Research in International Business and Finance 34 (2015) 52–65

Contents lists available at ScienceDirect

Research in International Business and Finance

journal homepage: www.elsevier.com/locate/ribaf

Allocation of shares to foreign and domestic investors: Firm and ownership characteristics in Swedish IPOs☆

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ARTICLE INFO

Article history:
Received 11 September 2014
Received in revised form 2 December 2014
Accepted 18 December 2014
Available online 27 December 2014

Keywords:
Finance
IPO
Foreign investors
Allocation
Underpricing
Breadth of ownership

ABSTRACT

In this article, we analyze underpricing of initial public offerings (IPOs) and holdings following offerings in Sweden. By exploiting a unique hand-collected data set with information on the ultimate holdings by institutional and individual investors, as well as boards of directors, we find, as most prior studies, that IPOs on average are underpriced. IPOs with low (high) initial return have higher (lower) holdings by individual investors. Institutional investors are, to a greater extent than individual investors, also able to identify underpriced firms.

1. Introduction

Initial public offerings (IPOs) are an important component of financial economics. The finding that IPOs on average are underpriced and, hence, associated with a positive first day return (the initial

☆ We thank Usha Mittoo and seminar participants at the SNEE Conference in Mölle, 2012 for helpful comments. We also thank an anonymous referee for helpful comments to improve the paper. We acknowledge excellent computational assistance from Håkan Mattsson and Mikael Segerlund. We also thank Andreas Lundell at Euroclear Sweden for helpful comments as well as providing us with detailed data on stock ownership. Martin Abrahamson acknowledges financial support from Svenska Spel. We remain responsible for all errors.

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http://dx.doi.org/10.1016/j.ribaf.2014.12.002
0275-5319/

return, IR) is perhaps one of the most well-recognized anomalies in corporate finance.[1] Empirical findings also report that IPOs underperform in the long run. In the empirical-oriented literature related to IPOs, there is ample evidence that this is a clear departure from market efficiency, and the fact that substantial sums of money have been left on the table has also rendered the anomaly as one of the puzzles in finance, as described by Brealey et al. (2014). Furthermore, as reported by Loughran et al. (1994) and later updated on Ritter's web-page, the well-documented underpricing of IPOs seems to be valid in several markets and also over long time periods (Chambers and Dimson, 2009).

One explanation for the underpricing of IPOs is the model by Rock (1986) which is based on the winner's curse problem. In his model, investors are classified into two groups, informed and uninformed. Informed investors have superior information and can identify IPOs when the offer price (OP) is lower than the market price (MP) whereas uninformed investors do not have this skill. The adverse selection problem implies that informed investors will only subscribe to underpriced IPOs (OP < MP) while the uninformed will subscribe in underpriced as well as overpriced IPOs (OP > MP). Hence, the uninformed investors will receive all overpriced IPOs, whereas they will only receive fractions in underpriced offerings as these will be oversubscribed. The adverse selection problem between the groups implies that in equilibrium, IPOs must, on average, be underpriced.

An additional explanation for the underpricing focuses on the role of the underwriter. Beatty and Ritter (1986) report that underwriters tend to underprice more (less) in offerings characterized as more (less) speculative. Prior studies have also demonstrated that underpricing is lower when the firm is taken public by a prestigious underwriter (Carter and Manaster, 1990). More recently, Roosenboom (2012) reports that underwriters in France, who also estimate the ex-ante market price prior to the flotation, deliberately underprice IPOs.

The contributions of this paper are twofold. It contributes to the IPO literature with analyses of firm and offer characteristics. Furthermore, it contributes to the literature related to corporate governance and equity ownership issues by different investors after controlling for domiciles.

We examine in detail whether domestic and foreign investors have different views and take different actions related to IPOs. Badrinath and Wahal (2002) and Sias et al. (2006) provide empirical support for the notion that stock ownership as well as breadth of ownership (defined as the fraction of investors holding the stock to all investors in the market) reflects investor' confidence in firms. In other words, given that institutional investors monitor firms in detail and thereby possess superior information (e.g., Cohen et al., 2002; Gibson et al., 2004), we posit that these investors should be able to identify underpriced IPOs and thereby "pick the cherries".

We are in a position to examine the "nepotism hypothesis" by Ritter and Zhang (2007), which is when investment banks allocate underpriced IPOs to affiliated funds. We test this hypothesis by examining holdings for three investor categories following an IPO: (a) domestic institutional investors, (b) foreign investors and (c) domestic individual investors. Given the conventional wisdom that institutional investors have better insights into monitoring firms, we posit that stock holdings by domestic individual investors will be lower (higher) in underpriced (overpriced) IPOs.

We examine stock ownership by the board of directors (BoDs) surrounding and following the IPO. Several studies have focused on the expiration of the lock-up period of BoDs, e.g., Chen et al. (2012) and Hakim et al. (2012). In this study, we examine BoDs holdings prior to the IPO until 3 years after the IPO.

Our paper is closely related to the extensive literature within the IPO area. For instance, Fernando et al. (2004) indicate that the relation between underpricing and the offer price for IPOs in the US can be described as being U-shaped. They also report that a higher offer price is related to an underwriter with a high reputation. Further, our study is related to the size (or the public float) in the flotation. As noted by Michel et al. (2014), the size of the IPO ("public float") is related to the long-run returns for which smaller (larger) public floats have higher (lower) post-IPO returns. Ritter and Zhang (2007) focus on the allocation of stocks in an IPO and report some support for the nepotism hypothesis.

[1] Underpricing, or the Initial Return *IR*, is defined as the difference between the first day's closing price (CP) less the offer price (OP) divided by the offer price for firm *i* on the first trading day on the stock exchange, day *t*. Thus, the *IR* for firm *i* is given by the expression: $IR_i = (CP_{i,t} - OP_i)/OP_i$.