

# The Effect of Initial Public Offers on Long run Stock Performance: Evidence from the Nairobi Securities Exchange

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**Abstract-** The main objective of any business is to maximize shareholders' wealth therefore this study endeavored to find out whether Initial Public Offers (IPOs) actually help a firm to achieve this objective in the long run. This study thus sought to find out the long run performance of a company's stock after it goes public. The study therefore looked at variables that show the performance of the stock in the long run such as share price, earnings per share and price earnings ratio of the stock. The study analyzed seven companies which went public between 2000 and 2006 using the Buy and Hold Abnormal Returns (BHAR) model. Observations were made on a yearly basis over six years to allow the researcher to analyze (BHAR) for the period of six years. The study drew data from balance sheets and the Income statements and information from the Nairobi Securities Exchange (NSE) on the companies' earnings.

Hypothesis testing was done using the student's t-test at 95% confidence level to find whether there is significant under performance of IPOs in the long run. The trend analysis findings showed that share price, price earnings ratio and the overall stock performance decreased in the long run after IPO. However the earnings per share increased after IPO. The buy and hold abnormal returns decreased in the long run after IPO; however the test of significance findings at 5 % level of significance showed that the decrease in stock performance after IPO was not significant. Generally the finding showed that the stock under performs in the long run after IPO but not significantly.

**Index Terms-** Long run, Initial Public Offer, Stock performance, Buy and Hold Abnormal Returns

## I. INTRODUCTION

As a firm becomes large, private financing through self-financing or use of debt may be inadequate to raise capital to fund expansion; this is the point at which it is optimal to go public, even though there are substantial costs associated with "outside" equity. Private firms therefore can raise money by offering securities for sale to the public for the first time. This is called an initial public offering and through the initial public offering a firm is said to have gone public (Ritter, 1991).

Mbui (2001) explains that the decision to list is explained mainly by the need to raise funds for expansion and growth without the interest burden of funds borrowed from lending institutions, to improve the liquidity of their securities and also to increase the public awareness about the company and its products.

Many companies are desirous of making an initial public offering, the main reason being to raise equity capital and to create a public market in which shareholders of the company can convert some of their wealth into cash at a future date (Bessler and Thies, 2007). This is in line with the main objective of any business which is to maximize shareholders' wealth. However, the decision as to whether or not to participate in the IPO rests with stock market investors. Further, investors would be interested to know how long they should maintain ownership of the stock so as to reap the maximum benefit out of it. This is possible only if they understand the nature of the performance of the stock over time.

## II. RESEARCH ELABORATIONS

Numerous studies have examined the performance of initial public offerings (IPOs) in several different markets and the majority of the studies have shown underperformance in the long run. (Ritter, 1998; Durukan, 2002; Bessler and Thies, 2007; Goergen et al, 2007; Kirkulak, 2008; Ljungqvist, 1997). Several studies have however shown positive abnormal returns in the long run (Kiymaz, 1996; Ozer, 1999). Lee et al (1996) found IPOs in Australian markets from 1976 - 1989 also underperformed in three years.

There are three common explanations for this underperformance. Miller (1977) assumes that there are constraints on shorting IPOs, and that the investors have heterogeneous expectations on the value of the firm. The most optimistic investors buy the IPO, and their valuation determines the first trading day's price. As the divergence in opinion about the firm's value becomes smaller, the valuation of the most optimistic investors and hence the trading price will be lowered, resulting in long-run underperformance.

Another explanation is the fads in the IPO market (Aggarwal and Rivoli, 1990; Shiller, 1990; Loughran and Ritter, 1995). During these periods investors become overly optimistic about the firm's value, and push the price higher than the fair value. Issuers are able to take advantage of these "windows of opportunity" to sell the stocks at a higher price.

The third explanation is "window dressing," which postulates that firms manipulate their accounting numbers to make the firms look better before public offering; thus beguiled investors will pay a higher price than the fair one. In the long-run investors learn the true value of the firm and the stock price will fall back (Teoh, Welch and Wong, 1998)

Bessler and Thies (2007) investigated the long run performance of IPOs in Germany between 1977 and 1995. Their findings suggested that the subsequent financing activity in the equity market is the most important factor for determining the future performance of an IPO. Durukan (2002) confirmed the anomaly that the IPOs provide abnormal initial returns in his study of the Istanbul Stock Exchange. The return analysis also generated results that support the fads hypothesis. That is, the long-term returns are negatively associated with short-term returns. Kiyamaz (1996) and Ozer (1999), who also investigated IPO performance in the Istanbul Stock Exchange showed that the IPOs do not underperform the market in the long run as is the case in majority of the other markets. Goergen et al, (2007),

found that small firms behave differently from large firms and suffer from worse long-run performance than large firms.

