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IPO GUARANTEE & POST-IPO PERFORMANCE OF KLSE SECOND BOARD COMPANIES

By

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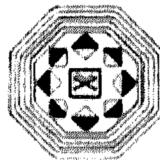

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ABSTRACT

This research attempts to study the performance of Second Board companies of the KLSE after their initial public offering. The profitability together with overall performance is examined after the 3-year profit guarantee period required by the Securities Commission. The objectives of this study are three-fold (1) to determine whether companies undertaking IPOs achieve their profit forecasts (2) to explain the factors that cause poor performance in many companies after listing and why others have remained profitable, and (3) to propose a better & more effective listing and disclosure requirements for future IPOs. In this study, the 5-year post-IPO performance of 177 sample Second Board companies will be examined. This covers the 3-year profit guarantee period after listing and 2 years beyond. The companies are analysed using financial ratios, cash flow together with non-financial indicators wherever appropriate. An attempt will also be made to isolate the influence of the 1997 crisis from the other contributing factors.

CHAPTER 1

INTRODUCTION

An initial public offering or IPO is essentially a new issue of shares, which is the sale of ordinary shares to the public out of previously closely-held authorised shares of a firm. In Malaysia, to raise capital by selling new shares, an application must be made to the public and allocation in the event of over-subscription is done by a public lottery regulated by the Securities Commission (SC) and the Kuala Lumpur Stock Exchange (KLSE). However, in recent years, the number of companies seeking initial public offering in the local equity market, KLSE has been reducing. This phenomenon is quite worrying since without a healthy market for IPOs, high growth companies would have only limited access to the public in raising capital.

The two most commonly used methods in evaluating the performance of IPOs are (1) the average initial return which calculates the share price return on the first day of listing, and (2) the long-term share price return based on a buy-and-hold strategy over a period of 3 to 5 years after IPO. Studies done on the long-term performance of IPOs across different countries yield contrasting results. Another way to evaluate whether an IPO is successful is to examine the companies' profitability after their profit guarantee period is over. A number of studies have been done based on the first 2 measures but none so far has been conducted on the basis of performance after profit guarantee.

1.1 Benefits and drawbacks of IPO

Before we look at the earlier studies done on IPO performance, let us briefly discuss the advantages and disadvantages of going public. In order to determine whether the benefits of IPO outweigh its drawbacks, we must evaluate them in the context of personal, shareholder and corporate objectives (Blowers, 1999)[1]. The benefits and opportunities provided by an IPO are as follows: -

1. Improved financial condition – money brought in from the public which need not be repaid can be used to improve business operations.
2. Increased shareholder value – investors are willing to pay more for public companies because of marketability of the shares, the sophistication attributed to public companies and the availability of more information.
3. Diversification of shareholder portfolios.
4. Estate planning advantages – the taxable value of a deceased investor's estate can be determined more easily if the shares owned are publicly traded.
5. More capital to sustain growth – more money for research and development, etc.
6. Improved opportunities for future financing – the improved debt-to-equity ratio will help company to borrow additional funds.
7. Enhanced corporate image and increased employee participation.

These benefits must be compared with the drawbacks and continuing obligations, which include the following: -

1. Loss of control – issuing new shares will dilute the existing shareholders' stake in the company.

[1] Blowers S., Griffith P., Milan T., The Ernst & Young LLP Guide to the IPO Value Journey, 1999, John Wiley & Sons, New York

2. Loss of privacy – regulatory bodies such as the Securities Commission may require disclosure of sensitive information such as executive compensation.
3. Limits on management's freedom to act – the management of the listed company will have new fiduciary responsibilities
4. The demands of financial reporting
5. Initial and ongoing expenses
6. Dealing with shareholders' expectations – long-term profitability may be compromised in the interest of maintaining annual and quarterly reported results.

In essence, by going public, a privately-held firm or successful venture capital project can raise money and hence achieve greater liquidity for its growth.

