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Investment bankers and IPO pricing: does prospectus information matter?

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Abstract

In this study, we examine those factors generally considered to impact IPO performance to assess the extent to which investment bankers might utilize this information in determining the spread within which the offering price is likely to be set and in setting the offering price. Interestingly, we find no evidence that the variables investigated are related to either IPO offer price spread or the IPO offer price. The implications of these findings are notable, as they raise the issue of what information might account for investment bankers' valuation decisions, as captured in the offer price spread and offer price.

Keywords: Investment bankers; IPO pricing; Prospectus information

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1. Executive summary

An IPO is one of the more critical junctures in the development of a firm. An entrepreneur's decision to take the firm public presents many exciting opportunities for the continued growth and prosperity of the firm. One of the more important reasons entrepreneurs elect to subject the firm and its management to the scrutiny of external investors and analysts is to generate funds that can be employed to facilitate the firm's continued growth. Absent generating funds via an IPO, many entrepreneurs/managers would be unable to pursue new projects and growth opportunities.

Given the importance of an IPO to the firm's entrepreneurs and initial owners, clearly understanding those factors that might impact the amount of funds generated via the stock offering is of critical importance. Previous research has investigated those factors associated with IPO performance, with particular focus on underpricing as a performance indicator. This research has demonstrated that certain factors may be associated with underpricing, resulting in IPO firms entrepreneurs/owners extracting less value from the firm at the time of the IPO than they might otherwise. For example, higher levels of equity retained by the CEO at the time of IPO should lead to less underpricing. Similarly, securing the services of more prestigious investment bankers should help IPO firms' entrepreneurs/owners extract greater value from the firm, resulting in less underpricing.

Interestingly, a key factor in determining underpricing remains relatively unexplored in the literature—IPO offer pricing. Investment bankers work with IPO firm management in setting the offer price spread and subsequently the offer price. These are critical decision points for IPO firm owners, as they significantly impact the amount of funds that will be generated at the stock offering. Despite the importance of these pricing decisions, we know very little about those factors that investment bankers might find informative when setting the offer price spread and offer price. This study reports the results of such an investigation.

Our analysis incorporates a series of variables that are reported in the registration statement, a document required by the Securities and Exchange Commission for any firm undertaking an IPO. A key component of the registration filing is the prospectus (or preliminary prospectus). In the prospectus, IPO firms' managers must disclose certain firm-specific information. Examples of this information are the constitution of the board of directors and the amount of equity to be retained by the firm's CEO. By better understanding the factors that investment bankers take into account in pricing the IPO firm, firms' owners can better position the firm to extract the greatest amount of value from the stock offering.

In an examination of 192 firms undergoing an IPO in the mid-1990s, we find no association between the publicly available information we investigate and either the offering price spread or the offer price. These results have important implications for IPO firms' entrepreneurs/owners. While preparing the registration statement is a complex, time-consuming process, it would appear that this information is not of primary importance to investment bankers in price setting. This raises an important question regarding what information is associated with this important IPO pricing decision process.