

## **Tie-in-Agreements in Initial Public Offerings: Evidence from India<sup>13</sup>**

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### **1. Motivation and Background**

In late 2011, based on its internal investigation, SEBI banned 7 newly listed companies and their directors from accessing the capital markets till further order. The investigation was triggered by extremely poor post-listing performance of these 7 stocks and allegation of collusion and irregularities in the primary (IPO) and secondary (NSE/BSE) markets. SEBI's investigation found evidence of irregularities concerning concealment of material information in the offer document, improper use of money raised through IPOs and irregular bidding/trading by *affiliated investors* during the offer and post-listing period. The investigation by SEBI led to a number of changes in the IPO regulation including a controversial one which required IPO firms to provide safety mechanism for small retail investors should the stock price fall below a certain threshold in the ensuing six months after listing. Keeping SEBI's investigation as the basis of analysis, the main objective of this paper is to assess how pervasive manipulation is in the Indian context. Using rich data available from the transparent Indian IPO setting, we examine whether manipulation is limited to only the 7 investigated IPOs or is it a much bigger problem.

### **2. Common features of irregular IPO**

Our in-depth examination of the IPOs investigated by SEBI show that there are five common features that stand out in the case of manipulated IPOs:

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13 A tie-in-agreement is an agreement between an investor and an underwriter which requires the investor to buy more shares of a new issue in the secondary market for receiving allocation from the underwriter in an initial public offering (IPO). This maintains a higher share price for the new issue as demand is inflated artificially.

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- a. significantly small participation from institutional investors;
- b. relatively aggressive participation by other investor categories;
- c. the association of low reputation underwriters<sup>15</sup>;
- d. high trading volume (trading volume refers to the total number of shares or contracts traded for a particular security during a specified time period): both total as well as bulk trades<sup>16</sup> in the immediate post-listing period; and
- e. poor stock market performance in the post-listing period.

### 3. Three hypotheses

Based on our analysis of the banned IPOs and drawing on Aggarwal, Purnanandam and Wu (2005), we develop three hypotheses to examine the pervasiveness of manipulation in Indian IPOs.

*Hypothesis #1:* We hypothesize that manipulated IPOs should exhibit poor listing and post-listing performance compared to other IPOs.

*Hypothesis #2:* Since manipulated IPOs are mostly speculative and weak (with low institutional subscription), we also hypothesize that the degree of flipping (selling) by informed institutional investors should be higher in these IPOs compared to non-manipulated ones.

*Hypothesis #3:* Finally, we hypothesize that manipulated IPOs should also exhibit higher turnover in the immediate post-listing period due to trades by affiliated investors who had supported the IPO during the issuance process but wanted to exit on listing.

### 4. Results of the Study

To conduct empirical analysis, we first create a proxy to identify manipulated IPOs. Based on the analysis of the banned IPOs and by taking into account the unique IPO

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15 An underwriter is usually an investment bank which helps companies in the IPO process including pricing and marketing of the IPO. The investment bank also pledges to buy all the unsold shares in the IPO. The investment bank charges underwriting fees for these services.

16 Bulk trades refer to transactions which account for more than 0.5% of the number of outstanding shares listed on the exchange.

mechanism in India, we consider significantly small institutional participation as a proxy for manipulated IPOs. We thus create two categories based on institutional participation from the sample of 129 smaller sized IPOs: (i) IPOs with 6 or fewer institutional bids and refer to them as *Manipulated* IPOs (ii) IPOs with 10 or more institutional bids and refer to them as *Control* IPOs. Since the maximum number of bids received by a banned IPO is 6, we use this as the cut-off figure for low institutional participation. This results in 64 *Manipulated* and 55 *Control* IPOs. Not surprisingly, we find that the median institutional subscription rate in *Manipulated* IPOs is only 0.41 with 3 as the size of the median bid compared to 7.58 times subscription rate and 29 as the size of the median bid, for *Control* IPOs.

Our empirical analysis examining listing and post-listing returns finds that *Manipulated* IPOs perform significantly worse than *Control* IPOs. The median *Manipulated* IPO has a return of -4% compared to a return of 21% for *Control* IPOs on the listing day. The difference in returns persists and becomes larger over-time. The results are consistent with our hypothesis and reflect the nature of manipulated agreements in Indian IPOs. Weak and speculative offerings which have an extremely small probability of success are turned into successful offering through *manipulated* agreements between the promoters/underwriters and affiliated investors who promise to support the offering both in the subscription stage as well as in the post-listing period in return for guaranteed benefits.