Kirkulak (2008) found out that Japanese IPOs underperform in the long-run. The results suggest that although Venture capital-backed companies have high initial returns, they perform significantly worse over a three-year time horizon than non-Venture capital-backed companies. Ritter (1998), documented that the earnings per share of companies going public typically grows rapidly in the years prior to going public, but then actually declines in the first few years after IPO. In Africa, evidence of IPO underperformance has also been documented by Michael and Ivan (1987) and Alli et al. (2010).

### III. FINDINGS

#### 4.1 Long run effects of IPO on share price

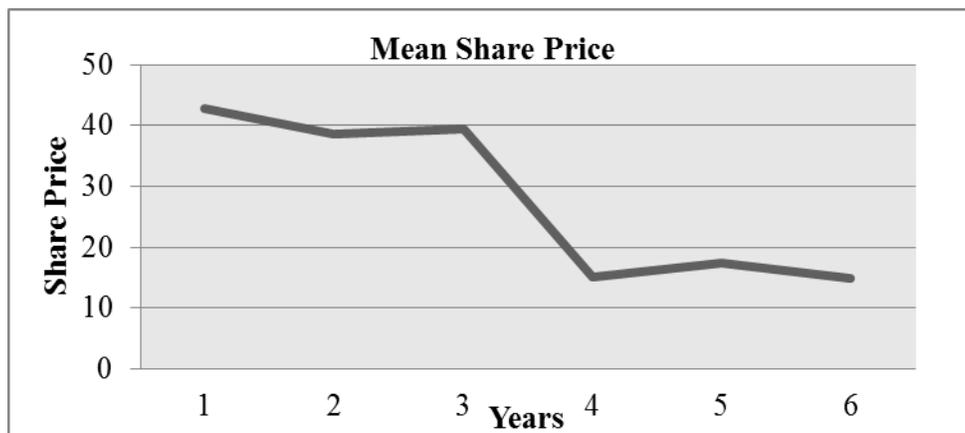
**Table 4.1 Share Price**

Company / Years	1	2	3	4	5	6
<b>Kenya Reinsurance</b>	28.5	23.5	20.5	21.75	16.85	15.52
<b>Access Kenya</b>	23.25	20.75	20.25	13.5	5.15	6.28
<b>Scangroup Limited</b>	24.75	29.75	26	26.5	45.6	41.5
<b>Kengen</b>	39.25	26	24.5	14.55	17.1	13.55
<b>Equity Bank</b>	139	150	176	14.35	26.75	16.4
<b>Mumias Sugar Co.</b>	26.6	12.7	6	12.85	7.15	8.52
<b>Eveready East Africa Ltd</b>	17.95	7.95	3.5	2.6	3	1.75
<b>Total P/E ratio</b>	299.3	270.65	276.75	106.1	121.6	103.52
<b>Mean share price</b>	<b>42.75714</b>	<b>38.66429</b>	<b>39.53571</b>	<b>15.15714</b>	<b>17.37143</b>	<b>14.78857</b>

Table 4.1 shows the share prices of the companies under the study over a period of six years. Year one represents the first year after the company goes public all the way up to the sixth year of listing. All the stocks showed a decline in the prices of

stocks. The short run period, that is, three years shows decline of the prices with a small margin but from the third year the prices drop drastically. The share price of stocks therefore decreases in the long run.

#### Trend of Share Price



**Figure 4.1: Trend of Mean Share Price**

Figure 4.1 shows the mean share price of the stocks from the first year after listing up to the sixth year. It is evident from the analysis that share price declines but remains relatively stable for

the first three years and from the third year the mean share price is seen to decline steadily up to the sixth year. Generally, the overall mean share price of the stocks decreased after companies

go public. From the trend in the figure above, it is evident that share price of stocks underperforms in the long run period.

**4.2. Long run effects of IPO on Earnings per share**

The earnings per share is also an indicator of the performance of a stock. This ratio shows the earnings for each

share of the company. Table 4.2 shows the earning per share of the seven companies under the study from the first year after initial public offer up to the sixth year.

