A Review of Research on Factors Influencing IPO Premiums

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Abstract. The IPO (Initial Public Offering) market has garnered increasing attention in recent years, and the IPO issue premium, as an important indication, is vital for both investors and firms. The purpose of this research is to investigate the elements that influence the IPO offering premium. This article discovers numerous crucial factors after examining and organizing related papers. First, the registration system, including its development history, is a key component in determining the IPO issue premium. Second, the market environment, such as market volatility and market maturity, influences the IPO issue premium. Furthermore, investor mood has a significant impact on the IPO issue premium. Finally, the prominence and experience of underwriting organizations have an impact on IPO issuance premiums. This study verifies the impact of the aforementioned factors on IPO issuance premiums and makes some interesting results by gathering relevant data and employing appropriate statistical methodologies. With a better grasp of these aspects, investors and firms can make more educated investment decisions by better understanding the mechanism of IPO issuance premium development.

Keywords: Initial Public Offering; Premium; Registration System; Market Variables; Investor Sentiment.

1. Introduction

1.1. Research Background

IPO refers to the initial offering of a company's common stock to the public, and generally, once the IPO is completed, the company can apply to be listed and traded on an exchange or quotation system. IPO premium refers to the price of the initial offering being higher than the actual value and price of the stock, which is mainly reflected in the fact that the price of the initial offering is much higher than the closing price of the stock on the day of the listing. This phenomenon is mainly reflected in the fact that the initial offering price of the stock is much higher than the closing price on the day of listing, enabling the company's investors to gain excess returns on the first day of listing. Successful initial public offerings bring sufficient capital to the company and increase the liquidity of the stock in the secondary market. It also reduces the company's risk.

Theoretically, according to the theory of supply and demand, the pricing of newly issued shares in the primary market should be determined by the demand in the secondary market, in which case supply and demand should be equal and the market should be in a state of equilibrium between supply and demand at this point in time, with no premium. However, research in recent years has shown that IPO premium is still a common problem in the global capital market, and it also exists in China's stock market, while China's market mechanism is still in a state of continuous development. Therefore, this paper attempts to study the following issues from the perspective of IPO premium, i.e., how market factors, investor sentiment and company characteristics affect IPO premium, through theoretical analysis and in the context of China's actual situation.

1.2. Literature Review

Ibboston (1975) was the first to suggest that there is a significant difference, which gives higher returns to IPO subscribers [1]. There may be a significant difference between the IPO price and the
first-day closing price, which gives higher returns to IPO subscribers. The existence of this phenomenon has been systematically studied, but no clear reason has been found, thus this phenomenon has been referred to as the "IPO premium puzzle". Since then, the existence of this premium phenomenon has been confirmed by researchers in countless countries around the world, and at the same time, there have been numerous studies and debates on the factors affecting the IPO premium phenomenon, and several highly persuasive theories have been developed. This paper reviews the research on the IPO premium phenomenon from the perspectives of information asymmetry theory, political decision theory, and behavioral finance theory.

Liu Wangxing (2012) points out that the main factors affecting the premium rate on the first day of IPO are categorized into three aspects, in which the growth factors (subscription price-earnings ratio and profit growth rate) have a much greater impact on the premium rate on the first day of IPO than the risky factors (subscription proceeds and net profit) and the speculative factors (winning rate and changeover rate) [2]. Hu and Yin (2020) find that overpricing of the initial public offering of stocks that improve the quality of listed companies' R&D disclosure can reduce bubbles caused by initial public offerings that are higher than the intrinsic value of the company [3]. Yeh et al. (2020) found that corporate credit disclosure can be more effective in reducing the first-day yield of IPOs and improving the efficiency of pricing in hot market periods [4].

### 1.3. Research Content And Significance

IPO premium disrupts the pricing function of the market, inefficient pricing, inefficient valuation of intrinsic value of enterprises, interferes with value discovery and increases the risk potential of the market and stock market. The purpose of this paper is to study how the differences in IPO premiums arise and try to analyze the drivers of IPO premiums from multiple dimensions, such as investor sentiment/market heat level, market environment, and institutional level, to better improve IPO premiums. This paper will try to analyze the driving factors of IPO premium from multiple dimensions, such as investor sentiment/market heat level, market environment level, and institutional level, in order to better improve the IPO premium problem and promote the long-term efficient and healthy development of the market. By analyzing the difference of IPO premium rates in different dimensions, this paper can improve the efficiency of IPO pricing to a certain extent, educate investors to invest rationally and play the role of the securities market in a timely and effective manner to improve the efficiency of capital allocation.

