Review Article
Volume 8:2,2020
DOI: 10.37421/economics.2020.8.346

Journal of Global Economics

ISSN: 2375-4389

Open Access

The Initial Public Offers Feeding Frenzy

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Abstract

Trends in the top Initial Public Offers (IPOs) of several popular private companies in India has shown to great effect that the market quotes a higher than usual value for the these private companies due to a frenzy among the public. This phenomenon is hypothesised by tracking various top IPOs which have taken place over the years with respect to popularity and the number of shares that have been issued in the market. Different other theories are also accounted for and have been encompassed along, the reasons for this frenzy widely differs from price offered during the opening bell to media releases.

Keywords: Frenzy · Behavioral pattern · IPOs · Popularity · Influence · Sentiment · Prediction

Introduction

An initial public offering, or IPO, is the very first sale of stock issued by a company to the public. Prior to an IPO the company is considered private, with a relatively small number of shareholders made up primarily of early investors (such as the founders, their families and friends) and professional investors (such as venture capitalists or angel investors). The public, on the other hand, consists of everybody else – any individual or institutional investor who wasn't involved in the early days of the company and who is interested in buying shares of the company. Until a company's stock is offered for sale to the public, the public is unable to invest in it.

The stock market is referred to as the secondary market, since traders buy and sell stock from other public investors, and not from the company itself. Only prior to the IPO does the company issue stock directly to shareholders. This means that when you buy shares of a company, you are not handing your investment money over to the corporation, but instead to whomever sold you their shares. When a company sells shares to the public, the company and its owners still typically retain a significant portion of the total stock, so some early investors and co-founders may still have a great deal of influence on the direction of the company despite there being a large number of new shareholders.

A look into the top IPOs of the past decade reveals that there arises a trend where the market tends to overvalue the stock price which is primarily because of the frenzy to procure the shares of the company that is going public for the first time. This phenomenon can also be closely linked to, The Influence of Outcome Desirability on Optimism which hypotheses that there exists a desirability bias among decision makers which clouds their decision making and puts them only at the view of an optimistic future and obvious facts are unwelcome by them.

This phenomenon is compared to that of the way hungry fish compete for their feedings and are in a frenzy to obtain their food before the others. This frenzy when followed up in the stock market leads to overvaluation of its general price because the demand for the stock increases and the share is oversubscribed multiple times than the company expects.

Hence the goal set to be met out by this article was to seek out any empirical evidence that can be traced back to the feeding frenzy. The feeding frenzy phenomenon solely depends on the free rate of exchange regime (free market), the free market is an economic system based on supply and demand with little or no government control. It is a summary description of all voluntary exchanges that take place in a given economic environment. Free markets are characterized by a spontaneous and decentralized order of arrangements through which individuals make economic decisions. Even though a financial market may not be considered to be a purely free market, individuals play a major role in price determination. Those goods which command the highest prices (when summed among all individuals) provide an incentive for businesses to provide these goods in a corresponding descending hierarchy of priority. However, the ordering of this hierarchy of wants is not constant. Consumer preferences change. When consumer preferences for a good increase, then bidding pressure raises the price for a particular good as it moves to a higher position in the hierarchy. As a result of higher prices for this good, more productive forces are applied to satisfying the demand driven by the opportunity for higher profits in satisfying this new consumer preference. Therefore as per the free market pricing mechanism system one can conclude that as the demand for a good (security in this article) increases the market tends to increase the price due to a bargaining war that happens as the price rise is demand driven.

As the investors have a good opinion on the company that is being listed and everyone want to grab a piece of it, this gives rise to the feeding frenzy. This effect can only be seen in high profile stocks which many investors seem to fancy. This article chooses the stock either by the number of times it was subscribed or by the number of shares the company issued, this effect also corresponds with the "too big to fail" mind set some people hold when it pertains to highly regarded or established companies.

Literature Review

Most theories about IPOs hypothesizes that IPOs are underpriced in order to gather the retail investors interest and gain the attention of the institutional investors. Individual retail investors are uninformed, poorly trained and highly inclined to market emotions and noise. Arbel suggested that as individual

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Received: 17 January, 2020; **Accepted:** 19 May, 2020; **Published:** 26 May, 2020

investors cannot analyze the market as specifically as how an institutional investors would analyze the market. Their study suggested that retail investors follow the market noise rather than the company valuation or internal factors [1].

Do measures of investor sentiment predict return? This paper studied the effects of market and investor sentiment and predictions on the earnings and running of the market, this helps to determine that market investments are based on sentiment rather than value judgements [2].

All that glitters: The effect of attention and news on buying behaviour of retail investor. In this paper the authors discuss the effect of attention grabbing stocks which have had favourable news and has been a media darling. Barber proposes that as the companies grab more eyeballs in the new there is a positive relation between retail investors a investing and the stock being held high by the news. This theory has been used in this paper to show that as the larger the IPO the more it is held up in the media and the larger the anticipation for the company to go public, which creates more demand in the market for the companys share as it goes public this demand leads to a very high closing price during the closing bell of the market. The paper chiefly hypothesizes that many investors consider purchasing the stock that have caught their eyeballs first, the choice set of the investor is determined by the stock that catches their attention first and then their preferences determine their choice. The determination of the choice set is done by attention grabbers that leads to biased decision making that is based All That glitters hypothesis [3].

The unbiased estimates of the value of a security is made by professional investors are often disrupted by retail investors who trade on the basis of market sentiment rather than a proper valuation of the security, these traders are deemed as noise traders by Derrien. Thus the article by Derrien proposed that investment bankers or institutional investors have motive to induce the noise traders to oversubscribing to new issues [4].

