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## The lead underwriter reputation and underpricing: study of company's IPO in Indonesia

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**Abstract:** We analyse the effect of lead underwriter reputation on underpricing during initial public offering (IPO) in the Indonesia Stock Exchange. This study predicts that companies using reputable lead underwriter will have a low level of underpricing. We analyse 163 companies that conduct an IPO from 2010 to 2017. The analysis results show that the reputation of a lead underwriter has a negative and significant effect on underpricing. This finding has an implication in the selection of underwriter during the IPO. For companies, underpricing is considered as the cost of capital. The higher the level of underpricing, the higher is the cost of capital in the IPO. This means that the funds collected by the firm during IPO are not optimal. Therefore, the findings of this study could be considered in determining the lead underwriter during the IPO.

**Keywords:** lead underwriter reputation; underpricing; initial public offerings; IPOs; Indonesia.

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## I Introduction

The underpricing phenomenon during initial public offering (IPO) is one of the capital market anomalies that are concerned by academics from various countries in the world. Previous researchers have analysed the causative factors of underpricing using several approaches, namely the adverse selection approach, principal-agent, signalling and heteroc 45 explanation (see Anderson et al., 1995; Ritter and Welch, 2002; Agrawal, 2009). Several theories have been documented by researchers, 63 h as winner's curse theory (Rock, 1986), principal-agent model (Baron, 1982), the signalling model (Allen and Faulhaber, 1989), and 34 vsuit avoidance theory (Tinic, 1988). However, the results of the literature review of Jenkinson and Ljungqvist (2001) and Ritter and Welch (2002) show that the proof of these theories is not conclusive 15 pecially in Southeast Asia (Amer and Ahmad-Zaluki, 2016). Therefore, further analysis of the underpricing phenomenon in Southeast Asia is needed, especially in developing countries such as Indonesia.

In the context of underpricing, Indonesia is one of the coun 7 es with a high level of underpricing. Empirical evidence from previ 1 s studies shows that the average level of underpricing in Indonesia is around 20% to 30% (Yolana and Martani, 2005; 68 anti and Niagara, 2006; Widiyanti and Kusuma, 2013). Widarjo et al. (2017) show that the average level of underpricing in Indonesia in 2000–2014 (excluding 2008 and 2009) is 33%. Several studies in Indonesia have shown empirical evidence on the factors that influence underpricing, such as ownership retention, auditor quality, corporate governance mechanism and voluntary disclosure (Yolana and Martani, 2005; Widiyanti and Kusuma, 2013; Darmadi and Gunawan, 2013; Widarjo and Bandi, 2018). However, research that focuses on underwriter reputation 62 especially lead underwriter, is still limited. Therefore, this study aims to provide empirical evidence on the relationship between lead underwriter reputation with underpricing 67 n developing countries by implementing alternative measurement for reputation and underpri 19 g.

This research focuses on the lead underwriter reputation as an important factor influencing underpricing level in Indonesia based on several arguments. First, in Indonesia, the company's IPO is generally guaranteed by several underwriters. Lead underwriter is appointed by these underwriters and has a responsibility to manage the IPO (for example, preparing a prospectus, doing book building and selling all shares). Therefore, the lead underwriter is one of the main 'actors' during the IPO. Besides, the lead underwriter generally has a greater portion of guarantees than other underwriters. This condition causes the lead underwriter to have a higher risk because if the offered shares are not sold, the underwriter is obliged to buy the shares. This is in line with full commitment agreement in underwriting which is commonly implemented in Indonesia. Also, a reputable lead underwriter will try to maintain their image and market share by succeeding in the company's guaranteed IPO. The indicators of IPO success are, among others, all shares were sold and low-level underpricing.