1.2 Problem Identification

In recent years, the number of companies going public in the local equity market, the Kuala Lumpur Stock Exchange (KLSE) has been falling. Table 1 below shows the total figures for both the Main Board and Second Board companies of the KLSE. Companies cannot rely merely on traditional forms of fund-raising. Gone are the days when IPOs were a sure-fire way to raise money. Of late, IPOs have had weak response in subscription and upon listing. A notable example is the Time dotCom Bhd IPO, the biggest in the last 5 years with 487.54 million shares, which was under-subscribed by 75 per cent [2].

[2] Shanmugan M., Sze J., "Facing the Axe", Malaysian Business 1 July 2001

Table 1 : No. of Companies Going Public & Amount of Capital Raised

Year	No. of IPO's	Funds Raised (RM million)
1993	44	842.5
1994	66	2,020.0
1995	51	4,206.0
1996	92	3,860.0
1997	88	5,470.0
1998	28	856.8
1999	21	986.1

Source: Malaysian Business, 16 March 2000

This phenomenon is quite alarming since without a healthy market for IPOs, fast-growing companies would have only limited access to the public in raising capital[3]. One main reason for the decline is the financial crisis of 1997. However, looking deeper into the administrative and regulatory processes of an IPO reveals that there is an increasing trend among smaller newly-listed companies on the Second Board of the KLSE to record losses (i.e. unable to stay profitable) once their 3-year profit guarantee trial period imposed by the Securities Commission is over.

[3] Ibbotson R., Sindelar J. & Ritter J., "Initial Public Offering", in The New Corporate Finance, (Editor: Chew D.) 2nd Edition, 1999, McGraw-Hill Singapore

1.2 Motivation for study

This research attempts to study the performance of Second Board companies of the KLSE after their initial public offerings. The Second Board is chosen for this study because of the following: -

1. The companies are smaller i.e. paid-up capital of RM40 million compared to RM60 million for the Main Board; as of 29 June 2001 the total market value of the Second Board (RM16 billion) is only 4.2 percent of the Main Board total (RM379 billion); intuitively these companies are more susceptible to changing market conditions and more prone to insolvency or failure.
2. Most privately-held companies went public through the Second Board; the Main Board consists of more established companies, including previously Second Board companies promoted to the Main Board; thus, a study of IPO for Second Board companies would be more meaningful.

The performance of these companies as well as their profitability will be examined during the 3-year profit guarantee period together with 2 years after that. The objectives of this study are thus three-fold: -

1.) To determine whether companies undertaking IPOs achieve their profit forecasts,

2.) To explain the factors that cause poor performance in many companies after listing and why others have remained profitable, and

3.) To propose a better & more effective listing and disclosure requirements for future IPOs.

CHAPTER 2

LITERATURE REVIEW

Raising capital is a common problem among companies that wish to expand and the most logical way of achieving this in today's free enterprise system is by going public or taking an initial public offering (IPO). Here the company has to sell part of its authorised capital which is still not subscribed to potential investors through a process of invitation to the general population.

In Malaysia, to raise capital by selling new shares, an application must be made to the public and allocation in the event of over-subscription is done by a public lottery regulated by the Securities Commission and the KLSE. An auditor is appointed to oversee this share allocation. About one-third of the issued shares of each IPO are compulsorily acquired by designated investment funds and members of certain segments of the Malaysian population, which are considered to have less equitable capital ownership in the nation's stock of private capital. This unique micro-structure process has been around since August 1976.

There are several ways to measure the performance of IPOs. Two most commonly used measures are (1) the average initial return which calculates the share price return on the first day of listing, and (2) the long-term share price return based on a buy-and-hold strategy over a period of 3 to 5 years after IPO.

As with the first measure, the average initial returns of IPOs on the first day of listing are mostly positive but the magnitude of the returns are somewhat different across different stock markets around the world, with Malaysia being one of the highest. Table 2 below gives a summary of the average initial returns on IPOs in several countries from earlier studies around the world.

