IPO PREMIUMS AND INVESTOR BEHAVIOR IN THE NEUER MARKET

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ABSTRACT

This paper presents an overview of the initial public offering premiums on equities listed in the German Neuer Market during the first four years of the market. The paper includes a discussion of the organization of the exchange along with the motivation for its creation. Descriptive evidence of the initial experience of the Neuer Market is also presented.

INTRODUCTION

The German Neuer Market unites growth firms needing capital with investors seeking higher returns. Because the risk of new firms without a proven history is high, investors may be hesitant to enter the market. By establishing and regulating a platform for this market, the Frankfurt Stock Market hopes to promote growth firms and meet a demand of its investors. It is patterned after the NASDAQ in the United States. In the first four years since the Neuer Market's creation in 1997, over 300 firms have gone public. The Neuer Market is now the home of technology stocks and where the majority of the turnover of all the German stock exchanges occurs.

NEUER MARKET ORGANIZATION

Innovative growth firms are typically capital-starved. Capital is needed to expand product lines, to establish market share and for basic operations, among other uses. Initially, firms use venture capital to make an idea a reality. Upon exceeding the limits of venture capital financing, firms must look elsewhere for the capital to grow. Small firms do not have the credit record or established business record to acquire funds from traditional sources. Bank loans and the corresponding interest payments strain liquidity for young firms especially because young firms are not likely to receive favorable interest rates. Growth companies may go public to gain the next level of financing. However, the German equity market is fairly underdeveloped. Less than 750 domestic companies have official trading status. In comparison, the New York Stock Exchange is home to over 3,000 firms and the NASDAQ has over 5,000 companies listed. The German stock market recognizes the lack of opportunity to raise capital in Germany. In an effort to keep the companies from seeking funds outside of Germany, the Frankfurt Stock Exchange established the Neuer Market. This new stock exchange solely for small, growth firms matches investors seeking higher returns with companies needing capital.

The organization of the Neuer Market coupled with the backing of the Frankfurt Stock Exchange stabilizes and encourages the growth market. First, the initial public offering generates an exit strategy for venture capitalists. By supporting a way for venture capitalists to withdrawal their capital, the Frankfurt Stock Market promotes further venture capital investment in Germany. In supporting the initial phases of growth, more companies may develop and list on the Neuer Market in the future further strengthening the market.

For admission to the Neuer Market all firms must designate at least two sponsors. The designated sponsors act like specialists by providing liquidity through binding purchases and sales of the stock. In addition, shares held by company management are ineligible for sale for at least six months following the IPO. These two criteria increase confidence in the company and in turn, increase marketability of the issue. Upon fulfilling the requirements for listing, each firm must float at least 20% of the total shareholder equity with a minimum value of Euro 5 million to ensure a base level of liquidity.

In order to maintain listing in the Neuer Market, each firm must satisfy transparency and marketability requirements more stringent than the other tiers. The German stock market is divided into three tiers with decreasing requirements. The highest tier with the most stringent listing requirements is official trading on which large-capitalization firms are traded. The Regulated Market is the second tier market and has correspondingly lower regulations. The Unofficial Regulated Market is the third and largest tier with few approval prerequisites and no continuing obligations. While officially in the Unofficial Regulated Market, Neuer Market firms follow more stringent criteria for listing than the other three tiers. The additional requirements provide greater transparency and liquidity to investors. Firms listed on the Neuer Market must publish reports quarterly and annually in both German and English compared to biannual reports in German for domestic firms in the Official Market. The reports must be in accordance with either International Accounting Standards or U.S. Generally Accepted Accounting Principles, making the firms internationally comparable [2]. Unlike the other markets, the Neuer Market firms must also have at least one analysts meeting each year. The increased depth of the reporting of company information encourages comparisons with both domestic and international firms and therefore, competition for investment funds. The increased transparency from the quality of the increased reporting lowers the risk and required return of the firms.

The Neuer Market fulfills a hole in German capital markets for investors seeking higher return equity. As German investors become increasingly responsible for their own retirements, the demand for growth equities rises. Foreign investors seeking diversification and higher returns are interested in German growth companies. A country must provide an outlet for this demand or else lose it to a competing stock market such as the NASDAQ.