### 2. Registration System And IPO Premium

In December 2019, the Securities Law of the People's Republic of China stipulated that IPOs should be converted from the previous approval system to a registered system. The government has reduced the intervention and judgment of new share issues so that the market has become the dominant share issue. As a result, more stocks are successfully issued, but the threshold for issuance is lowered, and a large number of low-level stocks enter the market. Consumers have more choices and may take more risks [5]. The IPO registration system requires the disclosure of company information and company founder information, and investors can choose to buy or sell stocks according to the updated information. Since the IPO registration system was issued, the premium degree has been greatly reduced, the stock liquidity is strong, and the premium trend has gradually declined.

One of the reasons for the IPO premium is that there are a large number of individual stockholders in the market, the number is large, and the individual share is small. Under the registration system, a large number of stocks have been successfully issued, stimulating investors' investment expectations and inducing investors to want to buy new stocks. At the same time, a large number of companies' successful issuance of shares exerts an impact on the market, ultimately leading to IPO premiums [1]. Under the registration system, a large number of companies have been listed successfully. The IPO registration system has low audit requirements, simplified company listing requirements, and faster
stock issuance. The difficulty for companies to raise funds is reduced, and after listing, companies adapt to market choices and make profits [6]. At the same time, companies with large scale and high social prestige are more likely to obtain IPO premiums. Investors are more willing to buy stocks with excellent development prospects and potential. In contrast, IPOs of companies that are expected to lose money tend to follow the market and are not prone to a premium.

On September 18, 2021, the government revised the issue of new shares under the registration system and issued the requirements of the "Inquiry New Regulation". In this way, the IPO pricing efficiency is improved, the company information is disclosed, and investors can search this information to determine whether to buy the company's shares. It is a blow to companies with low reputations. In order to control the IPO premium and make the IPO issue price adapt to the market price, the government has also improved the relevant laws and regulations. The company shall not intentionally conceal information, and investors have the right to know the company's changes, which alleviates information asymmetry [7]. Since the IPO registration system, underwriters need to strengthen their responsibilities, and investors need to buy new shares rationally and pay attention to the changes in the company, rather than blindly buying new shares and thus losing money. China has made a lot of efforts in IPO from the approval system to the registration system. Although there is now a premium for IPOs, it is much less than before. At the same time, through a series of reforms and innovations, IPO issuance is mostly based on market equilibrium. The Impact of Market Environment on IPO Premiums

Since the establishment of China's capital market, the phenomenon of investors "speculating on new stocks" and new stock premiums has become commonplace, seriously distorting the market's benign pricing mechanism and leading to inefficient resource allocation. Although China's stock market has been committed to improving all aspects of the market mechanism for many years, the phenomenon of new stock premiums still exists to varying degrees. Excessive premiums for stocks in the secondary market create arbitrage space between the primary and secondary markets, which invites more speculative behavior and further increases the risk of IPOs.

A number of studies have found that IPOs suffer from severe short-term underpricing and that the timing and location of IPOs are not significantly different from the returns on IPOs, although different methods of issuance can affect returns. Some studies have confirmed that the difference in underpricing rates between A-share and B-share IPOs is very large and that the time between issuance and listing significantly affects IPO premiums [8]. Some scholars have found that the percentage of original shareholders' ownership is positively related to IPO premium, which is due to the very high internal retention rate, indicating that the original shareholders are optimistic about the future performance of the company, which is totally good news [9]. Some studies have shown that, in general, the IPO issue price of Chinese stocks better reflects the intrinsic value of the company than the market price, and the main reason for the low IPO pricing is that the secondary market price is too high [10].

In general, when the market is booming, investors have a higher risk appetite and are willing to pay a higher IPO premium. And a more liquid and active IPO market will result in higher issue premiums.

3. The Effect of IPO Premiums On Investor Sentiment

Emotions and expectations of investors have a significant impact on stock prices; extreme optimism, in particular, can lead to big changes in stock prices and blind investment behavior. According to the investor sentiment theory, the presence of bias in investor cognition and excessive psychological expectations will have an effect on stock prices. The stock market value judgment of different investors is based on the individual's stock market knowledge reserve, and the most optimistic and positive investors determine the final price of the stock, and the market's equilibrium price will be increased accordingly if the investors' valuation of the stock is higher.

