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The role of optimistic news stories in IPO pricing

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ABSTRACT

This study investigates the influence of optimistic news stories on first-day pricing of initial public offerings (IPOs) in Australia between 1995 and 2005. Unlike the United States, Australia has no quiet-period regulation limiting the dissemination of information from media before IPO listing dates. We find that optimistic news stories are negatively associated with IPO underpricing. Results from a relative valuation model show that IPOs which received positive news stories ahead of the first trading day are not overpriced relative to their industry benchmarks. These results suggest that optimistic news stories mitigate information asymmetry and adverse selection problems. However, optimistic news stories do not appear to inflate the share price on the first day of trading. Our findings suggest that regulation mandating a 'quiet period' before the commencement of trading in IPOs is neither necessary nor desirable in the Australian environment.

1. Introduction

Initial public offerings (IPOs) are characterised by a high level of information asymmetry between potential investors and issuers. Because of this information asymmetry, it is often difficult for IPO issuers to easily communicate their capabilities and prospects to potential investors. As a result, it makes it difficult for investors to price the new issue properly. Hence, this can cause adverse selection and a moral hazard problem, making IPOs a risky investment (Beatty and Ritter, 1986; Ritter and Welch, 2002). To induce investment IPO firms tend to offer a discount on issue price (often in the form of underpricing). However, discounting the IPO issue price may not be in the best interest of issuers as it represents money 'left on the table' and reduces IPO proceeds available to finance the firm's operations. To reduce the information gap, IPOs may distinguish themselves in the market using a variety of signals (Ritter and Welch, 2002). Research has documented a number of indirect IPO quality signalling channels, including the retaining of substantial ownership by insiders (Leland and Pyle, 1977), hiring quality auditors or appointing reputable underwriters (Titman and Trueman, 1986). Few studies have examined the direct signalling effect of news stories about an IPO firm.

In the Australian environment, where the offer/issue price is fixed, news stories immediately preceding the IPO listing date is unlikely to be informative to the professional investors, but it may play an informative role for retail investors (individuals or uninformed investors). Retail investors have limited access to IPOs because investment bankers usually favour their large and established customers in allocating IPO shares (see Rock, 1986; Benveniste and Spindt, 1989). So news stories are potentially an important source of information for uninformed investors. Liu et al. (2013) argue that news or other media coverage preceding an IPO listing is unlikely to contain any "genuine news" – new, material information – in addition to what is in the prospectus. Therefore, news stories reaffirm the information in the prospectus assisting

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retail investors to make an informed decision. In addition, while uninformed investors have access to information in the IPO prospectus, they might hesitate to participate in IPO subscriptions due to the 'winner's curse' proposed by Rock (1986). Similarly, uninformed investors may lack specific knowledge of the IPO firm's future cash flow and avoid the risk of investing because of high information asymmetry. By providing streamlined information about IPOs through public channels, news reports may reduce IPO uncertainty and increase the probability of the float being successful.

This study investigates the information effect of optimistic news stories in the 30 days preceding the listing date. We investigate the effect of a unique set of optimistic news stories on first-day return for a sample of 593 IPO issues in the period 1995 to 2005[1]. Our focus on the Australian market allows us to develop greater insight into the informational role of optimistic news stories before listing, which cannot be observed to the same extent in the United States IPO market because of the 'quiet period' regulation. Unlike the U.S., Australia has no regulation limiting the communication of newsworthy information preceding an IPO listing. We select the 30 day pre listing window because IPO offers to retail investors start after the lodgement of listing application and usually are open for a period of 3–4 weeks[2].

Our research begins with an investigation as to whether the information signalling effect of optimistic news 30 days prior to listing reduces information asymmetry and thus reduces first day return (i.e. underpricing). To compensate for information asymmetry, issuer will lower the issue price leaving more 'money on the table' which causes first day underpricing. We argue that optimistic news reduces information asymmetry, and therefore reduces the level of first day underpricing. Consistent with our hypothesis, optimistic news stories are negatively associated with IPO first-day return (underpricing). The negative association between optimistic news and underpricing suggests that optimistic news during the pre-listing period reduces information asymmetry and thus mitigates adverse selection.

We examine the combined signalling effect of engaging an underwriter (which is optional in Australia and used by only half of the IPO in the sample) and optimistic news stories on IPO first-day pricing. In support of our hypothesis, we find the interaction of engaging an underwriter and optimistic news covered by media is negatively associated with IPO first-day underpricing. The finding suggests that news stories tend to reduce investor's uncertainty and this effect is stronger in the presence of underwriters.

There is a possibility that optimistic news stories may be associated with higher first day IPO prices due to hyping. Prior research consistently finds a bias towards optimism in news reports about IPOs, and there is some evidence that news plays a role in inflating security prices (e.g., Lang and Lundholm, 2000; Bhattacharya et al., 2009; Ho et al., 2010). We therefore employ a relative valuation measure – industry-adjusted market-to-book equity ratio – to further test whether IPOs subject to optimistic news reports are over-valued relative to this industry benchmark. If IPOs subject to optimistic news are indeed overvalued, this would suggest that optimistic news is used to inflate the first-day price. Our results show that IPOs subject to optimistic news are not overpriced relative to their industry benchmarks. Similarly, underwritten IPOs subject to optimistic news are undervalued rather than overvalued relative to their industry benchmarks. Overall, results suggest that optimistic news stories communicate IPOs future prospects to potential investors, especially retailed investors.

We contribute to the literature by providing insight into the informative influence of optimistic news stories reported during the 30 days prior to IPO listing. Our study provides evidence from a jurisdiction outside the U.S. as to the potential benefit of a quiet period policy by investigating in an unregulated environment the influence of optimistic news on first-day pricing. While prior research has examined the influence on IPO pricing of news coverage in the U.S. during the months preceding the IPO listing – a period that coincides with investment banks promoting a new issue (Cook et al., 2006; Bhattacharya et al., 2009) – the flow of newsworthy information immediately preceding the listing date is restricted because of the quiet period regulation[3]. For example, Silvers (2004) argues that many U.S. companies, from the date the IPO prospectus is filed with the SEC, have sought to avoid potential litigation by shutting down all forms of public announcements and other activities that would promote awareness of the IPO through the media. Our findings indicate that regulation mandating a quiet period, as found in the U.S., is not necessary in the Australian environment.

The rest of this paper is organized as follows: Section 2 reviews the prior literature and develops hypotheses; Section 3 explains the data sample and the empirical methodology; Section 4 reports and discusses the empirical results; and Section 5 concludes.

2. Literature review

2.1. Institutional environment

Although there are some similarities between the Australian and U.S. IPO markets, there are some fundamental differences in the structure of the offering mechanism. First, firms listed on the Australian Stock Exchange (ASX) are on average smaller

[1] In the present study unique news refers a single news item. We do not include repeated news items as typically used in research investigating media coverage.

[2] See listing on ASX http://www.asx.com.au/listings/listing-capital-raising/listing-process.htm.

[3] The quiet period regulation prevents IPO firms, their underwriters and affiliated groups from issuing forecasts, projections or predictions relating to firm performance or publishing opinions concerning values. In 1988 the Securities Exchange Commission (SEC) mandated a quiet period extending from the date the IPO firm files its preliminary registration with the SEC to 25 day following IPO listing date (SEC Release #3844). In 2002, the quiet period was extended from the filing date to 40 days post listing (NYSE Rule 472; & NASD Rule 2711).