Second, the literature shows that the use of reputable lead underwriter is an effective signalling mechanism in reducing information asymmetry in the market (Su and Brookfield 44 13; Sundarasan et al., 2017; Kim and Hwang, 2018). Carter and Manaster research (1990), Megginson and 2 Weiss (1991), Bruton et al. (2009) and Bansal and Khanna (2013) have 33 ven that underwriter reputation has a negative effect on underpricing level and has a positive effect on the company's long-term performance. Third, most research on underwriter reputation in Indonesia uses the underwriter ranking

method developed by Carter and Manaster (1990) using guarantee frequency as a basis for reputation measurement (see Prawestri and Indrasari, 2014; Murtini, 2015; Putra and Sudjarni, 2017), while the research that uses guarantee value as a basis for measuring reputation is still limited. Fourth, in 2018, the Indonesia Stock Exchange was ranked 10th in the global IPO. In that year, there were 55 new companies listed on the IDX, or 4% of the total IPO worldwide (Nabhani, 2019). This indicates the increasing interest of companies in Indonesia for IPO. The increase of company interest in IPOs is strengthened by the incentive of 5% reduction of income tax for issuers with a minimum public share of 40% (Hidayat, 2019).

This study provides several contributions to the IPO literature. First, this research adds literature in the research focuses on IPO in developing countries, to reduce the research gap in developed and developing countries. This research is conducted in developing countries which have high IPO interest and a relatively high level of underpricing so that it can provide benefit for IPO stakeholders, especially companies that will conduct an IPO. Second, this study uses market share method of guarantee value as an alternative measurement of underwriter reputation, which is different from previous research that uses guarantee frequency. Furthermore, we also conduct principal component analysis by combining three reputation indicators (value-based reputation, volume and underwriting frequency) into one component. The formed new component score is a composite score which calculated from the linear combination of the three lead underwriter reputation indicators. We also use an alternative method to measure underpricing using initial returns adjusted to market returns. By using these alternative measurements, it is expected that a more accurate estimation can be obtained. The next section in this paper discusses the theory and hypothesis formulation, followed by research methods and analysis results. The conclusions and implication of the study are explained at the end of this paper.

## 2 Literature review and hypothesis

The literature shows that information asymmetry is the main factor that causes underpricing during IPO (Ritter and Welch, 2002; Hanley and Hoberg, 2012; Bottazzi and Da Rin, 2016). Additionally, information asymmetry is one of the most researched topics, including in Indonesia, both empirically and theoretically (Ljungqvist, 2007). Information asymmetry during IPO is not only occurred among investors (informed and uninformed investor) but can also occur between a company (issuer) and its underwriters (Aron, 1982; Rock, 1986; Welch, 1989). In this context, the issuer has the best information about the quality and prospects of the company in the future. Underwriters have better information about market conditions and the needs of potential investors. On the other hand, potential investors only have limited information about the quality and prospects of the company.

The limited information owned by prospect investors about the quality and prospects of the company can result in a lower price of the company's stock in the secondary market. Underpricing is a cost of capital for company owners which commonly called 'money left on the table' (Singh and Van der Zahn, 2007; Ritter, 2015). In this context, lead underwriter as representative of all underwriters has an important role in the IPO process to communicate the quality and prospects of the company to

potential investors in the capital market. A highly reputable lead underwriter will maintain market share and reputation when making guarantees for a company. Based on their expertise and experience, lead underwriter will make every effort to succeed in the IPO of the guaranteed company. The low level of underpricing is one indicator of the success of underwriter in the IPO of a company. Therefore, companies will choose reputable lead underwriter to reduce the level of underpricing.

The use of highly reputable underwriter in the IPO process can have a positive impact on the perception of potential investors about company quality (Certo et al., 2001; Su and Brookfield, 2013). Furthermore, Chen and Mohan (2002) state that high-quality companies will provide a signal of company quality by hiring highly reputable underwriter. This argument is supported by several studies which provide evidence of the negative effect of underwriter reputation on underpricing (Carter and Manaster, 1990; Bruton et al., 2009; Bansal and Khanna, 2013; Sundarasan et al., 2017). Based on the theoretical literature and the results of previous research, we formulate the following hypothesis:

H1 Lead underwriter reputation has a negative effect on underpricing.