Table 2: Average Initial Returns on IPOs in Different Countries Worldwide

Country	Sample Size	Time Period	Average Initial Return (%)
Australia	266	1976-89	11.9
Brazil	62	1979-90	78.5
Canada	258	1971-92	5.4
China	226	1990-96	388.0
France	187	1983-92	4.2
Germany	170	1978-92	10.9
Hong Kong	334	1980-96	15.9
Japan	472	1970-91	32.5
Korea	347	1980-90	78.1
Malaysia	132	1980-91	80.3
Mexico	37	1987-90	33.0
New Zealand	149	1979-91	28.8
Singapore	128	1973-92	31.4
Thailand	32	1988-89	58.1
United Kingdom	2,133	1959-90	12.0
United States	13,308	1960-96	15.8

Source: Ross, et al (1998), Fundamentals of Corporate Finance, 4th Edition, McGraw-Hill

2.1 Studies on the Kuala Lumpur Stock Exchange

Studies done on the long-run performance of IPOs across different countries yield contrasting results. Tay[4] (1993) conducted a study on 70 IPOs for KLSE Main Board companies for a period between January 1974 and December 1989. Performance here is measured in terms of share price increase between first day trading and holding the shares for 1 to 3 years; the results were positive returns i.e. the cumulative average adjusted returns (CAR) relative to the overall market recorded were 10.45%, 2.30% and 3.69% for the 12th, 24th and 36th month after IPO respectively. Tay attempted to do a cross-sectional regression on the 3-year unadjusted holding period return as the dependent variable with initial return, net tangible asset per share and market value of

[4] Tay Seng Wu (1993) "The Long Run Performance of Initial Public Offerings in Malaysia", Capital Markets Review, Vol. I No. I

stock at initial listing as the independent variables; the coefficient of determination R^2 is only 43.4 percent and the explanatory variables are significant at $\alpha = 0.1$ (i.e. 90% confidence level). Tay argued the firm size effect is more apparent in the long run than in the short run i.e. small-sized firms perform better than bigger-sized firms in the long run.

Another study on IPOs in Malaysia was done by Ku Nor Izah[5] with a sample size of 63 new issues during a period between January 1980 and December 1989. She found that the investor would not make any abnormal return if he / she participated in the market on the first day of listing and thereafter; there was no significant difference in price between the initial listing and the following months, up to one year. The study also found that shares obtaining high over-subscription rate tend to achieve high excess returns.

In terms of capital gains, IPOs in Malaysia are mostly profitable to investors on the first day of trading but not beyond that. Othman Yong[6] (1991) from his study 33 IPOs during a period between January 1983 and early 1988 found that the first day average return was 167 percent, and he claimed that the best time to sell one's newly-acquired shares in on the first day of trading as the average return dropped to 154 percent after one year.

Despite the lack of studies done on IPO performance specifically during and after profit-guarantee period, let alone on Malaysian companies, a related study by Shamser & Ariff[7] (1994) done on the accuracy of the profit forecasts of companies pursuing IPO may be relevant. This study based on prospectuses of new issues from period 1975-1988, examined the degree of forecast accuracy compared with actual

[5] Ku Nor Izah, et al, "Performance of New Stock Issues on the KLSE", Capital Markets Review, 1993 Vol. 1 No.1

[6] Othman Yong, "Performance of New Issues of Securities in Malaysia", The Malaysian Accountant, June 1991

[7] Shamser M., Ariff M., "Accuracy of Profit Forecasts", Capital Market Review, 1994

earnings during the one year following listing. The results showed reasonable accuracy of forecasts when compared to similar studies done in developed countries. This was mainly due to the strict scrutiny by the relevant regulators such as the Securities Commission and the high degree of professionalism demonstrated by our merchant bankers and accountants. The researchers also claim that the formation of the SC effective from March 1993 has further enhanced the discipline among participants through stricter enforcement of the requirement that companies should not materially depart (i.e. more than 10 percent) from their profit and dividend payment forecasts.

The following sections give a review of other related works on IPO companies from other countries, including in the more developed capital markets in the United States and United Kingdom.

2.2 Studies on regional capital markets

Studies on IPOs performance done in neighbouring countries such as Singapore and Thailand generally reveal similar trends where initial average returns are much better than long-run returns. Brannman[8] (1994) using a sample size of 36 IPOs in Singapore between 1990 and 1993 shows that very larger investors suffer negative average excess returns with small investors getting returns significantly greater than could be obtained elsewhere; this is due to an inefficient response by large and small investors to the revised Singapore rationing rules.