Earnings per share was calculated as:  $\text{Earnings per share} = \frac{\text{Total earnings attributable to ordinary shareholders}}{\text{Outstanding shares}}$

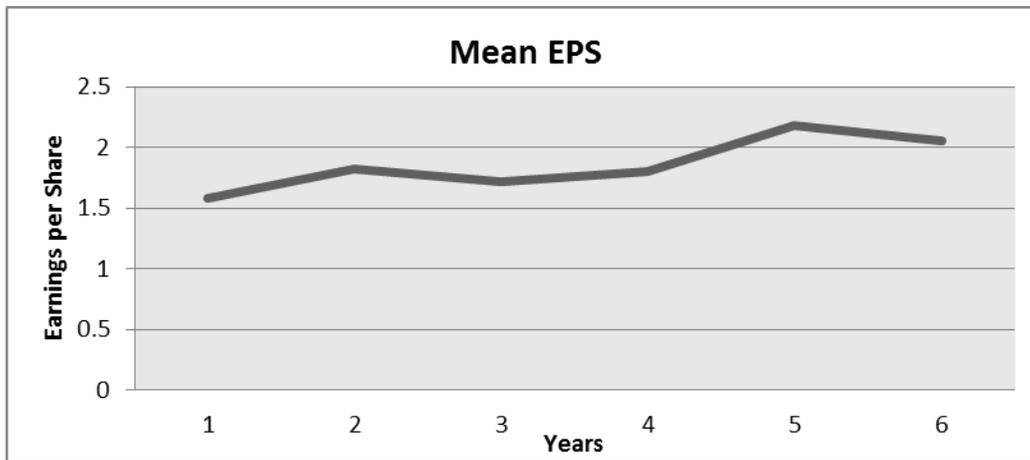
**Table 4.2 Earnings per Share**

Company	Years	1	2	3	4	5	6
Kenya Reinsurance		1.5987	1.9847	1.6865	1.8547	1.9847	2.568
Access Kenya		1.76954	2.2547	1.700125	1.81547	2.36587	2.3658
Scangroup Limited		1.14987	1.36587	1.76854	1.765987	2.1547	1.6584
Kengen		1.9754	1.72364	1.74879	1.78547	1.874	1.91487
Equity Bank		2.01254	1.5987	1.729897	1.847	1.6559	2.03654
Mumias Sugar Co.		1.3658	1.9874	1.6987	1.75647	2.5987	1.8759
Eveready East Africa Ltd		1.15478	1.8547	1.674	1.795487	2.6587	1.97451
<b>Total EPS</b>		11.02663	12.76971	12.006552	12.620584	15.29257	14.39402
<b>Mean EPS</b>		<b>1.57523</b>	<b>1.824244</b>	<b>1.7152217</b>	<b>1.8029405</b>	<b>2.1846528</b>	<b>2.056289</b>

Table 4.2 shows the earnings per share over a period of six years for the seven companies under the study. The mean EPS for all the companies under the study showed that the earnings per share increases from the first year after the IPO. In the

second year however there is dilution as can be seen by the decrease, but from the third year the earnings per share increases steadily. In the first three years there is an increase but with a small margin, in the long run however the increase in the ratio is much more significant.

**Trend of Earnings per Share**



**Figure 4.2 Mean Earnings per Share**

Figure 4.2 shows the mean earnings per share of the companies' after listing in the NSE. The trend shows the EPS increase after the first year then becomes steady and increases again in the fourth year. Generally, the EPS increases after the IPO. This shows that the earnings increased relative to the number of outstanding shares. From the trend in figure 4.2, it is evident that the EPS increases in the long run after IPO.

**4.3 Effects of IPO on Price-to Earnings Ratio**

The price earnings ratio shows the future expectations of investors therefore it was used as an indicator of stock performance in this study. The researcher analyzed the price earnings ratio of the seven companies from the first year after the companies went public up to the sixth year. The table below shows Price earnings ratio of the seven companies for six years after initial public offer.