### 3 Research method

#### 3.1 Data and sample

The samples consist of companies which conducted IPO in Indonesia Stock Exchange from 2015 to 2017. The data are extracted from company IPO prospectus and stock price reports obtained from the Indonesia Stock Exchange website, company website, and the Investment Gallery of the Faculty of Economics and Business, Universitas Sebelas Maret.

#### 3.2 Empirical model

In testing the effect of lead underwriter's reputation on underpricing, estimates are determined based on the following model:

$$\text{UNDP}_i = \alpha + \beta_1 \text{UDWREP}_i + \beta_2 \text{LnSIZE}_i + \beta_3 \text{LnAGE}_i + \beta_4 \text{AFFILIATION}_i + \beta_5 \text{ROA}_i + \beta_6 \text{AUDITOR}_i + e_i$$

The dependent variable is underpricing (UNDP), measured using initial returns which are adjusted to market returns. We consider that this measurement reflects the returns obtained by investors better than the company's initial returns which are not adjusted to market returns. From the investor perspective, a high initial IPO return is not necessarily comparable to the obtainable return from investing in other company at the same time.

The main explanatory variable is the lead underwriter reputation (UDWREP) measured using the market share of the lead underwriter based on the underwriting value in the previous one-year period. This measurement is considered better than the underwriter reputation that commonly used by the researcher in Indonesia, namely the ranking method developed by Carter and Manaster (1990). There are at least two arguments that can explain the advantages of the market share method compared to the ranking method which commonly used by previous researchers:

- 1 The market share reflects the development of underwriter's rank that fluctuates every year.
- 2 The market share data is on a ratio scale, not nominal or ordinal scale like underwriter reputation data in previous research which is a categorical variable (dummy).

The literature shows that there are several important factors beside underwriter that affect on underpricing (see Kirkulak and Davis, 2005; Albring et al., 2007; Chang et al., 2008; Tian, 2011; Razafindrabinina and Kwan, 2013). Therefore, this study uses several control variables, namely: the number of assets (ASSET), the age of the company (AGE), lead underwriter's affiliation with the issuer, return on asset (ROA) and auditor reputation (AUDIT). To reduce extreme data variance, we transform the value of total assets into natural logarithms form. Description and measurement of the research variables are presented in Table 1.

**Table 1** Description and variable measurement

Variable	Description
UNDP	<p>Underpricing (UNDP) is the difference between the offering price of shares during the IPO and the closing price of shares on the first day in the capital market. Underpricing proxied by initial return (IR) which is adjusted to market return (MR) on the first day of trading in the stock exchange. The value of this variable is calculated using the following formula:</p> $UNDP = IR - MR$ <p>where</p> $IR = \frac{P1 - P0}{P0}$ $MR = \frac{\text{Composite stock price index } t - \text{Composite stock price index } t-1}{\text{Composite stock price index } t}$
UDWREP	<p>Lead underwriter reputation is measured using the market share of lead underwriters based on the underwriting value in the previous one-year period. The value of this variable is calculated using the following formula:</p> $UDWREP_t = \frac{\text{Underwriting value } t-1}{\text{The total value of IPO companies } t-1}$ <p>If there is more than one lead underwriter, the highest underwriting portion is chosen from all lead underwriters.</p>
LnSIZE	Natural logarithm of company assets (in rupiah).
AGE	Number of years since the company was founded up to the IPO.
AFFILIATION	Indicator variable (dummy); the sample company is given a score of 1 if it has an affiliation with the lead underwriter and a score of 0 if there is no affiliation with the underwriter.
ROA	Return on asset was calculated by dividing year-end net income by total asset.
AUDITOR	Indicator variable (dummy); the sample company is given a score of 1 if audited by auditor who affiliate with the big four and a score of 0 if audited by auditor who does not affiliate with the big four.