INITIAL PUBLIC OFFERINGS

Firms ready to go public have exceeded the financing of venture capital and are willing to risk valuation in the marketplace. Investors in small, growth firms seek higher returns but at a cost of high risk. Thus, a good IPO market indicates an appetite for risk by market participants [8]. IPOs occur in the primary market but the capital gains potential occurs in the secondary market. Investors pricing the IPOs recognize that the connection between the primary and secondary markets. The price at which they can resell the issue in the secondary market partially determines what they are willing to pay in the primary market. The price of the IPO is set based upon a fair market value of the stock. However, investment bankers unsure of the fair market price and wanting the issue to be a success tend to underprice the issue [10]. This discrepancy leads to a positive speculative return for the initial owners. Empirical evidence from the United States has shown that the average underprice is 15% but varies over time [5, 7, 9, 11]. Further studies have examined the speed of price adjustment and found it usually occurs within one day [3, 6]. The speculative return is present only initially and usually to institutional investors who are better able to gain access to the issue [4].

During 1997, thirteen firms held IPOs for a total market capitalization of Euro 4,138 million, representing just 0.57% of the total capitalization of the Frankfurt Stock Exchange. During 1998, another forty-five firms listed bringing the total capitalization to just over Euro 26 million. The firms together returned 173.9% in 1998. At the end of 1999, 198 firms were listed on the Neuer Market with a market capitalization of Euro 111,276 million, representing 8.01% of the total German stock market. The total return was 66.2%. In 2000, another 133 firms held IPOs, making the Neuer Market the home of 26.56% of all domestic shares. Fifty-six foreign companies, primarily from other European countries, are also listed. The total return for the Neuer Market was –39% for 2000. The turnover on the Neuer Market has been over 60% of the turnover on the entire market since inception.

When the demand for the shares exceeds the supply, the initial holders of the IPO receive a premium also called a speculator's return. Within the Neuer Market over ninety percent of the IPOs had positive IPO premiums. The average return over the first four years was 46%. In both 1997 and 1998, only one firm each year earned a negative return. SER Systeme returned a negative 48.86% in 1997 while Lobster Network Storage earned a negative 14.29% in 1998. The high return was 323.08% in 1997 and 308.16% in 1998. The average speculative return was 57.35% in 1997 and 75.27% in 1998. In 1999, the returns ranged from –20.83% to 360.87% and only twelve of the 132 firms listing earned negative returns. Sixteen firms earned negative speculative returns in 2000, with the majority coming in the last six months. The range of speculative returns was –25% to 433.33% for 2000. The average speculative return was lower in 1999 and 2000 than in the prior years but still high at 44.89% and 45.94%, respectively.

Technology stocks dominate the Neuer Market. The firms can be divided into ten industries. In terms of capitalization, the largest industries are technology and Internet, each making up one-fifth of the total value. Financial services at 18.38% and biotechnology at 13.76% are the next in size. Media and entertainment, industrial services, and telecommunications each make up a little over 5% of the total value. Software, information technology services and medical technology are the smallest sectors.

CONCLUSION

Smaller companies are a key source of new ideas and growth. Within Germany the breadth of the equity market has traditionally been limited to large-capitalization companies. Recognizing the lack of available capital, the Frankfurt Stock Exchange initiated the Neuer Market in 1997 to bring together these two sides. In order to provide a stable platform for this market, the Neuer Market has strict listing requirements. The regulations result in greater transparency and marketability, lowering the risk for all market participants.

The initial price and the opening price of IPOs are rarely the same, leading many investors to speculate on new issues. The price in the primary market is set intentionally lower to ensure a successful IPO. Investors bid in the secondary market hoping to own the latest growth stock with the ability to resell it at a potentially higher price. Of all the IPOs during the first four years, only thirty stocks earned negative initial returns. The majority of the stocks are in the technology area. Faced with the wide swings in the market, some IPOs reaped the benefits of the technology boom. By 2000, more initial returns were negative but the average was still over a positive 40%. The Neuer Market's purpose was to encourage firms to go public in Germany and provide an investment opportunity for German investors. The initial experience of the Neuer Market indicates that firms and investors responded to it.

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