[8] Brannman L., "Average Returns to Small and Large Investors in Singapore Initial Public Offerings", Capital Markets Review, 1994 Vol.2 No.1

Another study by Lee[9] (1996) done on initial and long-run returns on 132 IPOs in Singapore for a period between July 1973 and December 1992 confirms that IPOs underperform the market in the long run i.e. 750 days or approximately 3 years after listing. Lee argues that excess demand for the share issue in the beginning caused the abnormally good post-listing behaviour in the short-term where as the poor longer term returns following this are not due to underpricing but can be explained as "fads" or "speculative bubbles" due to over-optimism on the part of investors.

A similar study by Allen[10] (1999) on 151 IPOs in Thailand for a period between 1985 and 1992 reveals the same story. The average initial return for the first day of trading is 63.49 percent while the cumulative adjusted return at the end of the 3-year anniversary is 10.02 percent. This result is consistent with the "fad" hypothesis reported by Ritter (1991). Allen argues that firm-specific factors have more effect on the long-run performance of IPOs than market conditions.

A recent study by Chen[11] (2000) on IPOs in China with respect to the type of shares issued i.e. local (A-shares) vs. foreign (B-shares), reveals that the local shares underwritten by domestic brokerage firms outperform the foreign shares which are underwritten by prestigious financial institutions and subjected to international accounting standards (IAS). A sample of 277 A-shares and 65 B-shares issued during a period between 1992 and 1995 were examined. The result is basically due to the fact that the initial returns of B-Shares are more in line with the underpricing observed in mature markets and the three-year market adjusted returns are positively associated

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[9] Lee P., Taylor S., Walter T., "Expected and Realised Returns for Singaporean IPOs: Initial and Long-Run Analysis", Pacific-Basin Finance Journal, 1996 Vol.4

[10] Allen D., Morkel-Kingsbury N., Piboonthanakiat W., "The Long-Run Performance of Initial Public Offerings In Thailand", Applied Financial Economics, 1999 Vol.9

[11] Chen G., Firth M., Kim J.B., "The Post-Issue Market Performance of Initial Public Offerings in China's New Stock Markets", Review on Quantitative Finance and Accounting, 2000 Vol.14

with the companies' accounting profit performances; this implies that prices are related to the business fundamentals of the companies.

2.3 Studies on capital markets in Australia & New Zealand

Other earlier studies on IPOs done are from Australia and New Zealand. A research conducted by Finn[12] (1988) on 93 new issues in Australia for a period between July 1966 and June 1978 reveals that the average return is 29.2 percent on the first day and the average cumulative market-adjusted return is negative 60 months subsequent to listing i.e. less than the overall market performance. Finn could not provide an explanation for this phenomena but argued that the joint process in Australia of initial issue-cum-listing, the listing requirements of the Australian Associated Stock Exchanges, the vesting of allotment rights to new issues to the sponsoring brokers with barriers to entry to stockbroking, provided the market structure which facilitated "underpricing".

A similar but more recent work done by Firth[13] (1997) on 143 IPOs in New Zealand during the period 1979 to 1987 shows that the returns on the first day averaged 26 percent increase over issue price where as a strategy involving buying the shares on Day 1 and selling them 3 years later would result in a loss of 14 percent. The study also reveals a continuing deterioration in performance in the following 2 years such that the loss would be 18 percent. Apart from this, the study emphasises the crucial role of profitability, both forecasts and actual, in explaining IPO long-term stock returns, hence consistent with the findings by Shamser and Ariff in Malaysia.