#### 4 Results and discussion

Table 2 shows descriptive statistics of all research variables. The maximum value of the underpricing variable is 0.56 with an average value of 0.237. This statistic shows that the cost of capital in the IPO in Indonesia is still relatively high. The average value of underpricing seems lower when compared with the results of previous research (see Widarjo et al., 2017). It is caused by the difference in underpricing measurement methods. In previous studies, underpricing is measured using initial return, whereas in this study underpricing is measured using initial return which is adjusted to the market return. Furthermore, the average value of lead underwriter reputation variables is 0.038 with the minimum value of 0.000 and the maximum value of 0.240. This statistic shows that the appointment or selection of lead underwriters for IPO is not concentrated in certain underwriters.

**Table 2** Descriptive statistics

	<i>Min.</i>	<i>Max.</i>	<i>Mean</i>	<i>Std. dev.</i>
UNDP	-1.000	0.710	0.237	0.280
UDWREP	0.000	0.240	0.038	0.051
SIZE	11.447	24,846.516	2,201.864	3,572.340
AGE	1.000	90.000	19.728	15.318
AFFILIATION	0.000	1.000	0.094	0.293
ROA	-0.320	0.510	0.065	0.096
AUDITOR	0.000	1.000	0.252	0.435

Note: The value of SIZE is expressed in billions of rupiah.

Correlation analysis in Table 3 shows that the highest correlation coefficient between independent variables is 0.211, which is the correlation between the lead underwriter reputation (UDWREP) and auditor reputation (AUDITOR). The value of the correlation coefficient is still far below the threshold of multicollinearity indicator, 0.7 or 0.8 (see Gujarati, 1995; Cooper and Schindler, 2003). Therefore, it can be concluded that the research model is free of multicollinearity problems.

**Table 3** Correlation

	1	2	3	4	5	6	7
1 UNDP	1.000						
2 UDWREP	-0.271	1.000					
3 LnSIZE	-0.300	0.188	1.000				
4 AGE	-0.132	0.047	0.123	1.000			
5 AFFILIATION	0.014	-0.018	0.028	0.053	1.000		
6 ROA	-0.178	0.100	-0.171	0.042	0.047	1.000	
7 AUDITOR	-0.382	0.211	0.205	-0.086	-0.096	0.132	1.000

Table 4 presents the result of the regression analysis on the effect of lead underwriter reputation on underpricing in 163 samples of companies that conducted IPO in Indonesia. In column 1, the analysis is conducted without using control variables, while in column 2, the analysis is conducted by adding control variables of total assets, age, affiliation

between lead underwriters and issuers, return on asset and auditor reputation. The analysis results in Table 4 show that the coefficient of reputation is negative and significant at the level of 5%. The negative sign on the regression coefficient means that companies using highly reputable lead underwriters service have a low level of underpricing. In line with the signalling theory hypothesis, the use of reputable lead underwriters can influence the perception of potential investors in the capital market. This indicates that reputable underwriters can reduce information asymmetry between issuers and potential investors, so potential investors can conduct a more comprehensive analysis of the quality and prospects of the company in the future.

**Table 4** Regression of underwriter reputation effect on underpricing

Variables	1		2	
	Coeff.	t-value	Coeff.	t-value
Cons	0.289***	11.416	1.627***	4.068
UDWREP	-1.353***	-3.574	-0.796**	-2.027
LnSIZE			-0.045***	-3.047
AGE			-0.002*	-1.659
AFFILIATION			0.003	0.039
ROA			-0.005**	-2.208
AUDITOR			-0.190***	-4.017
R <sup>2</sup>	0.073			0.263
Adj. R <sup>2</sup>	0.068			0.234
F-value	12.771			9.267
Sig.	0.000			0.000
N	163			163

Note: \*\*\*, \*\* and \* indicate significance on the level 1%, 5% and 10%, respectively.