Price-to Earnings Ratio was calculated as:  $\text{Price-to Earnings Ratio} = \frac{\text{Market Price per Share}}{\text{Earnings per Share}}$

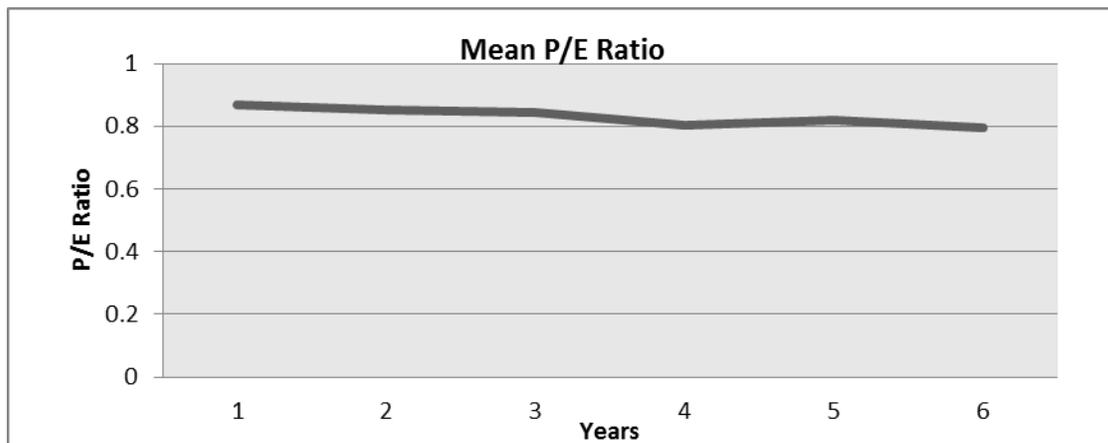
**Table 4.3 Price-to Earnings Ratio**

Company	Years	1	2	3	4	5	6
Kenya Reinsurance		0.9487	0.8547	0.83547	0.769854	0.824971	0.785794
Access Kenya		0.9147	0.89745	0.886547	0.7985	0.796547	0.802547
Scangroup Limited		0.84597	0.9147	0.81254	0.85471	0.856947	0.779854
Kengen		0.81647	0.79854	0.78654	0.81647	0.769854	0.723658
Equity Bank		0.86944	0.84756	0.8547	0.78974	0.89745	0.85476
Mumias Sugar Co.		0.79845	0.814579	0.9147	0.838745	0.75981	0.83471
Eveready East Africa Ltd		0.87654	0.83547	0.8249	0.759482	0.8197	0.795647
<b>Total P/E ratio</b>		6.07027	5.962999	5.915397	5.627501	5.725279	5.57697
<b>Mean P/E ratio</b>		<b>0.867181</b>	<b>0.851857</b>	<b>0.845057</b>	<b>0.803929</b>	<b>0.817897</b>	<b>0.79671</b>

Table 4.3 shows the P/E ratio of the seven companies under the study from the first year after listing in the NSE up to the sixth year. The researcher calculated the mean Price earnings ratio for all the companies so as to show the general effect of IPO

on the P/E ratio in the long run. The mean P/E ratio showed decrease from the first year after listing and the decrease is constant up to the sixth year. The researcher then used this data to create a trend of the mean P/E ratio.

**Trend of Price earnings ratio**



**Figure 4.3: Trend of mean Price earnings ratio**

Figure 4.3 shows the mean price earnings ratio of the companies'. From the figure, it can be observed that the P/E ratio decreases at a slow rate from the first year after the IPO. The trend shows a decline in the ratio over the six years under the study though not at a high rate. Generally the trend shows a decrease in the mean P/E ratio. This shows that the investors expect lower returns in the long run after a company is listed in the NSE.

**4.4 Overall Stock Performance**

The researcher analyzed the overall stock performance of the companies under the study. This was done using the results of the share price, earnings per share and price earnings ratio, specifically the mean that was used to create a trend in figures 4.1, 4.2 and 4.3. The analysis was necessary so as to show the combination of the three aspects and to come up with a trend. Table 4.4 shows the mean of share price, EPS and P/E ratio for all the six years analyzed in this study. The final column shows the mean of the three aspects that were used to show stock performance in this study.

