresario arguments include De Bondt and Thaler (1985), Aggarwal and Rivoli (1990), and Agaarwal and Rhee (2008).

Divergence of Opinion Theory

Uncertainty in quality and pricing of IPOs create a difference in opinion among both the optimistic and pessimistic investors, resulting in overvaluation on the listing day. Subsequently, as the information flows to the secondary market, divergence of expectation gets narrowed down and large scale corrections in the prices take place. Other studies providing ample empirical support for the divergence of opinion theory includes Gao, Mao and Zhong (2006), Diether, Malloy and Scherbina (2002), and Houge et al (2001).

Entrenchment Theory

This explanation highlights the relationship between company governance and IPOs success. Morck, Shleifer and Vishny (1988) document that risk of management entrenchment increases with an increase in ownership control. They argued that the negative effect of entrenchment is reflected more while valuing securities. Mazzola and Marchisio (2003) find that family business IPOs,

Factors affecting success of IPOs

In this section, we review the current theoretical literature as it pertains to the IPO factors analyzed in this study. The specific areas addressed are: (1) the costs of going public; (2) ownership structure and governance issues; (3) pricing issues; and (4) the stage at which firms go public via an IPO.

The Cost to Go Public

Bhagat and Frost (1986), Ritter (1987), Barry, Muscarella, and Vetsuypens (1991), Aggarwal and Rivoli (1991), Lee et al. (1996), and Chen and Ritter (2000) have all studied the costs of raising capital. All of these studies find evidence of economies of scale in the offering process. That is, very large issues tend to enjoy a relatively lower cost of going public and very small issues tend to pay a relatively larger price to conduct an IPO. Additionally, for issues that are neither very large nor very small, Chen and Ritter (2000) document that over 90% of the issues pay a gross underwriter spread of exactly 7%.

Governance Issues

Board of director literature (for example, Lipton and Lorsch 1992; and Jensen 1993) argues that the optimal size of corporate boards is between seven and nine members. The function for the optimal size is concave downward. As such, the extant theory suggests that the utility of the board size increases until at least seven members are reached.

Thus, due to the firms in our sample and the concave nature of board of director utility functions, we hypothesize that there will be a direct relationship between the number of directors and the likelihood of a successful offer. This prediction is an extension of the empirical findings of Frye (1998) who finds a positive relationship between the number of outside board members and IPO success.

Pricing Impacts on Going Public

Seguin and Smoller (1997) provide evidence that an inverse relationship exists between the offering price of an IPO and subsequent market performance. Specifically, they find that lower priced stocks have higher mortality rates. This study extends their research to determine whether a similar relationship exists between the offering price and success of IPOs (measured by aftermarket returns in Seguin and Smoller (1997) and by a successful offer in this study). Relying upon the Seguin and Smoller (1997) logic and results, we predict a positive relationship between the offering price and the probability of a successful IPO.

The Timing and Going Public

The recent frenzy over Internet-related IPOs brought wide-spread public attention to the market for new issues. This was a direct consequence of the phenomenal increase in the valuation of these companies prior to and during the frenzy. More recently the share prices of these firms have fallen back considerably from their highs, as have the number of new issues. The Internet industry is not alone in its experience. IPOs in general have been found to occur after abnormal run-ups in their industry market index. Further evidence suggests that IPOs, on average, perform poorly post-issue. Combined, these two observations have led researchers to tentatively conclude that firm insiders are able to exploit their superior information to time the market by issuing during a temporary "window of opportunity".

The Research Design

Research design refers to the way the study is designed, that is, the method used to carry out a research. It is important to highlight the two main methods when investigating and collecting quantitative and qualitative data (Mugenda, 2008). A quantitative approach is strongly linked to deductive testing of theories through hypotheses, while a qualitative approach to research is generally is concerned with inductive testing (Saunders et al, 2003). The main focus of this study is quantitative. However some qualitative approach was used in order to gain a better understanding and possibly enable a better and more insightful interpretation of results from the quantitative study.

Target population

The study was implemented at Nairobi Securities Exchange (NSE). The target population for this study was companies that have floated their shares on the NSE between the year 2000 and 2012.The number of companies which have floated their shares at the NSE between the year 2000 and 2012 is 10. (NSE 2012).The target population for this study was all the 10 listed firms. A population of 360 management staff was identified from three levels of management which includes 1 top manager, 2 middle level and 3 lower management staff from each of the 10 quoted companies.

Sampling and Sampling Procedure

Sampling technique according to Orodho and Kombo, (2002) is the procedure a researcher uses to gather people, places or things to study. According Cooper & Schindler, (2003) a sampling frame is a listing of the entire population from where a sample size is selected. The smaller the sample, the larger the sampling error and the larger the sample, the smaller the error (Kerlinger, 1978). Stratified sampling technique was used among the various strata which include top, middle and lower level managers working in the listed companies.