In the article On the marketing of IPOs cook articulates through the way how an IPO is effectively marketed by an investment banker in order to increase the propensity of a sentiment trader to subscribe to the initial issue, this is based on the general economic assumption that with supply remaining constant (number of shares issued by the company) and the demand increasing monumentally (investment bankers inducing noise traders) the price of the security tends to shoot up and ends up on a higher note during the closing bell [4].

Are investors influenced by how earnings press releases are written? In this article the positive and negative words used in newspaper clippings describing the news relating to the company or the IPO event effects the investors sentiment highly which Henry analysed through computer tools, this phenomenon was letter named as sentiment analysis. His results suggested that the tone influences investors' reactions. An explanation for this result is provided by prospect theory, which wherein predicts that framing financial performance in positive terms (press releases in his study) causes investors to think about the results in terms of increases relative to reference points. Results also suggest that longer press releases reduce the market impact of unexpected earnings. This sentiment analysis can also be traced back to the feeding frenzy [5].

Analysis and Discussion

On viewing the top IPOs to have taken place in the Indian subcontinent, it can be said that these top IPOs namely Reliance power, Coal India, General Insurance Company and New India Insurance it can be said that the shares tends to steep down after its unusually high day and starts diminishing by the end of the first month. A look into these shares show that the shares fall down by an average of Rs. 103 but after producing extraordinary results on its opening day. Many theories theorize that this can be heavily linked to the underpricing of these companies on its initial day which therefore increases its demand and hiking the price onto great extents and producing good returns to the initial day traders and making them a good return.

It can be assumed that this feeding frenzy cannot be thought to be applied to all securities as to increase the demand of a security it is necessary for the underwriter, investment banker or any other security broker to make the traders develop a propensity towards the security which will turn into demand and increase the price of the share. This phenomenon can be observed many a time among the top IPOs in many countries and their security market. Investment bankers have developed this phenomenon predominantly by using underpricing to create a frenzy in the market. This paper focuses on the linking the feeding frenzy to various other theories hypothesised by other researchers in different papers and there does seem to exist a connection between various theories like sentiment analysis, security underpricing and the new listing bias.

This paper serves to contribute to the many theories that exist regarding underpricing of IPOs and abnormal performances of IPOs in various markets across the globe. The article takes into consideration the various other papers that look into underpricing of IPOs done by underwriters and investment bankers and how this influences the performance of the security specifically in the Indian market scenario.

Table 1. Analysis of top IPOs and their price in India.

Security Name	Opening Day (Rs.)	A month later (Rs.)	% Change
Reliance Power	222	196	12 (Fall)
Coal India	348	321	8 (Fall)
New India Insurance	675	546	19 (Fall)
General insurance Company	417	397	5 (Fall)

Table 1 portrays the top IPOs to have taken place in India in the past decade, analysis of their price on the day of their IPO and the price of the security a month later clearly reveals a sharp fall in price. This fall in price of the security cannot be attributed to the intrinsic value of the security whereas this can be presumed to be the market correcting the price of the security which is closer to its intrinsic value. This is presumption is made because it can be safely assumed that after the day traders have barged in to grab a piece of the stock the market would begin to correct itself through shortselling by experienced traders or by experienced analysts who understand the market and industry behavior well. As the market begins to correct itself and the day traders begin dumping their stocks which leads to a fall in the price of the security.

The above securities were considered to the research as they fell into category of too big to fail and were created a fair noise in the market for itself by having a real high market capitalisation or was oversubscribed multiple times when compared to other IPOs in the same period of time. These stocks were also picked from different sectors and were (or) are considered to be market leaders in their respective sectors.

This paper shines light on the feeding frenzy phenomenon and the various other aspects and papers that have to be considered to get a good understanding of this phenomenon and to illustrate the various economic and psychological aspects that are used by most investment bankers or underwriters to artificially skyrocket the price of the security on its opening day. Various other papers have also undertaken the effort to show how IPOs have underperformed in the longer time frame but have failed to umbrella all the other papers and come out with a single explanation comprising the various different aspects that have been studied throughout.

The paper only takes into consideration securities that would have an influence on the day traders or noise traders or sentiment traders as even though they seem to be retail investors they are capable of causing massive price fluctuations to the stock [6-8].

Conclusion

This paper focuses on the various different aspects that have been mapped by different researchers and their empirical analysis and providing an umbrella to bring all of the aspects under one study. This paper ensures to have touched upon various aspects of IPOs and how market sentiments, media promotion and different economic aspects that lead to the feeding frenzy phenomenon. The phenomenon can be mainly observed due to the retail investors or noise investors or sentiment investors who day trade stock or purchase stocks because of the surrounding or existing noise in the market pertaining to the security. It has to be taken into consideration that the intrinsic value of the security/company is completely different from the price of the security that is being traded in the market. The noise traders focus more on aspects pertaining to the price of the security and not its intrinsic value which shoots the security's price way off the radar. In cannot be said without doubt that the feeding frenzy will take place on all securities that are belled off in the market but it can be said that the feeding frenzy can definitely be observed given certain circumstances that can be used favorably by both the issuer as well as the traders. If the issuers are able to catch the attention of the traders and create enough noise in the market by being able to market the IPO properly will make it favourable for them. Whereas day traders can involve themselves in shortselling the stock if they are able to match up a decent estimate of the intrinsic value of the security.

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How to cite this article: Nitin Shanker, Arul Francis S. "The Initial Public Offers Feeding Frenzy". J Glob Econ 8 (2020) doi: 10.37421/economics.2020.8.346