**Table 4.4 Overall Stock Performances**

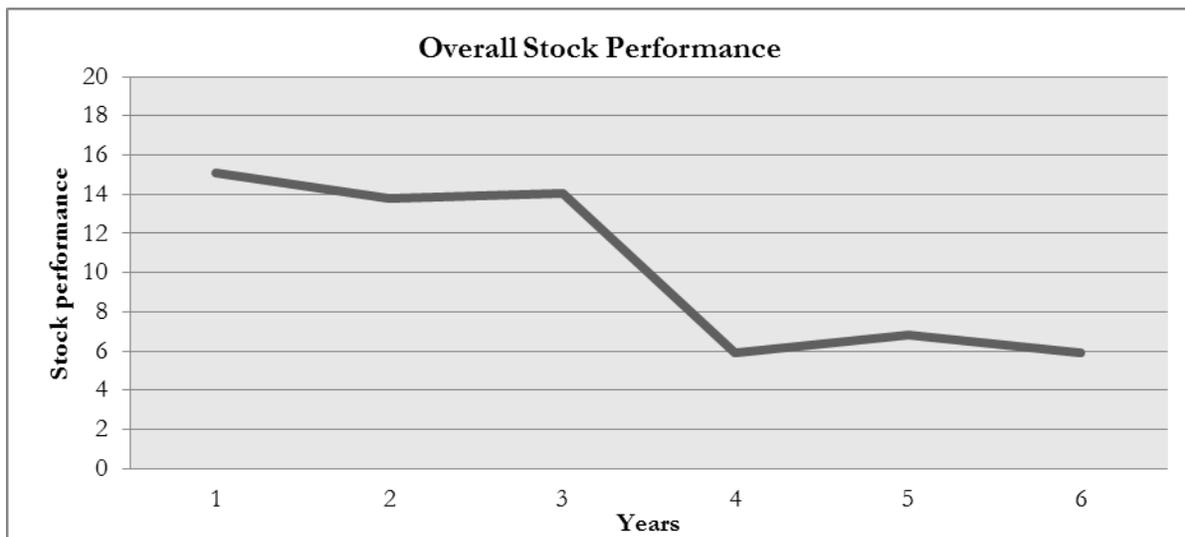
Years	Mean price share	Mean Ratio	P/E	Mean EPS	Overall Stock performance
1	42.75714	0.8671814		1.5752329	<b>15.0665181</b>
2	38.6642857	0.851857		1.8242443	<b>13.780129</b>

3	39.535714	0.845056	1.7152217	<b>14.0319972</b>
4	15.157142	0.8039287	1.8029406	<b>5.9213371</b>
5	17.371428	0.817897	2.1846529	<b>6.79132597</b>
6	14.7885714	0.79671	2.0562886	<b>5.88052333</b>

Table 4.4 shows the mean of the Share price, EPS and the P/E ratio from the first year after the companies were listed in the NSE up to the sixth year. It is evident that the performance is relatively stable in the first three years because there is decrease in performance in the second year but improvement is seen in the third year. From the fourth year however there is decline in

performance of the stocks with a large margin as can be seen by the drop from 14.031997 to 5.921337. The performance of the stocks can be seen to be poor as compared to the short run performance. The researcher then used a line graph to create a trend of the overall stock performance.

**Trends in Overall Stock Performance**



**Figure 4.4: Trend of overall Stock performance**

Figure 4.4 shows the overall stock performance of the seven companies under the study based on the mean share price, mean EPS and the mean P/E ratio over a period of six years. From the figure, the overall stock performance of companies declines after the companies are listed. The second year shows some stability but then there is a sharp decline from the third year.

It is evident that the first three years there was slightly poor performance but in the long run period, that is, the six years the stock performance is poor. This shows that the long run performance of stocks is generally poor.

**4.5 Buy and Hold Abnormal Returns**

The buy and hold abnormal returns have been used as the basis of study for most empirical studies about long run performance of stocks. The researcher therefore calculated the BHAR to investigate whether the stocks underperformed in the long run. The researcher calculated buy and hold abnormal

returns (BHAR) of all the seven companies under the study annually from the first year after the companies listed in the NSE up to the sixth year.

**Stock Returns**

In order to calculate Buy and Hold Abnormal Returns, the return of the stock is subtracted from the return of the IPO.

$$BHAR = \frac{1}{N} \sum_{i=1}^N [(\prod_{t=1}^T (1 + R_{i,t})) - (\prod_{t=1}^T (1 + R_{M,t}))]$$

Where N is the number of stocks and  $R_{M,t}$  is the benchmark return at time  $t$ .