Data Collection Instruments

Primary data was collected through questions and interview. Cooper and Schindler, (2008), stated that the questions in a study are directly related to research questions. In development of a survey questionnaire, the variables for which information need to be collected have to be identified followed by their operational definition. Questionnaires consist of series of specific, usually short questions that are either verbally by an interviewer or answered by the respondent on their own (self administered). The questions can either be open ended or close ended question item. In closed- ended questions, the response categories are exhaustive such that they include possible responses expected from respondents. They are also mutually exclusive implying that only one category can be selected as the answer to a question. The number of closed-end questions in any survey exceeds the number of open ended questions. Open ended questions focused on unconventional answers which were not know by the researcher, while closed ended questions ensured the objectivity of the information from the respondents by being on point and precise.

Data Analysis

Before processing responses, the completed questionnaire was edited for completeness and consistency. The data was then coded to enable the responses to be grouped in various categories. The researcher used qualitative and quantitative techniques in analyzing the data. After receiving questionnaires from the respondents, the responses was edited, classified, coded and tabulated to analyze quantitative data using statistical package for social science (SPSS) version 20.0.Tables and other graphical presentations as appropriate was used to present data collected for ease of understanding and analysis. The researcher used the data with the aim of presenting the research findings in respect to IPO success.

Summary of the Findings

From the study, most of the respondents had served in their respective firms for over 10 years, and most of them were middle level managers which was a clear indication that these respondents were well versed with the factors influencing successful initial public offering (IPO) among stock exchange listed companies. The study also found that most of these firms had been listed for over 5 years. Most of these firms nature of business was to provide both financial and non financial services. The majority of these firms also were located only in major cities.

Costing

On the costing factors that affected the cost of the firms going public, the study found the costing factors that affected the cost of the firms going public to a great extent were listing cost, auditors cost and transfer of the listing cost to the investors.

Governance

On governance issues, the study found that in most of the firms, the size of the board of their institutions was 5 to 10 members. The proportion of executive directors to non executive directors in most of these firms was 0-25% and the board members in most of these firms were nominated and selected by members of the organization. The study also found that the governance issues that affected the success of IPOs to a great extent were information disclosure, segregation of duties, and board of directors, corporate social responsibility and auditing on schedule.

Pricing

On pricing, the pricing factors that were rated as high in affecting the firms going public were offer price, efficient capital market and subsequent market performance, while the timing factors that were rated as high in impacting the success of IPO were; market conditions, value of these companies, dividend stream, future value, private equity, industry index as and firm insiders.

Timing

Other factors that influenced the success of IPO were factors were market performance, comparison with other companies, allocation of applicants, nature of business, management framework, public perspective, company reputation, economic status, previous IPOs success/failure, revenue income, leadership styles, resource control, company profits, section of the year, advertisement, competition in the market, firm's financial performance, investors confidence, cot of IPO and market trends.

Conclusions

From the study, the researcher concluded that the cost factors that affected the firms' success of IPOs were listing costs, auditors' costs and transfer of the listing cost to the investors.The study also determined that the pricing factors that affected the firms going public were offer price, efficient capital market and subsequent market performance.

Governance issues also affected the success of IPO in Kenya. This is true because from the study, the governance issues affected the success of IPOs in the companies listed at the Nairobi stock exchange included; information disclosure, segregation of duties, board of directors, corporate social responsibility and auditing on schedule.

The study also concluded that for the success of IPOs, timing was very important. This is because from the study, there were timing factors that affected the success of IPOs. These factors were market conditions, value of these companies, dividend stream, future value, private equity, industry index as and firm insiders.

The study also concludes that other factors that affected the success of IPO apart from pricing, governance and timing factors were comparison with other companies, efficiency in the past, allocation of applicants, nature of business, management framework, public perspective, company reputation, economic status, previous IPOs success/failure, revenue income, leadership styles, resource control, company profits, section of the year, advertisement, competition in the market, firm's financial performance, investors confidence, cot of IPO and market trends.

Recommendations

From the findings and conclusions, the study recommends that cost of going public, governance issues, pricing factors, and timing factors affect the success of the IPOs.

The study therefore recommends that for the firms to succeed in IPOs, they should take into consideration the costing factors that affect the cost of going public. These factors are such as listing costs, auditors' costs and transfers costs.

The study also recommends that the firms should also consider the governance issues before going public. These firms should ensure that the board has enough members to help in the success of the IPO and the gap of the proportion of the executive directors to executive directors should be bridged.

The study also recommends that the pricing factors, efficient capital market, subsequent market performance and brokerage, offer price and commission should be considered by the firms before going public.

The firms should also ensure that the timing factors before going public. These timing factors are such as the market conditions at the time of offer, the value of the firms and dividend stream. This will therefore ensure successful initial public offering.

The study also recommends that the firms should also consider other factors such as the economic situation, previous IPOs performance, allocation of the applicants, advertisement, value of these companies, dividend stream, future value, private equity, industry index as and firm insiders, profits of the firm and also their reputation to the public for the IPO to be successful.

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