[12] Finn F., Higham R., "The Performance of Unseasoned New Equity Issues-Cum-Stock Exchange Listings in Australia", Journal of Banking and Finance, 1988 Vol.12

[13] Firth M., "An Analysis of the Stock Market Performance of New Issues in New Zealand", Pacific-Basin Finance Journal, 1997 Vol.5

2.4 Studies on well-developed capital markets

Levis[14] (1993) conducted a study on IPO long-run performance in the United Kingdom. He used a sample of 712 new issues on the London Stock Exchange during the period 1980 to 1988. Cumulative average adjusted returns (CAR) were calculated over a period of 36 months. The study finds that the average first day return is 14.3 percent where as in the long run, the IPOs underperform the market – the average returns are -11.38 percent, -8.31 percent and - 22.96 percent after the 1st, 2nd and 3rd years of listing. Levis argues that there is a positive relation between size of issue and long-run performance as the performance of the bottom 20 percent of the companies, in terms of amount of funds raised, is clearly inferior to that of their larger counterparts.

Ritter[15] (1991) posits that a strategy of investing in IPOs at the end of the first day of trading and holding them for 3 years would leave the investor with only 83 cents relative to each dollar from investing in a group of matching firms of comparable size and industry on the American and New York Stock Exchanges. This result is comparable to the study done by Keloharju[16] (1993) on Finnish IPOs which left the investor with 79 cents if he were to invest one dollar in the Helsinki index. Ritter's study on 1,526 IPOs during a period of 1975 to 1984 reveals that many firms went public near the peak of industry-specific fads and these investors were over-optimistic about the firms' prospects. The finding that IPOs underperform on average implies that the cost of raising external equity capital is not inordinately high for these 1,526 firms in the sample.

[14] Levis M., "The Long-Run Performance of Initial Public Offerings: The UK Experience 1980-1988", Financial Management, Spring 1993

[15] Ritter J., "The Long-Run Performance of Initial Public Offerings", Journal of Finance, March 1991

[16] Keloharju M., "The Winner's Curse, Legal Liability, and the Long-Run Performance of Initial Public Offerings in Finland", Journal of Financial Economics, 1993 Vol. 34

2.5 Issues from previous studies

While none of the above studies addresses the problem of profit guarantee directly, they do at least raise the following 3 very important issues regarding IPO performance[17], namely: -

1. Is the documented underperformance a sample-specific phenomenon or does it apply to other offerings over different periods?
2. Do IPOs ever recover from the relative decline or does the underperformance continue after the 36-month period?
3. Is there a systematic relationship between long-run performance and first-day returns?

Jain[18] and Kini (1994) in their study on 682 IPO companies between 1976 and 1988 attempt to give potential explanations for declining post-IPO operating performance. The first reason is possibly due to increased agency costs when a firm makes the translation from private to public ownership. Secondly, it could be that managers attempt to window-dress their accounting numbers prior going to public. And the third reason is that entrepreneurs time their issues to coincide with periods of unusually good performance levels, which they know cannot be sustained in the future.

Before we proceed with our study on post-IPO performance on KLSE Second Board companies, let us first take a look at the regulatory framework of the capital market in Malaysia.

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[17] op cit. - Ritter

[18] Jain B., Kini O., "The Post-Issue Operating Performance of IPO Firms", The Journal of Finance, December 1994, Vol. XLIX No.5

CHAPTER 3

BACKGROUND ON REGULATORY FRAMEWORK

3.1 The Securities Commission

The Securities Commission (SC), a statutory body reporting to the Minister of Finance, was established under the Securities Commission Act 1993. It is the sole regulatory agency for the regulation and development of capital markets. The SC has direct responsibility for supervising and monitoring the activities of market institutions, including the exchanges and clearing houses, and regulating all persons licensed under the Securities Industry Act 1983 and Futures Industry Act 1993[19].

3.2 KLSE Second Board

The KLSE launched its Second Board on 11 November 1988 with the objective of enabling small and medium-sized companies, which are profitable and have good prospects, to raise capital funds to finance their business expansion. The stringent listing requirements of the Main Board and the Capital Issues Committee (CIC) tend to deny smaller companies the opportunity to raise public funds[20]. The Second Board would therefore facilitate and accelerate access to the capital market for these smaller companies.

