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Determinants of IPO Valuation in Saudi Arabian Companies

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Amis & Motivation

This topic has been ignored and no study, till now, addresses the determinants of IPO premium or tries to explore the factors that affect pricing of IPO – IPO premium - in the Saudi market.

The study aims, in particular, to address the impact of certain elements on pricing of shares in some companies during IPO. The study will concentrate on the relation between IPO premium and (1) the book value of the issuing company, (2) profitability of the issuing company, (3) debt ratio of the issuing company and (4) the external auditor.



The conceptual framework

This study shall concentrate on the variances of premiums in Saudi companies. The premium is measured through establishing the difference between the offer price declared in a company prospectus and the amount of the face value of the share of that company, which is 10 SAR per share. Variations of IPO price in companies are controlled by certain financial and non-financial elements. This study tries to shed light on some of these elements in the Saudi market and in particular the elements, which are connected with the financial statements.



According to signaling theory, managers of companies going public, tend to present wanted and required information within prospectuses such as present and expected growth opportunities. They aim to emphasize the value of the company for outsiders and hence increase the share value, Certo (2001). This study will use signaling theory in addition to the theory of resources exploitation, which states that institutions are exploiting their resources to distinguish themselves from other competitors. This theory is considered as complementing theory for signaling theory, Daily (2005), as companies, try during book – building to convince investment institutions of the feasibility of investment in their shares.



Within the context of fair value valuation of the price of initial offering shares, the accounting model, presented by Ohlson and Feltham, bridges the gap between a firm's real value and the available historical financial and accounting data of the firm. Ohlson and Feltham model contributes also to establishing a proper conceptual framework of the studies about the relevance of accounting data and value. The results of the model testing can be used for assessing the impact of accounting information on the share real value, Richardson and Tinaiker (2004), Holthausen and Waths (2001). The model provides relevant information for the increase of the share real value against the book value, represented in assets valuation, which is not recognized in accounting.



Hypotheses Development

Bensveniste and Spindt (1998) document that the issuing firms, usually present themselves to the investors in a manner better than their reality.

These studies have come with a general result stating that the IPO firms are generally overpriced, comparing with the actually listed firms.

This study will examine the variations in premiums between Saudi firms. It is assumed that the premium is affected by a number of financial and non financial factors, and hence this study shall try to introduce some of these factors in the Saudi market.



IPO premium and book value

Ohlson develops a model through which equity market value is estimated as a linear function for historical earnings and equity book value. The book value is one of the most important factors that should be considered in determining share price, whether by investors or by firms. Klein (1996) states that the share price has a direct relation with IPO's book value. This gives rise to the following hypothesis:

H1 Assuming that all other factors are controlled, whenever the book value increases, the IPO premium of Saudi firms will increase.



Premium and profitability

In continuation to what has been stated by Kim and Ritter (1999) regarding the effect of profitability on IPO pricing and what stated by Aggarwal, Bhagat and Rangan (2007) about the effect of profitability on pricing, this study expects that the IPO premium increases with the increase of the share profitability. This leads us to assume the following hypothesis to understand the impact of profitability on premium:

H2 Assuming that all other factors are controlled, whenever the earnings per share increases, the IPO premium of Saudi firms will increase.



Premium and debt

This study, through including debt ratio in its test model, tries to explore the impact of this ratio on determination of IPO premium. Increase of debt ratio is expected to have a negative effect on determination of IPO premium. This leads to measuring the impact of debt ratio in the firms going public according to this hypothesis:

H3 Assuming that all other factors are controlled, whenever the debt ratio decreases, the IPO premium of Saudi firms will increase.



The premium and the size of external auditor

The studies of Titman and Trueman (1986), Simunic (1989), Beatty and Stein (1987) confirm the existence of reverse relation between demand on auditors quality and IPO risks. Based on these studies, this paper expects an existence of positive relation between the quality of auditors and the IPO price – premium.

H4 Assuming that all other factors are controlled, IPO premium of Saudi firms will increase when the size of the external auditor is big.



RESEARCH METHODOLOGY

The theoretical study explains that the IPO premium may be affected by four main variables, which are: the book value, earnings per share, debt ratio and the size of external auditor. Based on this we can formulate the model regression for testing each one of the three variables of the IPO premium as follows:

$$P_{t,i} = a + \beta_1 BV_{t-1,i} + \beta_2 EPS_{t-1,i} + \beta_3 Debt_{t-1,i} + \beta_4 Auditort_{t-1,i} + e$$

Where:



SAMPLE SELECTION

The study population represents 28 Saudi companies which have entered the IPO in the Saudi market with a premium during the period from 2005 to 2010.



Descriptive statistics

	Observations	Mean	Standard deviation	Minimum	Maximum
IPO premium	28	38.37	0.196	2.00	100.00
Book value	28	14.79	13.95	8.56	86.18
Earnings per share	28	3.85	4.58	0.29	24.68
Dept ratio	28	0.407	0.196	0.00	0.80



Results

The statistical results of the study model show, in general, that the model is significant, and has explanatory power of 30%.

General Model

$$P_{t,i} = a + \beta_1 BV_{t-1,i} + \beta_2 EPS_{t-1,i} + \beta_3 Debt_{t-1,i} + \beta_4 Auditor_{t-1,i} + e$$

Variables	β Coefficients	T	Significance level
A	25.18	2.08	0.048
Book value	- 0.222	-0.43	-.668
EPS	3.637	2.39	0.025
Debt	9.14	0.48	0.6336
Auditor	-1.639	-0.20	0.843

Adjusted R2 = 0.30
Variance test analysis = 4.17F



This result is contrary to the research expectation; as the premium is expected to increase according to the increase in book value as per the literature review.

Results show that the EPS is the only significant variable of the study variables.

This result is considered logical, as the relation between EPS with the share price is stable for a long time. The most important thing considered by an investor is the net profit of the company and earnings per share.



The statistical test reflects no significance of the debt ratio variable. This means that the Saudi market does not consider the debt ratio when evaluating the IPO shares.

The results of the table show that size of auditor variable has reverse impact on the IPO premium with negative coefficient of 1.63. This means that the value of the premium decreases with the increase of auditor size. Nevertheless, the negative coefficient is not significant, which indicates its weak impact on the IPO premium.





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