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ASSESSMENT AND FACTORS OF RISK IN AN IPO'S

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Abstract:

In present scenario IPO's are the best way of investment for the good returns as well. These IPO's totally depends on market. Investment in IPO's may contain risk factor and may be harmful in terms of loss. So, in this paper the risk assessment and risk factors associated with IPO's should be described so that one can get to know about theses risk and their impact on IPO's. This paper will also help researcher for their study related IPO and their associated risk. In this paper author described introduction to IPO and what kind of risk can be there investing in IPO.

Keywords:

Significance of IPO, Kinds of Issues, Risk Factor, Risk Assessment.

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1. INTRODUCTION

The initial public offering of equity shares or changeable securities by a company, which is followed by the list of a company's shares on a stock exchange, is known as an '**Initial Public Offering**'. In further words, it refers to the primary sale of a company's regular shares to investors on a community stock exchange, with a meaning to raise new capital.

The mainly significant objective of an IPO is to *increase capital* for the company. It helps a company to hit a broad range of investors who would afford large volumes of capital to the company for prospect growth and development. A company going for an IPO stands to make a lot of wealth from the sale of its shares which it tries to predict how to use for additional extension and development. The company is not required to pay back the capital and the new shareholders get a right to future profits distributed by the company.

2. LITERATURE REVIEW

The two key factors in any investment decision are return and risk. Under the assumption that investors are risk-averse and seek to minimise the risk for any level of expected return, intuition

suggest that additional return must compensate investors for assuming additional risk (Aaker and Jacobson,1987).

The study regarding risk has been an important and long discussion topic in several areas, such as economic, finance, and strategic management. In the economic area, risk is usually related to the choice under uncertainty conditions. It is Irving Fisher (1906) who firstly discussed the uncertainty of future asset returns that is described in terms of a probability. However, the most fundamental theory on risk is Knight's study (1921) that discusses risk versus uncertainty. The theory says that risk exists when the economic agent can assign numerical probabilities to events in a certain situation. If the probabilities cannot be assigned, then uncertainty exists. Referring to previous studies, Hicks (1934) suggests that preferences for investments could be represented as preferences for the moments of the probability distributions of their returns. He also proposes that preferences could be represented by indifference curves in mean-variance space. Then, this study is expanded by von Neumann and Morgenstern's study (1947), which is well known as 'The Expected Utility Theory'. Within this theory, an individual's attitude towards risk is reflected in the shape of his or her utility function. Eventually, Hick's study has led to the spread of risk research to other disciplines. (The New Palgrave Dictionary of Money and Finance, 1994).

3. COMPANIES FALL INTO TWO BROAD CATEGORIES: PRIVATE AND PUBLIC

A secretly held company has fewer shareholders and its owners don't have to reveal much information regarding the company. When a secretly held corporation wants additional capital, it can borrow cash or sell stock to increase needed funds. Often "going public" is the greatest option for a growing business. Compared to the costs of borrowing huge sums of money for ten years or further, the costs of an initial public offering are small. The capital raised never has to be repaid. When a company sells its stock openly, there is also the opportunity for appreciation of the share price due to market factors not directly associated to the company. Anybody can go out and integrate a company: just put in some money, file the right legal documents and follow the coverage rules of jurisdiction such as Indian Companies Act 1956. It usually isn't possible to buy shares in a private company. Individual can approach the owners about investing, but they're not compelled to sell you anything. Public companies, on the other hand, have sold at least a section of themselves to the public and trade on a stock exchange. That is why doing an IPO is also referred to as "going public."

Why go public?

Prior to deciding whether one should absolute an IPO, it is essential to consider the optimistic and downbeat effects that going open may have on their mind. Naturally, companies go communal to increase and to offer liquidity for their shareholders. But there can be further benefits. Going open raises cash and typically a lot of it. Being openly traded also opens many financial doors:

- Because of the improved examination, public companies can typically get better rates when they issue debt.

- As lengthy as there is market demand, a communal company can forever issue more stock. Thus, mergers and acquisitions are easier to do because stock can be issue as part of the deal.
- Trading in the untie markets means liquidity. This makes it likely to implement things like employee stock ownership plans, which assist to attract top talent.

Going public can also increase a company’s status which in turn, can help the company to increase in the marketplace.

4. DIFFERENT KINDS OF ISSUES

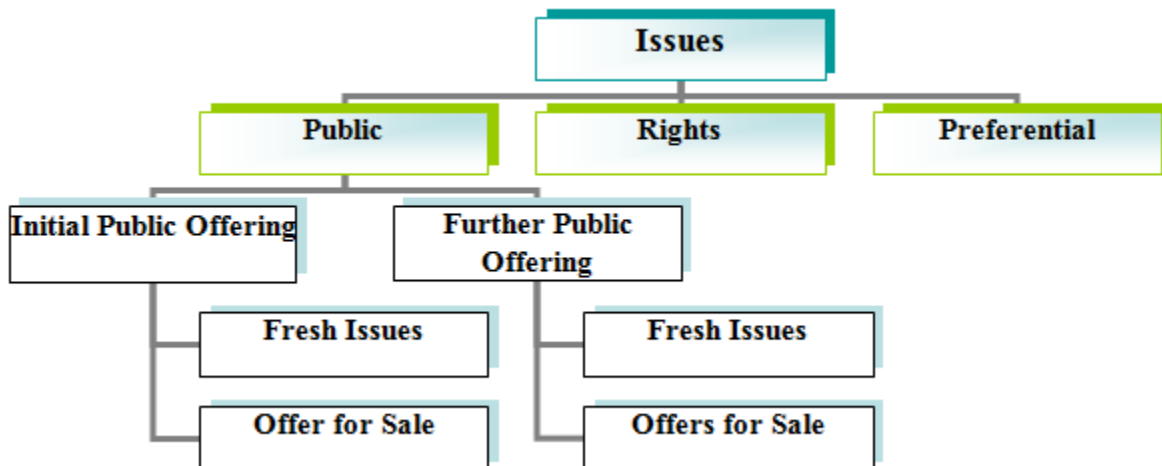


Figure 1: Kinds of Issues

5. SIGNIFICANCE OF IPO

Investing in IPO has its hold set of advantages and disadvantages. Where on one offer, high element of risk is concerned, if successful, it can even result in a upper rate of return. The rule is: Higher the risk, higher the returns.

