Abstract

It is often recommended that the issue price of an IPO be equal to the fundamental value because this is the optimum price for all the parties involved in the IPO process including the underwriters and investors. However, this rarely happens in practice because in determining issue prices, certain subjective considerations are made that have nothing to do with the perceived fundamentals of the company. It is this relationship between the fundamental value at the time of an IPO and the issue price selected that is the focus of this research project. In determining whether a particular IPO has been undervalued or overvalued, most studies take the initial day closing price as a substitute for the fundamental value and compare it with the issue price. However studies such as those carried out by Purnanandam and Swaminatham (2004) demonstrate the need for a more realistic approach in determining fundamental values for the purpose of establishing under pricing/under valuation. In this particular study a retrogressive discounted cash flow approach was used to determine the fundamental values at the time of the IPOs by using the post-IPO financial performance of the companies to determine the free cash flows to the firm. These free cash flows along with a terminal value were then discounted back to the IPO date. A sample of 5 IPOs that were carried out between the year 2006 and 2010 was selected for this study. The results that were obtained after a detailed analysis were mixed, with 60% of the sampled companies showing that they were significantly overvalued at the time they went public by an average of 128.7%. It is important to note at this point that 2 of the companies that registered the largest valuation premiums namely, Eveready East Africa Ltd and Safaricom Ltd experienced sharp price reversals a few months after going public. 40% of the IPOs were found to be under valued with discounts averaging 43.5%. A mean computation of the entire sample revealed an overall average premium of 59.9% for the entire sample, this in line with the results of Purnanandam and Swaminatham (2004) that found that on average IPOs in India that were described as being under priced, were in fact over valued by an average of 50%.