This argument is supported by several studies that show a positive relationship between underwriter reputation and the level of voluntary disclosure (see Bazzzi and Da Rin, 2016; Widarjo et al., 2017). Furthermore, lead underwriters also have an important role in providing information about the company's earnings forecasts. The forecast of future earnings is one of the important information for investors in valuing company shares (see Kim and Ritter, 1999; Jelic et al., 2001). Besides, several previous research results also show a positive relationship between underwriter reputation and the company's future performance (Carr et al., 1998; Su and Bangassa, 2011).

The analysis results in Table 4 also show that the variables of company size, company age, return on assets and auditor's reputation have a negative and significant effect on underpricing. This indicates that investors also consider these variables in analysing the company's stock valuation which do an IPO. Large companies have high capacity and capability of tangible and intangible resources, so they have better competitiveness and business development capabilities compared to smaller companies. Older companies are also positively perceived by investors, because an old company is considered experienced and tested in competitive business competition. In addition, older companies generally have good cooperations and relationships with company stakeholders, so they have better business sustainability compared to younger companies. Besides the size and age of the



company, the return on assets and auditor's reputation are also important factors that influence the underpricing level. Return on assets reflects the company's ability to manage its assets to generate profits. The higher this ratio, the better the company's ability to manage and utilise assets. The auditor's reputation is one indicator of audit quality and the quality of the company's financial statements. Auditors affiliated with big four have a better ability to detect fraud in financial statements. This indicates that the management assertions which expressed in the financial statements have a value of relevance and represent the real condition of the company (representative faithfulness). Therefore, investors give higher appreciation to the company's stock price that is audited by auditors who affiliated with big four.

#### 4.1 Further analysis

We analysed the effect of lead underwriter reputation on underpricing using different proxies. Table 5 presents the analysis results of the use of alternative measurements of lead underwriter reputation, while Table 6 shows the results of the analysis on underpricing variables. The first column in Table 5 shows the result of analysis of lead underwriter reputation based on three indicators, underwriting value, volume and frequency. These results indicate that the regression coefficient of the lead underwriter reputation variable based on the guarantee volume is positive and not significant, while reputation based on the underwriting frequency shows that the regression coefficient is negative and significant at the level of 10%.

**Table 5** Further analysis (the alternative measurement of the lead underwriter reputation)

Variables	1		2		3	
	Coeff.	t-value	Coeff.	t-value	Coeff.	t-value
Cons	1.719***	4.261	0.246***	11.416	1.651***	4.129
UDWREP_Value	-1.169**	-1.980				
UDWREP_Vol	0.519	1.087				
UDWREP_Freq	-0.204*	-1.804				
UDWREP_Factor			-0.063***	-2.922	-0.037*	-1.854
LnSIZE	-0.047***	-3.210			-0.047***	-3.191
AGE	-0.002	-1.527			-0.002	-1.631
AFFILIATION	0.021	0.316			0.005	0.074
ROA	-0.004**	-2.111			-0.005**	-2.392
AUDITOR	-0.178***	-3.762			-0.194***	-4.098
R <sup>2</sup>	0.282		0.050		0.260	
Adj. R <sup>2</sup>	0.245		0.044		0.231	
F-value	7.570		8.537		9.118	
Sig.	0.000		0.004		0.000	
N	163		163		163	

Note: \*\*\*, \*\* and \* indicate significance on the level 1%, 5% and 10%, respectively.

Based on these results, it can be said that the measurement of lead underwriter reputation based on underwriting value is the better indicator compared to other indicators. The

underwriting value represents lead underwriter's funding capacity and reflects the level of risk assumed by the lead underwriter when conducting underwriting (under the full commitment agreement). Therefore, reputable lead underwriters will only guarantee high-value companies that have good quality and prospects. This is different from the underwriting volume and frequency. Even though the number or volume of underwriting shares is large, the underwriting value is not necessarily large, because shares volume may be large but the value per share might be small. Likewise, the underwriting frequency, although underwriters often guarantee, the underwriting value may be small, so the level of risk borne is also small. The regression coefficient of reputation based on vol<sub>53</sub> is positively and significantly indicating a reduction in the level of risk in selling the company's shares in the market. Price discounting is one of the strategies taken by the lead underwriter to maintain its reputation concerning the sale of offered shares.