We follow this with analysis of institutional flipping in the immediate post-listing period. Consistent with our hypothesis, we find that the median foreign institutional holding in *Manipulated* IPOs falls from 5.24% of shares outstanding at the time of allocation to 0.09% in the first reporting period post IPO listing. Unlike *Manipulated* IPOs, firms in the *Control* group see participation from different domestic institutional investors who appear to hold on to their allocations in the post-listing period. We observe the participation of domestic institutional investors in 50 of the 55 *Control* group IPOs compared to only 18 of the 64 in *Manipulated* IPOs.

Our analysis of trading turnover, where we analyse total trading as well as bulk trades, exhibits significantly higher turnover for *Manipulated* compared to *Control* group IPOs. *Manipulated* IPOs exhibit a median total turnover of 7.42 times compared to a median turnover of 4.94 times for the *control* group IPOs on the first day of trading. In

terms of bulk trades, we not only find significantly higher bulk trades, but also find that a significantly higher proportion of total trading is in the form of bulk trades in *Manipulated* IPOs. Further, bulk trades account for 72% of the total turnover for the median *Manipulated* IPO compared to 52% for the *Control* group.

In order to establish a robust evidence of manipulation, we further examine bulk traders to see if there are common traders across manipulated IPOs. Not surprisingly, we find as many as 9 common affiliated traders in the 6 IPOs banned by SEBI. Further there are 20 common affiliated traders in 5 of the 6 banned IPOs and 31 in 4 of the 6 banned IPOs. Two things stand out for these affiliated investors. First, the bulk trades by these investors account for significant portion of the total bulk trades. Second, in 4 of the 6 IPOs, bulk trade investors incur significant losses on account of these trades. For instance, the 31 affiliated investors suffered a loss of Rs 42 million in case of Taksheel Solutions. We find that there are as many as 44 IPOs, 33 of which are *Manipulated* IPOs, where at least 6 of the 9 affiliated investors make bulk trades within the first month of listing. More importantly, our analysis shows that these affiliated investors rarely make bulk trades in other IPOs. We also examine the gains/losses of these affiliated traders from bulk trades in the first month of listing. Results show that, while the gains/losses almost averages to zero for these traders in the *Control* group, they make a significant positive gain in IPOs with positive return on the first day of trading (in case of control group). The gains and losses are more pronounced when we only consider IPOs in which at least 6 of the 9 affiliated investors make bulk trades upon listing.

## **5. Contribution of the Study**

This paper makes several contributions to the IPO literature. This is the perhaps the first study that examines manipulation in the context of IPOs outside of the US. Since this paper deals with manipulation, the study also contributes to the broader literature on financial frauds particularly in the context of emerging markets where investor protection measures are weak.

The second important contribution is related to the nature of manipulation that has been examined in this research study. While past studies have looked at the underwriter and the informed (institutional) investor alliance involving allocation of high quality offerings, this study looks at manipulation associated with low quality offerings. It is found that despite enhanced transparency and limited underwriter

discretion, promoters and underwriters are still able to manipulate IPOs by colluding with affiliated investors.

The third contribution is that by providing a clear evidence of IPO manipulation, the need to have a better approach towards IPO regulations to protect and enhance the welfare of the uninformed retail investors has been highlighted. While SEBI has put in some additional regulations following their investigation of the banned IPOs, it still remains inadequate. For one, SEBI would do well to analyse and apply some of the regulations currently in force in other markets. Under the current security issuance regulations in Korea, investors have the right to sell their stocks back to underwriters within the first month of trading at 90% of the offer price. With put back options, investors investing in IPO stocks are protected as they can recover a substantial part of their investment if the price of IPO stocks falls below 90% of the offer price. Similarly, extreme movement in stock prices, such as the one seen in case of Taksheel solutions, can be avoided by having price limits. For IPOs in Korea, the opening price on the first day of trading is determined within 90% to 200% of the offer price. Once the opening price is set, then daily price limit of +15% and -15% is applied during the trading day.<sup>17</sup> Further, regulation of the current practice where undersubscribed portion of other investor categories (namely, institutional and quasi-institutional) is re-allocated to retail investors should be prohibited by regulation.

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17 To apply Korean regulation to Taksheel case in India, once the opening price is set at 157.40, it can only move up to 181.01 and drop down to 133.79 during the trading day, which is much narrower than the actual high of 185 and low of 38.5.