Overly optimistic investor behavior, on the other hand, can easily lead to blind investing and overconfidence. Investors make trading judgments based on their own psychological condition in this
situation, without proper study and thought. Investor sentiment is a presence in financial markets that is absent from noise trading and trading based only on overconfidence. This deviates significantly from classic rational investment theory.

Retail investors are subject to market over-optimism and are unable to operate rationally like institutional investors. As IPOs continue to sell like hotcakes, more and more investors are drawn into trading in the IPO market. Stock prices frequently fail to reach market equilibrium in a short amount of time due to a restricted supply of new stocks. New shares are over-sought by optimistic investors, leading to rising share prices and creating illusions. However, over time, the market gradually corrects the overly optimistic expectations, and the stock price returns to its true value. Therefore, it is possible for the IPO market to underperform in the long run.

Some scholars have explored the relationship between investor sentiment and IPO premium from both theoretical and empirical perspectives. Some scholars believe that investor sentiment represents investors’ irrational speculative tendencies and measure investors’ irrational behavior by constructing investor sentiment indicators [11]. Some experts use theoretical analysis to find that there are many small and medium-sized investors in China's investment market, and their irrational response to the market performance is an important reason for the phenomenon of China's high IPO premiums. The study found that there are a large number of small and medium-sized investors in China's investment market, and their irrational behavior has largely led to the phenomenon of China's IPO high premium [12]. For the high premium in the GEM market, a study found that investor sentiment in the secondary market trading can have an impact on the IPO premium phenomenon, when investor sentiment is high, the trading behavior will be more frequent, and the GEM IPO premium rate will be higher, and the premium phenomenon will appear [13]. In addition, some studies also divided investor sentiment into two dyads of rational institutional investors and irrational individual investors and established the corresponding theoretical model for empirical research. The results show that the IPO premium and these two kinds of emotions show a positive correlation, which is the result of the joint role of emotions [14].

Overall, investors’ emotions and expectations have a significant impact on stock prices, and excessive optimism can lead to stock price volatility and blind investment behavior. Rational thinking and thorough analysis are key to avoiding the investment process being influenced by emotions. At the same time, investors should also pay attention to the speculative atmosphere in the market so as not to be guided by excessive optimism and make irrational decisions.

4. Conclusion

4.1. Key Findings

In general, both enterprises and investors should be rational about the premium of China's IPO and make reasonable strategies and decisions by fully considering the market environment, company fundamentals, industry prospects, and other factors. Enterprises should endeavor to improve their competitiveness and profitability, establish good investor relations, and reasonably determine the issue price. Investors should conduct adequate due diligence, diversify their investment risks, rationally judge the level of premium, and adopt the concept of long-term investment. Through reasonable strategies and decision-making, it helps to realize better investment returns.

The study of the influencing factors of IPO issuance premiums is an issue that cannot be ignored in today's society. Scholars at home and abroad have researched the issue of influencing factors of IPO premium, obtained revealing research results on the influencing factors of IPO issue premium, and made detailed analyses around the registration system, market environment, and investor sentiment. From the literature collected so far, the above-mentioned factors are correct to a certain extent, but there are also deficiencies and shortcomings in these studies. Further empirical evidence and research are needed to find out whether there are other factors affecting the IPO issue premium.
4.2. Future Prospects

Follow-up research can be carried out and improved in the following aspects, and the deficiencies and further research directions and contents of the paper mainly include the following points: First, due to the limitation of space and analytical focus, this paper may not be comprehensive enough in exploring the specific impact mechanism of the release of the registration system reform on the IPO issuance premium and analyzing the perspective of heterogeneity. Secondly, the relatively short period of time for the implementation of the registration system has led to the fact that the findings of this paper may not be comprehensive, and therefore the impact of the registration system on the IPO premium needs to be tested over a longer period. Follow-up research can be carried out and improved in the following aspects, and the deficiencies and further research directions and contents of the paper mainly include the following points: First, due to the limitation of space and analytical focus, this paper may not be comprehensive enough in exploring the specific impact mechanism of the release of the registration system reform on the IPO issuance premium and analyzing the perspective of heterogeneity. Secondly, the relatively short period of time for the implementation of the registration system has led to the fact that the findings of this paper may not be comprehensive, and therefore the impact of the registration system on the IPO premium needs to be tested over a longer period.

Authors Contribution

All the authors contributed equally and their names were listed in alphabetical order.

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