**Table 6** Further analysis (underpricing measurement by initial return)

Variables	1		2	
	Coeff.	t-value	Coeff.	t-value
Cons	1.612***	4.045	1.636***	4.106
UDWREP	-0.802**	-2.051		
UDWREP_Factor			-0.037**	-1.886
LnSIZE	-0.044***	-3.018	-0.046***	-3.163
AGE	-0.002*	-1.681	-0.002	-1.652
AFFILIATION	-0.002	-0.023	0.000	0.004
ROA	-0.004**	-2.161	-0.005**	-2.346
INDUTOR	-0.192***	-4.068	-0.195***	-4.149
R <sup>2</sup>	0.264		0.261	
Adj. R <sup>2</sup>	0.236		0.233	
F-value	9.323		9.180	
Sig.	0.000		0.000	
N	163		163	

Note: \*\*\*, \*\* and \* indicate significance on the level 1%, 5% and 10%, respectively.

Furthermore, to anticipate inconsistencies in the analysis results and to produce robust estimation models, we conducted principal component analysis to reduce the components of reputation into a fewer number, so that each retained component explains maximum data variance. The score formed from the new components is a composite score which is calculated from the linear combination of all lead underwriter reputation indicators (Gudono, 2014). The analysis results presented in Table 5 columns 2 and 3 shows the regression coefficients that are negative and significant at the level of 1% and 10%. The analysis results are consistent with the results of the previous analysis (Table 4 column 2). The consistency of research results can also be seen in the result of the analysis that uses initial returns as a measurement of underpricing. Table 6 columns 1 and 2 show the regression coefficients for lead underwriter reputation that are negative and significant at the level of 5%. Thus, it can be concluded that the lead underwriter reputation is an important factor that can reduce the level of underpricing in companies conducting IPO.

## 5 Conclusions

This study examines the effect of lead underwriter reputation on underpricing in Indonesia. The reputation of the lead underwriter is considered as a signal of a company's quality that capable of reducing the level of underpricing during the IPO. Consistent with our predictions, this study proves that the lead underwriter reputation has a negative effect on underpricing level. These results are robust based on the result of sensitivity analysis. The analysis results indicate that the mechanism of signalling the company's quality through the use of highly reputable lead underwriters has proven to be effective in reducing the level of underpricing. The highly reputable underwriter is considered to have an ability to make an accurate estimation of the intrinsic value of the company. Therefore, the price of a stock during the IPO will not far different from the stock price in the capital market. This research has important implications for companies in selecting underwriter during an IPO. For companies, underpricing is considered as the cost of capital. The higher the level of underpricing, the higher the cost of capital in the IPO. This means that the funds obtained by the company during the IPO are not optimal. Therefore, the results of this study can be used as a consideration in determining the lead underwriter during an IPO. In the context of the research method, the study results provide evidence that the measurement of reputation based on the market share of underwriting value is a better measurement method than volume and frequency-based. Therefore, this study provides additional references for similar research, especially in developing countries with semi-strong market efficiency levels such as Indonesia.

Nevertheless, several limitations are admitted. This study only captures the reputation of lead underwriters based on market share one year before the underwriter is hired by a company. In addition, this study does not consider the expertise or specialisation of lead underwriters. Future study can consider lead underwriter reputation in a longer period, for example, the average reputation for three years before hired as an underwriter in a company. In addition, future research can also consider lead underwriter industry specialisation as an indicator of lead underwriter quality. This study does not consider the underwriting fees, which is another limitation of this study. The variables studied in the current study are important to be considered for future research. In the perspective of agency theory, underwriting fees are one of the variables that can motivate agents (underwriters) to work appropriately with the interests of the issuer. Thus, the agency conflict can be reduced and the company's main goal to get the maximum funding can be achieved.

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