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The effects of affiliations on the initial public offering pricing

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ABSTRACT

This paper studies the impact of affiliations between lead managers, venture capitalists, and institutional investors on the Initial Public Offering (IPO) pricing. Using a sample of 1996 US IPOs issued between 1997 and 2010, we find that affiliations strongly and positively affect the offer price by improving the information production process. We also show that the underpricing is affected by affiliations because of conflicts of interest that exist between the players: when an institutional investor is affiliated with a lead manager or with a venture capitalist we observe nepotistic behavior in hot IPOs and dumping ground behavior in cold IPOs.

1. Introduction

The presence of affiliations between players in financial operations is widespread in the financial field (Berger, Demsetz, & Strahan, 1999; Crockett, Harris, Mishkin, & White, 2004). Indeed, the industry's structure has been extensively shaped by consolidation and also by the implementation of diversification strategies brought into play by the major investment banks over the last few decades. Moreover, regulators have progressively reduced the barriers to cross-ownership of financial companies (see the Financial Services Modernization Act of 1999).

As a result, investment banks are allowed to contemporaneously perform at least two of the following: underwrite an IPO; manage a mutual fund investing in the IPO; or manage a venture capital fund selling the company in the IPO. Data on US IPOs show that it is quite common for lead managers (LMs) to be affiliated with the mutual funds (MFs) buying the IPO or with the venture capitalists (VCs) selling the IPO; it is also common that MFs are affiliated with VCs.

In the past, the Investment Company Act of 1940 and Rule 10(f)-3 adopted by the SEC in 1958,[1] limited the participation of funds affiliated with any manager of an IPO; the ‘spirit’ of the rules was to prevent the lead manager from using funds under its control as a

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[1] The Investment Company Act of 1940 and Rule 10(f)-3 adopted by the Security and Exchange Commission (SEC) in 1958 imposed restrictions on mutual funds buying any of the shares in a security offering during the existence of the syndicate if the fund was in any way related to any syndicate members. In the following years, the SEC amended Rule 10(f)-3 several times. In 1979 a limit was introduced to allow an affiliated fund to buy up to 4% or $500,000 of an offering, whichever was the greater, although in no circumstances could the purchase be more than a maximum percentage limit of 10% of the offering. In 1997 the SEC amended the rule again, raising the maximum percentage limit to 25%, and the dollar amount limit was dropped. The SEC further amended the rule in 2003 to apply the percentage limit only when the affiliated underwriter was the principal underwriter.

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dumping ground for unmarketable securities. More recently, due to pressure exerted by the financial industry, the SEC has progressively relaxed these rules, thus exposing investors to conflicts of interest among players.

In this paper, using a sample of 1996 IPOs in the US from 1997 to 2010, we investigate if and how affiliations among players influence the IPO pricing. More specifically, while previous literature has focused on the effects that affiliations produce on the secondary market price as a result of conflicting interests between affiliated players, we broaden the perspective by considering the effects of affiliations on both the primary and the secondary market price. Regarding the primary market price, we investigate the way the IPO offer price is fixed during the bookbuilding, while in relation to the secondary market price we analyze the underpricing in the aftermarket.[2] Such a twofold analysis stems from the framework we propose, where affiliations have two different effects: on the one hand, they facilitate the information production that takes place in the primary market during the bookbuilding; on the other hand, affiliations might also lead to conflicts of interest among the affiliated players, which exert their effects in the secondary market.

The information production process consists in each player sharing their information in the primary market: the LM is better informed about the ongoing demand during the bookbuilding, the VC has insider information about the firm, whereas the MFs know their own demand schedule and possibly those of other funds; when two of these players are affiliated, they are likely to share the information they have, thus reducing the information asymmetries and also the risk of mispricing the offer. That being so, the LM is expected to be more confident in pricing the IPO and this, in turn, should lead to an increase in the offer price, consistent with the findings of Ibbotson, Sindelar, and Ritter (1988) and Benveniste and Spindt (1989). The empirical results of our study confirm such an increase in the offer price for all types of affiliations (LM with MF, LM with VC and VC with MF).