Stock returns were calculated as: Dividend per share/ Stock nominal price

**Table 4.5 Buy and Hold Abnormal Returns**

Company / Years	1	2	3	4	5	6
Kenya Reinsurance	2.45614	4.2553191	4.8780487	5.74712643	10.9792284	8.1673201
Access Kenya	1.2903225	1.9277108	1.97530864	2.222222	0	2.1834116

<b>Scangroup Limited</b>	3.02521008	2.88461538	1.96078431	1.13821138	1.6867469	1.7309228
<b>Kengen</b>	3.07692307	3.67346938	3.43642611	2.9239766	3.6900369	3.4971035
<b>Equity Bank</b>	1.43884892	1.3333333	1.70454545	2.78745644	2.9906542	4.87804878
<b>Mumias Sugar Co.</b>	0	8.6141766	2.56934	3.618677	2.9790209	2.6530447
<b>Eveready East Africa Ltd</b>	0	0	0	0	0	0
<b>Total BHAR</b>	11.28744457	22.68862456	16.52445321	18.43766985	22.3256873	23.10985148
<b>Mean BHAR</b>	<b>1.61249208</b>	<b>3.24123208</b>	<b>2.36063617</b>	<b>2.63395284</b>	<b>3.1893839</b>	<b>3.30140735</b>

Table 4.5 shows the buy and hold abnormal returns calculated annually over a period of six years. Some of the companies such as Kenya Reinsurance, Access Kenya and Equity Bank showed increase in BHAR from the first year after listing up to the sixth year. There are other companies that showed decrease in the abnormal returns such as ScanGroup Limited, Kengen and Mumias Sugar Co.

Eveready East Africa results were exceptional as they showed that the company did not record any buy and hold abnormal returns from the first year after listing in the NSE. This is because since the company went public it had not offered

dividends for its shareholders for the entire period of six years. This meant that the researcher did not have a figure for dividend per share in the calculation thus the results showed no abnormal returns.

It was therefore necessary to calculate the mean buy and hold abnormal returns for all the seven companies. The mean BHAR showed decrease from the first year after listing. There was increase in the returns in the third year then a steady decrease after that. The researcher then used a line graph to show the trend on the buy and hold abnormal returns.

### Trend of Buy and Hold Abnormal Returns

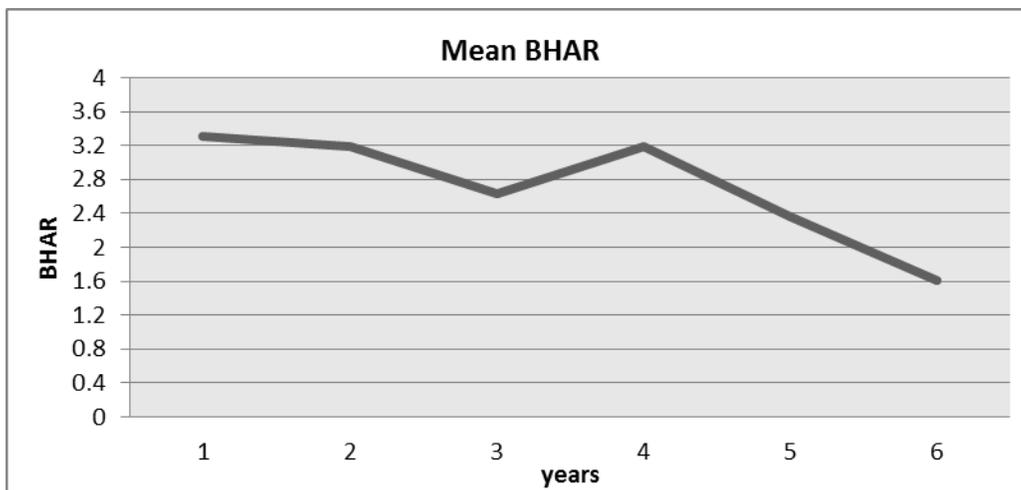


Figure 4.5 Trend of mean Buy and Hold Abnormal Returns

Figure 4.5 shows the trend of the mean buy and hold abnormal returns of the seven companies under the study from the first year after listing in the NSE up to the sixth year in the post IPO years. The buy and hold abnormal returns decline in the first three years rises in the fourth year then declines steadily. Generally, there is a decline in buy and hold abnormal returns in the long run after the companies go public. This shows that the stocks of the companies underperform in the long run as is evident from the trend.