The company issues an IPO with its personal set of management objectives and the depositor looks for investment keeping in mind his own objectives. Both have a lot of risk concerned. But then investment also comes with an improvement for both the company and the investors.

The implication of investing in IPO can be studied from 2 viewpoints – for the *company* and for the *investors*. This is discussed in detail as follows:

Significance to the Company: When a secretly held corporation needs supplementary capital, it can borrow cash or sell stock to increase needed funds. Or else, it may choose to “go public”. "Going Public" is the best selection for a growing business for the following reasons: The cost of an initial public offering is small as compared to the costs of borrowing huge sums of money for ten years or more.

- i. The capital increased never has to be repaid.

- ii. When a company sells its stock openly, there is also the possibility for admiration of the share price due to market factors not straightforwardly related to the company.
- iii. It allows a company to tap a wide team of investors to provide it with big volumes of capital for future growth.

Significance to the Shareholders: The investors frequently see IPO as an easy way to make money. One of the most attractive features of an IPO is that the shares presented are usually priced very low and the company's stock prices can be raised significantly during the day the shares are offered. This is seen as a good chance by 'speculative investors' looking to mark out some short-term profit. The 'speculative investors' are concerned only in the short-term potential rather than long-term gains.

6. PRIMARY MARKET AND SECONDARY MARKET

When shares are bought in an IPO it is known as primary market. The primary market does not absorb the stock exchanges. A company that plans an IPO associates an investment banker who will in turn call on securities dealers to help sell the new stock issue.

This procedure of selling the new stock issues to probable investors in the primary market is called underwriting.

When an investor buys shares from another investor at an approved current market price, it is called as buying from the secondary market.

The secondary market involves the stock exchanges and it is synchronized by a regulatory authority. In India, the secondary and primary markets are governed by the SEBI (Security and Exchange Board of India).

7. KINDS OF PUBLIC OFFERINGS

- **Primary offering:** - New shares are sold to increase cash for the company.
- **Secondary offering:** - Existing shares (owned by VCs or firm founders) are sold, no new cash goes to company. A single offering may comprise both of these initial public offerings.

8. THE RISK FACTOR

Investing in IPO is frequently seen as an easy way of investing, but it is extremely risky and many investment advisers advise against it unless you are principally experienced and knowledgeable. The risk factor can be recognized to the following reasons:

- **Unpredictable**

The Unpredictable outlook of the IPO's is one of the main reasons that investors advise against investing in IPO's. Shares are initially offered at a low price, but they see major changes in their

prices during the day. It might rise considerably during the day, but then it may fall steeply the next day.

- **No past track record of the company**

No precedent track record of the company adds auxiliary to the dilemma of the shareholders as to whether to invest in the IPO or not. With no past track record, it becomes a complicated choice for the investors to decide whether to invest in an exacting IPO or not, as there is basis to decide whether the investment will be profitable or not.

- **Potential of stock market**

Returns from investing in IPO are not certain. The Stock Market is extremely volatile. Stock Market fluctuations generally affect not only the individuals and household, but the economy as a whole. The instability of the stock market makes it complicated to predict how the shares will perform over a period of time as the profit and risk potential of the IPO depends upon the state of the stock market at that exacting time.

9. RISK ASSESSMENT

The opportunity of buying stock in a talented start-up company and finding the next victory story has intrigued many investors. But before taking the large step, it is essential to understand a few of the challenges, basic risks and potential rewards connected with investing in an IPO.

This has made **Risk Assessment** a significant part of Investment Analysis. Higher the preferred returns, higher would be the risk associated. Therefore, a thorough analysis of risk connected with the investment should be done before any consideration.

For investing in an IPO, it is necessary not only to know about the working of an IPO, but we also require knowing about the company in which we are planning to invest. Hence, it is imperative to know:

- The essentials of the business
- The policy and the objectives of the business
- Their products and services
- Their competitors
- Their share in the current market
- The scope of their issue being successful

It would be extremely risky to invest without having this basic knowledge about the company.

There are 3 kinds of risks involved in investing in IPO:

- **Business risk:**

It is significant to note whether the company has sound business and management policies, which are reliable with the standard norms. Researching business risk involves investigative the business model of the company.

- **Financial risk**

Is this company solvent with enough capital to suffer short-term business setbacks? The liquidity situation of the company also needs to be considered. Researching financial risk involves investigative the corporation's financial statements, capital structure, and other financial data.

- **Market risk:**

It would helpful to check out the demand for the IPO in the market, i.e., the appeal of the IPO to further investors in the market. Hence, researching market risk involves investigative the appeal of the corporation to current and future market conditions.

10. CONCLUSION

In this paper author explains that IPO's are the regular share of a company that is sell by a company to raise their capital structure. In is also described that companies falls in two categories like public and private. The public offering is of two type primary offering and secondary offering where primary offering means that new shares are to be sold and in an secondary offering existing shares held by VC and other are to be sold. Risk factor in IPO can be unpredictable, no past record of the company, potential to stock market. The risk assessment explains that there are three types of risk associated with an IPO that is business risk, financial risk and market risk.

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