This increase in the offer price due to affiliations would be expected to be followed by a larger underpricing, as a result of the partial adjustment phenomenon (Hanley, 1993), according to which the LM does not fully adjust the offer price in view of the information disclosed by other players (see the next section for a more in-depth discussion of this point). Our results suggest that this does indeed occur.

Nevertheless, in our framework, the underpricing is also affected by the conflicts of interest between affiliated players. More specifically, such conflicts are not the direct cause of a greater level of underpricing (as discussed in Ritter & Zhang, 2007), which may simply be the consequence of partial adjustment, but rather they can change the relationship between the underpricing and the increase in the offer price. In other words, the conflicts of interest do not cause the partial adjustment, but they do affect its magnitude. As such, a larger or smaller partial adjustment in our framework is interpreted as the interests of one affiliated player prevailing over those of the other. As expected, our results show that both the LM and the VC adopt a nepotistic behavior in favor of their affiliated funds when the IPO is hot (smaller partial adjustment), while they might dump the shares into affiliated funds in cold IPOs (larger partial adjustment).

The rest of the paper is organized as follows: in section 2 we review the literature on information asymmetries and affiliations in IPOs and present our interpretative framework; in section 3 we present our models and hypotheses; section 4 reports the data and methodology adopted in the empirical analyses, while a discussion of our key findings is presented in section 5, together with some robustness tests. Section 6 concludes.

2. Framework and literature review

Our framework assumes that affiliations among players influence IPO pricing for two reasons: i) as a result of improvements in the information production process and ii) as a result of conflicts of interest. With regard to the first reason, substantial information asymmetries exist in the field of IPO deals; IPO firms are new to the market and investors have limited knowledge about them (See & Rashid, 2011). If we look at the problem from the LM perspective, two kinds of information asymmetries affect IPO pricing. On the one hand, issuing firms (and the VC that might be involved) have an informational advantage over investors in that they know the firm's activities and future plans, together with the current and prospective financial situation. This asymmetry can affect the pricing because issuers might have an incentive to misrepresent themselves to potential investors as being of a higher quality than they actually are. On the other hand, mutual funds, due to their pervasive activity as investors, might have superior information about the level of interest in the market for the prospective listing shares. Moreover, as suggested by Rock (1986), funds could hold superior information about a firm's competitors, or have private information about the characteristics of the issuing firm that the firm cannot credibly convey (the quality of its management for example). As a consequence, these information asymmetries make it difficult for the LM to settle a fair sale price for an IPO. That being so, affiliations among these players could definitely affect the information production in IPOs, but only a few papers have focused on this effect, which is expected to be revealed by the IPO offer price. In the case of a LM-VC affiliation, Puri (1999) proposed a theoretical framework that states that when lead managers are venture investors, the offer price is higher, thanks to their certification effect. In contrast, Li and Masulis (2004) found that when a lead manager has a prior venture investment in an IPO issue, the increase in the offer price with respect to the initial file range is smaller; the authors' interpretation is that lead managers with venture investments have greater access to issuer specific information (as they can have possible board membership or board observation rights as well as frequent access to senior management), and this makes the initial filing range more precise.

Our interpretative framework is based on the idea that the first effect of all types of affiliations is to reduce the uncertainty about the true value of the deal and the primary market demand; as a consequence, the lower risk of mispricing the IPO should encourage the LM to set a higher offer price. Bajo, Chemmanur, Simonyan, and Tehranian (2016) also reported that larger information produced during

[2] Other studies use the term initial returns instead of underpricing thus allowing for the possibility of a negative initial return. In this paper, the term underpricing is more appropriate because of the partial adjustment framework: as the offer price is set conditional to the expected initial return, the latter must be positive and the former underpriced in order to induce participants to take part to the IPO. A negative initial return can only be an ex post unexpected outcome.

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