3.3 Pre-listing requirements

The listing requirements for the Second Board are basically the same as those for the Main Board except that the entry requirements and the continuing listing requirements

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[19] From SC website *www.sc.com.my/html/publications/fr_public.html*

[20] op cit. - Ku Nor Izah (1993)

are less strict. The only differences for the Second Board as of 1 May 1999 are as follows[21]: -

1. Paid-up capital of at least RM40 million.
2. Either profit track record for 3 financial years of minimum RM12 million aggregate with an after-tax profit of at least RM1 million per annum (Option1) or profit track record of 5 financial years of minimum RM12 million aggregate with an after-tax profit of at least RM4 million for the most recent year (Option 2) – see Table 3 below.

Table 3: Second Board Historical Profit Track Record Requirement

	Previous Requirements	Revised Requirements as of May 1999
Option 1		
Profit record*	3 years	3 years
Aggregate after-tax profit	RM 6 million	RM 12 million
Minimum after-tax profit per year	RM 1 million	RM 1 million
Minimum after-tax profit for the most recent year	-	RM 4 million
Option 2		
Profit record*	-	5 years
Aggregate after-tax profit	-	RM 12 million
Minimum after-tax profit per year	RM 2 million	-
Minimum after-tax profit for the most recent year	-	RM 4 million

* On an uninterrupted basis

Source: Securities Commission's website on 'Revised Requirement for Listing', April 1999

[21] Othman Yong, How to Make Money from the Malaysian Stock Market, June 1999, Leeds Publications, Kuala Lumpur

3. At least 25 percent but not more than 50 percent of the issued and paid-up capital in the hands of a minimum number of 500 public shareholders not less than 1,000 shares each, and
4. Only a summary of the prospectus needs to be advertised.

One lesson learnt from the economic crisis is the urgency to revamp the securities industry and remove weaknesses in corporate governance and financial reporting[22]. Listed companies must meet high international standards required by investors and revamping the KLSE listing rules and regulations was inevitable as the capital market moved towards a disclosure-based regime[23].

In its effort to revamp the securities industry, the SC imposes stricter regulations for listing. For example, construction and trading/retailing companies are now only allowed to be listed on the Main Board. In addition, the SC has strengthened the profit track record requirement for companies seeking listing on both the Main Board and Second Board[24]. Minimum share-capital requirements for both Main and Second Boards have also been increased and these companies are given a grace period of 3 years (from April 1999) to comply.

The effort of the KLSE to develop more comprehensive rules has resulted in the revamp of the existing KLSE Listing Requirements. Released on 22 January 2001, the new LR is a major achievement for the Malaysian securities industry as it is the culmination of the collective efforts of industry participants and regulators to ensure

[22] Raj C., "On the Alert", Malaysian Business, 16 March 2000

[23] New Straits Time, 18 May 2001 "KLSE Must Emulate International Standards"

[24] From SC press statement on 30 April 1999

continued growth in the capital market[25]. The key objectives of the Revamped Listing Requirements ("RLR") are:-

1. To enhance corporate governance and transparency,
2. To enhance efficiency in capital market activities,
3. To strengthen investor protection, and
4. To promote investor confidence.

3.4 Post-listing requirements

In general a newly-listed Second Board company is required to maintain profitability in the first 3 years of its operations subsequent to IPO. This is an agreement the company has to fulfil in order to keep its counter open for trading on the Second Board.

With the Revamped Listing Requirements, the SC has also amended its previous requirement on future profit performance. Previously, Second Board companies must record after-tax profit of at least RM 2.5 million. Effective 15 February 2001 this has been removed and in its place is a new requirement that a company seeking IPO should subsequent to listing be in a position to sustain its earnings at a reasonable level commensurate with its enlarged share capital base.

In early 2001, KLSE has tightened its *financial conditions* for listed companies[26]. Under KLSE Practice Note 4 paragraph 2.1 announced on 31 January 2001, a listed company would be deemed to have breached the minimum financial condition if: -

[25] PWC Alert bulletin on "Revamp of the KLSE Listing Rules", Issue No.16, February 2001

[26] Sindhu J., "KLSE Tightens Financial Rules for Listed Firms", The Star, 1 February 2001