### 4.6 Tests of Significance

Hypothesis testing on whether the effect of IPO in the long run was significant was done using MS Excel t test two sample means with unequal variances for each category and yielded the following results. The tests were done at a 95% level of significance using the 't' student test.

#### 4.6.1 Share price 't' Statistic

Hypothesis testing was done to establish whether the effect of IPO on share price in the long run is significant.

H<sub>0</sub>: There is no significant effect of IPO on share price of companies quoted at Nairobi Securities Exchange in the long run.

H<sub>A</sub>: There is a significant effect of IPO on share price of companies quoted at Nairobi Securities Exchange in the long run.

	Variable
Mean	28.0457138
Variance	0.000255791

Observations	7
Hypothesized Mean Difference	0
Df	7
t Stat	-4.032479368
P(T<=t) one-tail	0.002490057
t Critical one-tail	1.894578604

The share price 't' statistic computed was -4.03248 and the p value was 0.00249 and fell in the critical region, implying that we reject the null hypothesis that there is no significant effect of IPO on share price of stocks in the long run and accept the alternative hypothesis that there is a significant effect of IPO on share price of stocks in the long run.

#### 4.6.2 Earnings per share 't' Statistic

	<i>Variable</i>
Mean	1.8954473
Variance	0.002688529
Observations	7
Hypothesized Mean Difference	0
Df	5
t Stat	0.634863596
P(T<=t) one-tail	0.2767141
t Critical one-tail	2.015048372

The computed earnings per share t statistic was 0.63486 and the p value was 0.27671 and fell in the acceptance region thus accept the null hypothesis that there is no significant effect of IPO on earnings per share of companies in the long run.

#### 4.6.3 Price earnings ratio 't' Statistic

Hypothesis testing was done to establish whether the effect of IPO on price earnings ratio in the long run is significant.

	<i>Variable</i>
Mean	0.711804
Variance	0.000654
Observations	7
Hypothesized Mean Difference	0
Df	7
t Stat	-2.31975
P(T<=t) one-tail	0.026707
t Critical one-tail	1.894579

The computed price earnings ratio test statistic was -2.31975 and the p value was 0.026707 and fell in the critical region thus reject the null hypothesis and accept the alternative hypothesis that there is a significant effect of IPO on price earnings ratio of companies in the long run.

#### 4.6.4 Stock performance 't' Statistic

Hypothesis testing on whether there is a significant under performance of IPO in the long run of companies after going

Hypothesis testing was done to establish whether the effect of IPO on earnings per share in the long run is significant.

H<sub>0</sub>: There is no significant effect of IPO on earnings per share of companies quoted at Nairobi Stock Exchange in the long run.

H<sub>A</sub>: There is a significant effect of IPO on earnings per share of companies quoted at Nairobi Stock Exchange in the long run.

H<sub>0</sub>: There is no significant effect of IPO on price earnings ratio of companies quoted at Nairobi Stock Exchange in the long run.

H<sub>A</sub>: There is a significant effect of IPO on price earnings ratio of companies quoted at Nairobi Stock Exchange in the long run.

public was done using MS Excel t test two sample means with unequal variances for each category and yielded the following results.

The tests were done at a 95% level of significance using the two tail test.

H<sub>0</sub>: There is no significant underperformance of stocks in the long run post-IPO.

H<sub>1</sub>: There is a significant underperformance of stocks in the long run post-IPO.

	<i>Variable</i>
Mean	10.24530512
Variance	0.002465867
Observations	7
Hypothesized Mean Difference	0
Df	8
t Stat	-1.327926278
P(T<=t) one-tail	0.110419532
t Critical one-tail	1.859548033

The computed stock performance test statistic was -1.3279263 and the p value was 0.1104195 and fell in the acceptance region thus accept the null hypothesis that there is no significant underperformance of stocks in the long run post-IPO.

#### IV. CONCLUSIONS

The study has shown that the overall stock performance in the long run after going public under perform in terms of trend analysis but not significantly. Companies that are private should start thinking of going public to reap the benefits associated with it. Though there substantial costs associated with going public, companies should not shun from the process since it has numerous benefits.

The study has shown that the stock performance of companies is poor in the long run based on the buy and hold abnormal returns. This should however not put to a halt the process of going public. There is the need to look at other motivators. Some of the motivators include; raising public capital to finance growth; allowing firms to have access to external financial sources; improved visibility and reputation i.e. the social capital to help the company to venture into new entrepreneurial opportunities.

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